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Review of Theories Explaining Tax Compliance Behaviour

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Abstract

Tax compliance remains a complex and often unattainable objective for many tax administrations, despite being a crucial component of public finance and governance. The study examines how taxpayer decisions are influenced by both non-economic (such as moral values, social norms, perceived fairness, and institutional trust) and economic (such as audit probability and penalties) factors using a qualitative literature survey method. Five main theoretical models—the Economic Deterrence Model, Socio-Psychological Theory, Fiscal Exchange Theory, Comparative Treatment Model, and Political Legitimacy Model—that explain tax compliance behaviour are thoroughly reviewed and synthesized in this study. The review's main conclusion is that there is not a single theory that adequately accounts for the variety of reasons people have for complying with tax laws. Instead, an integrated approach that considers the interplay between voluntary, value-based motivations and enforcement mechanisms is necessary to gain a thorough understanding of taxpayer behaviour. The findings of this study reveal that creating efficient tax systems requires taking into account deterrence tactics as well as initiatives to promote equity, openness, and political legitimacy in government.

Keywords: compliance with corporate taxes, fiscal exchange, political legitimacy, the deterrence theory, tax morale

Review of Theories Explaining Tax Compliance Behaviour

Tax compliance behaviour has long remained a complex socio-economic phenomenon shaped by an intricate interplay of economic incentives, psychological predispositions, social norms, and institutional frameworks. Scholars across multiple disciplines have long sought to understand the determinants of voluntary tax compliance, particularly given the persistent challenge of tax evasion throughout recorded history (Tanzi & Shome, 1992). Historical evidence suggests that tax resistance dates back to ancient civilizations, with documented cases of tax avoidance in Roman and medieval societies (Webber & Wildavsky, 1986, as cited in Slemrod, 2007). While early philosophical discussions by thinkers like Plato recognized tax noncompliance as a fundamental societal issue, systematic academic inquiry into taxpayer behaviour only emerged as a distinct field of study in the latter half of the 20th century (Richardson & Sawyer, 2001).

The foundation of modern tax compliance research was established by Allingham and Sandmo's (1972) groundbreaking application of Becker's (1968) economics of crime framework to taxpayer decision-making. Their expected utility model, which emphasized audit probabilities and penalty rates as key deterrents, spawned decades of theoretical refinements and empirical validations (Alm, 2012). Subsequent scholarship has significantly expanded beyond this economic paradigm, incorporating insights from behavioural economics (Kahneman & Tversky, 1979), social psychology (Cialdini, 1984), and institutional theory (North, 1990) to develop more nuanced explanations of compliance behaviour (Devos, 2014; McKerchar & Evans, 2009).

Contemporary research identifies five primary theoretical lenses for understanding tax compliance. Economic Theory of Tax Compliance (Allingham & Sandmo, 1972) suggests that taxpayers weigh evasion costs against benefits, with compliance rising under higher audits and penalties (Alm & McKee, 1998). Yet, many comply despite low detection risks, indicating economic factors alone are insufficient (Feld & Frey, 2002). Behavioural influences like risk aversion (Kahneman & Tversky, 2013) and tax rate effects (Yitzhaki, 1974) also matter. The Socio-Psychological Theory highlights moral duty and fairness perceptions (Braithwaite, 2003; Torgler, 2003a), with tax morale (Ameyaw et al., 2016) and social norms (Alm et al., 1999) driving compliance. The Fiscal Exchange Theory (Levi, 1988) links compliance to perceived government spending benefits (Alm et al.,1992; Torgler, 2003c). The Comparative Treatment Model (Wenzel, 2005) shows that fairness in enforcement boosts compliance (Murphy & Torgler, 2004; Tyler, 2006). Lastly, the

Political Legitimacy Model (Levi, 1988) ties compliance to trust in government (Kirchler et al., 2008), where corruption reduces willingness to pay (Torgler, 2003).

This paper reviews five key theoretical perspectives—economic deterrence, socio-psychological, fiscal exchange, comparative treatment, and political legitimacy models—to provide a comprehensive understanding of tax compliance behaviour.

Problem Statement

Tax compliance remains one of the most persistent challenges in public finance, with governments worldwide struggling to balance revenue collection with taxpayer cooperation. Despite centuries of tax systems and decades of academic research, the puzzle of why citizens choose to comply with or evade tax obligations remains only partially solved (Tanzi & Shome, 1992). The historical persistence of tax evasion - from ancient Roman gold hoarding to modern offshore accounts (Webber & Wildavsky, 1986, as cited in Slemrod, 2007) - suggests that this is not merely a technical problem of policy design, but a fundamental issue of human behaviour and social organization.

The foundation of modern tax compliance research, established by Allingham and Sandmo (1972) and rooted in Becker's (1968) economic theory of crime, presents taxpayers as rational actors calculating costs and benefits. While this perspective generated valuable insights about audit probabilities and penalty effects (Alm & McKee, 1998), its limitations became apparent as researchers observed widespread compliance even in low-enforcement environments (Feld & Frey, 2002). This compliance paradox sparked the development of alternative theories incorporating psychological, social, and institutional dimensions (Devos, 2014; McKerchar & Evans, 2009).

Contemporary scholarship now recognizes tax compliance as a complex behavioural outcome influenced by multiple factors, such as, economic calculations (Yitzhaki, 1974), moral dispositions and ethical values (Ameyaw et al., 2016), perceptions of fairness and reciprocity (Alm et al., 1992; Levi, 1988), social norms and peer behaviour (Alm et al., 1999), and trust in government and political legitimacy (Kirchler et al., 2008). Yet this theoretical pluralism presents its own challenges. With five major theoretical perspectives - economic deterrence, socio-psychological, fiscal exchange, comparative treatment, and political legitimacy models - the field lacks an integrated framework explaining how these factors interact (Kirchler, 2007). The relative importance of economic versus non-economic factors remains contested (Devos, 2014), as does the universality of these theories across different cultural and institutional contexts (Richardson & Sawyer, 2001).

Furthermore, practical applications remain problematic. Tax authorities worldwide struggle to implement policies that effectively combine enforcement with trust-building measures (Fjeldstad & Heggstad, 2012). The definitional challenges - from narrow legal compliance (James & Alley, 2002) to broader ethical responsibility (Roth, 1989) - complicate both research and policy evaluation. Based on this, the following research question will be considered in this study: What is the overall explanation of economic, psychological, social, and institutional theories on corporate tax compliance behaviour, and what are the implications of their interaction to developing corporate tax policies in developing economies like Nepal?

Objective of the Study

The main goal of this study is to investigate and compile different models and theories that explain why people either comply with or do not comply with their tax obligations. The authors want to show how complex tax compliance is and how both economic and non-economic factors affect how taxpayers behave. The study aims to educate tax administrators and researchers about the intricacies of taxpayer behaviour by examining these models and indicating that a mix of models might be required to create efficient tax systems.

Research Method

This study employs an integrative narrative theoretical review approach. Such a strategy is suitable in cases where empirical testing of the hypotheses is not the goal, but rather the synthesis of various theoretical standpoints and the production of conceptual clarity are required. The review relies on the literature that is proven by numerous experts in the field of economics, psychology, sociology, and political science to analyse five prevailing models of tax compliance. A facilitated review of the tax compliance literature identified relevant academic articles, books, policy reports and empirical studies. The chosen theories were reviewed in terms of their assumptions, explanation mechanisms, their empirical evidence, and weaknesses.

Special focus was placed on studies that placed corporate taxpayers in the limelight, as well as those that provide results on economies in the developing or transitional states. The analysis also includes a contextual synthesis of the relationship between theoretical knowledge to the Nepal corporate tax environment. This type of integrative method makes it possible to have a holistic view of how enforcement, trust, fairness, fiscal reciprocity and institutional legitimacy interrelate to influence corporate tax compliance behaviour.

Perspectives on Tax Compliance

A survey of the body of research on tax compliance shows that a wide range of factors influence people's decisions to comply with the law. The Internal Revenue Service (IRS) identified 64 factors thought to affect taxpayer reporting behaviour as early as 1978 (Alm et al., 1999), and the list has kept growing. Few, if any, models are able to account for all of these factors and their underlying drivers at the same time due to their complexity. Therefore, as points out, it makes sense to "concentrate on the factors that appear to have the most impact on compliance levels," especially those that are pertinent to the particular context being studied.

Tax compliance determinants are categorized by existing research into two to five broad theoretical models, which are sometimes called *School of thought* (Devos, 2012; Fjeldstad&Heggstad, 2012; McKerchar & Evans, 2009). In accordance with the research conducted by the Organization for Economic Co-operation and Development (OECD, 2010), this paper uses the five-factor framework put forth by Fjedstad and Heggstad(2012) and Ali et al. (2013).

Economic Theory of Tax Compliance

Allingham and Sandmo (1972) first put forth the Economic Theory of Deterrence, which was later developed by Srinivasan (1973). Its foundation is Becker's economics of crime model. According to this hypothesis, taxpayers are logical utility maximizers who balance the expected costs of being discovered and punished against the financial gains from evasion. When the sum of audit probability and penalty severity is greater than the possible benefit of non-compliance, compliance is anticipated (Alm &McKee, 1998; Erard & Feinstein, 1994).

If there is a high risk of lying about income, this framework assumes that taxpayers weigh the costs and benefits and decide to report it honestly (Fischer et al., 1992; James & Alley, 2002). The same base model was used by Yitzhaki (1974), who discovered that if a higher marginal tax rate isn't offset by a correspondingly higher risk of detection, evasion may increase. According to Alm et al. (1992), reasonable taxpayers may still decide to evade taxes because audits are infrequent and fines are frequently light.

However, this theory has been criticized for relying too much on the assumption of high risk aversion, which is frequently not seen in empirical research (Feld & Frey, 2002). Although they have an impact on compliance, detection, and sanctions are insufficient to account for behavioural variances (Andreoni et al., 1998). Moreover, compliance behaviour is strongly influenced by psychological and social elements like moral obligation, perceptions of fairness, and peer pressure (Kahneman & Tversky, 2013; Raskolnikov, 2009). Notwithstanding these objections, the deterrence model continues to play a crucial role in the study of tax compliance and has influenced more general models such as the Slippery Slope Framework, which combines enforcement with trust-based compliance (Kirchler, 2007).

Tax compliance is driven by rational cost-benefit analysis, where taxpayers weigh the probability of detection and penalties against the benefits of evasion. The Income Tax Act, 2002 includes penalties (Sections 117-121) and prosecution (Section 122) for non-compliance. Inland Revenue Department (IRD) conducts audits and investigations, but weak enforcement and corruption reduce deterrence. Low detection rates and minimal penalties (compared to potential gains) may encourage evasion, especially among high-income earners and businesses.

Socio-Psychological Theory of Tax Compliance

The socio-psychological theory of tax compliance emphasizes how taxpayers' willingness to follow tax laws is shaped by personal attitudes, beliefs, perceptions, and psychological characteristics. Unlike purely economic theories, which stress rational calculations of cost and benefit, this theory includes components such as moral values, perceived fairness, trust in government, and social influence (Braithwaite, 2003;Kirchler, 2007).

One important idea is tax morale, the natural desire to pay taxes formed by internalized social standards and personal ethics (Torgler, 2003a). Stronger compliance is linked to high degrees of tax morale, particularly when people view the tax system as fair and reasonable (Kirchler et al., 2008). This inherent quality is strengthened by trust in tax authorities, perceived legitimacy of the system, and respectful treatment by officials.

The socio-psychological approach to tax compliance is centred on perceived fairness, both distributive (how equally tax burdens are distributed) and procedural (how fairly the tax process is administered), which is another crucial component. According to Wenzel (2002), taxpayers are more likely to comply when they believe the system is fair.

Peer pressure and social conventions are also important. The actions of others in their social surroundings have an impact on people; if tax compliance is viewed as the standard, people are more likely to adhere to it (Alm et al., 1999). On the other hand, compliance may be weakened by the perception that others avoid paying taxes.

Additionally, this theory incorporates psychological concepts like identity, guilt, and cognitive dissonance. Individuals typically refrain from actions that go against their moral principles or sense of self, and many do so to keep a positive compliance behaviour.

Compliance is influenced by moral obligations, social norms, and peer behaviour rather than just economic incentives. Tax morale is generally low due to distrust in government, perceived corruption, and lack of visible public benefits. Informal economy dominance (estimated at 40% of GDP) fosters a culture of tax avoidance. Taxpayer Education Programs by IRD aim to improve voluntary compliance by fostering trust.

Fiscal Exchange Theory of Tax Compliance

The perceived relationship between taxes paid and the benefits received from government services is a major determinant of taxpayers' willingness to comply, according to the fiscal exchange theory of tax compliance (Cowell & Gordon, 1988). According to Levi (1988), this theory is based on the notion of a social contract, in which taxes are viewed as a reciprocal exchange between the state and its citizens rather than just an obligation.

This point of view holds that citizens assess the effectiveness, equity, and benefits of government spending. They are more likely to willingly abide by tax laws if they think the government uses tax money sensibly and offers worthwhile public goods and services, like infrastructure, healthcare, and education (Alm et al., 1992; Torgler, 2003c). This theory also emphasizes reciprocity: citizens are willing to pay taxes when they feel that the government reciprocates by delivering tangible or intangible benefits (Feld & Frey, 2002). The strength of this reciprocal relationship significantly influences tax morale and compliance behaviour.

Alm et al. (1992) found experimentally that taxpayer compliance rates rise when they are informed of how tax revenues are used. In the same vein, Torgler (2003c) discovered that higher degrees of tax compliance in various nations correspond with better perceived fiscal exchange quality.

Therefore, fiscal exchange theory emphasizes that for increasing tax compliance, improving openness, responsibility, and the perceived fairness of public spending may be as crucial as audit and penalty tactics.

Taxpayers comply when they perceive a fair exchange (public goods/services for taxes paid). Weak service delivery (poor infrastructure, healthcare, education) reduces willingness to pay taxes. Local Government Taxation has improved some fiscal exchange, as local taxes fund visible projects (roads, schools). Tax protests (e.g., business strikes against high taxes) reflect dissatisfaction with fiscal policy.

Comparative Treatment Model of Tax Compliance

The Comparative Approach According to the tax compliance model, taxpayers' perceptions of the treatment they receive from tax authorities—particularly in comparison to how others are treated—have a big impact on their willingness to comply. This model, which has its roots in social comparison and equity theory, contends that compliance behaviour is largely influenced by perceptions of justice, fairness, and equal treatment (Murphy & Torgler, 2004; Wenzel, 2005).

This model states that taxpayers evaluate their own compliance choices by contrasting them with those of others in comparable situations. They may view the system as unfair and become less compliant if they feel they are receiving less favourable treatment than their peers, such as more audits, higher taxes, or fewer public benefits (Wenzel, 2002). On the other hand, taxpayers are more likely to voluntarily comply if they believe that the treatment is fair and consistent.

A crucial component of the Comparative Treatment Model is procedural justice. Even in the absence of stringent enforcement measures, research indicates that compliance increases when taxpayers perceive tax authorities to be fair, courteous, and open in their processes (Murphy & Torgler, 2004; Tyler, 2006). Increased trust and an internalized commitment to comply result from this sense of justice, which also strengthens the legitimacy of the tax system.

Murphy and Torgler (2004) contend that the treatment of taxpayers can have a greater impact on procedural justice than the results of particular tax-related decisions. The process's perceptions of equality, dignity, and voice strengthen citizens' sense of their status as valued members of society, which promotes moral compliance.

Thus, the Comparative Treatment Model emphasizes how important it is for tax authorities to treat taxpayers fairly, respectfully, and consistently in order to build trust and promote long-term compliance behaviour.

Compliance depends on perceived fairness in tax treatment compared to others. Tax evasion by elites (politicians, wealthy business owners) fosters resentment among salaried employees (who face Pay-As-You-Earn [PAYE] deductions). Informal sector vs. formal sector disparity—small businesses evade taxes while registered firms face strict compliance. Tax exemptions & loopholes for politically connected entities create perceptions of unfairness.

Political Legitimacy Model of Tax Compliance

The Political Legitimacy Model highlights that taxpayers' perceptions of the legitimacy of the political system and governing authorities have a significant impact on their willingness to abide by tax laws. According to Levi (1988) and Howard and Tyler (1986), legitimacy is the conviction that the government has the authority to rule and that its institutions and laws are proper, fair, and deserving of respect.According to this model, tax compliance is closely related to how legitimate the state is perceived by its constituents and is not just a result of psychological characteristics or deterrence.

Taxpayers are more likely to see paying taxes as a civic obligation and to do so willingly when they think the political system is just, representative, open, and accountable (Kirchler et al., 2008; Levi, 1988). Taxpayers are more inclined to see paying taxes as a civic obligation and to do so willingly when they think the political system is just, representative, open, and accountable (Kirchler et al., 2008; Levi, 1988). Conversely, tax evasion can be encouraged and morale seriously damaged by perceptions of corruption, inefficiency, or lack of responsiveness (Torgler, 2003b).

Levi (1988) proposed the idea of *quasi-voluntary compliance*, in which people obey the state not only out of force but also because they believe it to be righteous and in the public interest. A key factor is the public's trust in government agencies, particularly with regard to how tax money is used. People are more willing to pay taxes when they perceive that they are being used to fund important public goods like infrastructure, healthcare, or education (Feld & Frey, 2002).

The degree to which taxpayers believe they have a political voice—for example, through democratic processes, participatory governance, and accountability mechanisms, also serves to reinforce political legitimacy. According to Torgler et al. (2008), taxpayers are more likely to believe that the tax system is just and legitimate if they feel that they are represented and involved in political decision-making. Compliance depends on trust in government and perceived legitimacy of tax policies. Political instability (frequent government changes) weakens trust in tax administration. Corruption in tax offices (bribes for lower assessments) undermines legitimacy. Progressive tax rates are designed to enhance fairness, but weak enforcement reduces legitimacy.

Results

The study discloses that tax compliance is influenced by a complex set of factors that go beyond mere deterrence. Although economic theory suggests that weak enforcement, low audit rates, and light penalties make tax evasion a rational choice-especially for high-income individuals and this explanation does not account for various behavioural differences. As a substitute, compliance is significantly weakened by a deep-seated crisis of trust and legitimacy, caused by perceived systemic injustices such as evasion by wealthy individuals and the informal sector, corruption in tax agencies, and political loopholes-which generate resentment and diminish moral obligation.

Additionally, the absence of a clear fiscal exchange, where inadequate public services like infrastructure and healthcare fail to provide a return on taxes paid, erodes the reciprocal bond between citizens and the state. Therefore, without essential improvements in political legitimacy, procedural fairness, and visible public benefits, mere enforcement strategies will not be effective in promoting widespread voluntary compliance.

Discussion

This study focused on understanding the theories relating to the compliance behaviour of corporate taxpayers. The results of this study indicate that enhancing tax compliance in Nepal necessitates a comprehensive strategy that includes both economic deterrents and non-economic incentives. Although the Economic Deterrence Model (Allingham & Sandmo, 1972) highlights the significance of audits and penalties in discouraging non-compliance, real-world evidence shows that enforcement measures alone do not suffice, especially in environments like Nepal, where the capacity for audits and the enforcement of penalties are limited (Alm & McKee, 1998; Feld & Frey, 2002). To improve the effectiveness of deterrence efforts, the Inland Revenue Department (IRD) of Nepal should strengthen its risk-based audit systems and uphold the severity and likelihood of penalties, as detailed in Sections 117 to 122 of the Income Tax Act, 2002. Nevertheless, compliance cannot depend exclusively on enforcement, particularly when detection rates are low and corruption undermines the tax administration's integrity (Kirchler et al., 2008; Torgler, 2003b).

To tackle the psychological and social factors influencing tax behaviour, policymakers should aim to increase tax morale, promote civic responsibility, and leverage social norms, as underscored by the Socio-Psychological Theory (Braithwaite, 2003; Torgler, 2003a). In Nepal, taxpayer education initiatives led by the IRD have aimed to foster trust and voluntary compliance, but these initiatives need to be intensified and more strategically tailored, particularly for participants in the informal sector who often exist outside of formal compliance frameworks. This approach aligns with Kirchler’s (2007) Slippery Slope Framework, which advocates for a combination of authority powers with efforts to build trust and collaboration. Public awareness campaigns emphasizing the moral obligation of paying taxes and the societal advantage of compliance can help foster a stronger tax culture. The Fiscal Exchange Theory further supports the notion that governments must enhance the visibility and quality of public goods and services financed by taxes (Alm et al., 1992; Levi, 1988). When taxpayers recognize a positive return on their tax contributions, such as enhancements in infrastructure, healthcare, or education—they are more inclined to comply voluntarily.

In the Nepalese context, inadequate service delivery and lack of transparency in public spending have diminished taxpayer trust, fostering a widespread perception that taxes are misappropriated. Issuing annual "Taxpayer Benefit Reports" at both local and federal levels could enhance perceptions of fiscal reciprocity and fortify the social contract between the government and citizens (Feld & Frey, 2002; Torgler, 2003c). Likewise, the Comparative Treatment Model underscores the significance of perceived fairness in the application and enforcement of tax policies (Murphy & Torgler, 2004; Wenzel, 2005). In Nepal, the belief that elites, large businesses, or politically connected individuals gain from exemptions or lenient enforcement diminishes the willingness of regular taxpayers to comply. Ensuring fair treatment of all taxpayers, particularly between formal and informal sectors, necessitates the elimination of arbitrary tax exemptions, intensified transparency in enforcement actions, and the simplification of compliance processes to minimize bureaucratic discretion (Tyler, 2006).

The perception of procedural justice, such as being treated with respect by tax officers or having a say in dispute resolution, plays a crucial role in influencing compliance behaviour. Finally, the Political Legitimacy Model suggests that taxpayers are more inclined to comply when they have trust in their government and believe that political institutions operate fairly, transparently, and democratically (Kirchler et al., 2008; Levi, 1988). In Nepal, ongoing political instability, prevalent perceptions of corruption within tax administration, and weak accountability mechanisms have undermined the legitimacy of tax institutions. According to Torgler (2003b), corruption and inefficiency damage tax morale and lessen citizens' readiness to pay. Enhancing institutional legitimacy through transparent governance, participatory budgeting, and involving citizens in the formulation of tax policy can promote a sense of civic duty and quasi-voluntary compliance (Levi, 1988).

In brief, this study indicates that taxpayer behaviour is influenced by a complex relationship of economic, psychological, social, and institutional factors. Therefore, effective tax policy must be multifaceted, encompassing not only enforcement mechanisms but also initiatives to build taxpayer trust, demonstrate the utility of public revenue, ensure fair treatment, and enhance political legitimacy. For Nepal, a successful path forward lies in leveraging the strengths of each theoretical model to create a tax environment that is not only enforceable but also equitable, transparent, and trusted by its citizens.

Conclusion

This study employs an integrative narrative theoretical review approach. Such a strategy is suitable in cases where empirical testing of the hypotheses is not the goal, but rather the synthesis of various theoretical standpoints and the production of conceptual clarity are required. The review relies on the literature that is proven by numerous experts in the field of economics, psychology, sociology, and political science to analyze five prevailing models of tax compliance.

A facilitated review of the tax compliance literature identified relevant academic articles, books, policy reports and empirical studies. The chosen theories were reviewed in terms of their assumptions, explanation mechanisms, their empirical evidence, and weaknesses. Special focus was placed on studies that placed corporate taxpayers in the limelight, as well as those that provide results on economies in the developing or transitional states. The analysis also includes a contextual synthesis of the relationship between theoretical knowledge to the Nepal corporate tax environment. This type of integrative method makes it possible to have a holistic view of how enforcement, trust, fairness, fiscal reciprocity and institutional legitimacy interrelate to influence corporate tax compliance behaviour.

Action Implications

The combination of five models of tax compliance helps to underline the necessity of having a balanced approach that incorporates both deterrence and legitimacy-building. Although enforcement policies like audits and other penalties can enhance compliance in the short run, sustainable voluntary compliance will rely on trust and fairness, as well as observable positive effects of taxation (Devos, 2014; Kirchler, 2007).

This is especially applicable to Nepal, where reforms like digital tax filing, PAN registration, and local taxation have the potential to be accomplished but need more audit capacity, equal treatment of taxpayers, and better provision of services to society. According to Fjeldstad and Heggstad (2012), the best way to ensure compliance is by transitioning to non-coercive cooperation and encouraging this through clear and responsible institutions.

In Nepal, therefore, tax policy must incorporate enforcement with policies that increase procedural fairness, build fiscal exchange, increase tax morale and mitigate corruption, and achieve a legitimate, equitable, and socially responsive tax system.

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