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ABOUT US

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With this thought, we hereby present to you

EXPLORING THE NEXUS BETWEEN BEHAVIOURAL ECONOMICS AND TAX COMPLIANCE: A MULTIDISCIPLINARY APPROACH TO POLICY EFFECTIVENESS

AUTHORED BY - K.PAVYAA ANGELINA

Abstract:

Humans, as inherently social beings, influence and are influenced by society in a dynamic interplay where the rate of individual actions affecting society often parallels society's influence on individuals. This intricate relationship necessitates that policymakers evaluate not only the collective societal response but also individual behavioural patterns. To address this, economists and social scientists have historically relied on standard assumptions of ideal human behaviour, forming the foundation for policies aimed at addressing societal needs and aspirations. However, with the contemporary world undergoing rapid and dynamic changes, the adequacy of these traditional assumptions has come into question. This paper delves into the intersection of behavioural economics and tax compliance, exploring whether the sole reliance on behavioural economic principles suffices in crafting effective tax policies or if additional interdisciplinary considerations are necessary. By analyzing factors influencing individual financial decisions and their subsequent impact on tax compliance rates, the study underscores the multidimensional nature of policymaking. It highlights that while behavioural economics provides critical insights, effective policy design demands a broader, multidisciplinary framework encompassing legal, social, and economic perspectives.

Introduction

Tax compliance serves as a critical cornerstone in shaping the nature and standard of governance within a country. Rooted in the constitutional ethos of being *for the people, by the people, and to the people*, tax compliance reflects the fundamental agreement between a government and its citizens. This relationship thrives on the principle of reciprocity, wherein taxes serve as the citizens' consideration for the fulfillment of governmental obligations. As articulated by Marziana, tax compliance can be understood as the degree to which individuals

adhere to the tax laws and regulations of their country.[1]

The significance of tax compliance transcends mere adherence to legal norms. It represents a dynamic flow of resources between the government and its people, ensuring financial integrity and enabling effective governance. To contextualize this process, the journey of taxation—from determining taxable income and filing returns to the government's utilization of revenues—reveals a structured system. Taxes collected are deposited into the Consolidated Fund of India, allocated between the Union and states, and classified into revenue and capital expenditures[2]. These funds eventually contribute to planned and non-planned budgets covering general, social, and economic services. This systematic flow underscores the critical role of tax compliance in maintaining a nation's financial health, fostering economic stability, and enhancing global standing.

However, achieving high rates of tax compliance is not merely a legal exercise. Beyond preventing financial leakages, compliance ensures a secure economic lifestyle for the populace, strengthens the bond of mutual responsibility between the government and its citizens, and propels a nation's development. Particularly in democracies like India, this relationship is vital, as it fosters accountability, promotes collective progress, and sustains a nation's socio-economic equilibrium.

Traditionally, legal frameworks have sought to regulate tax compliance through penalties and enforcement mechanisms. Yet, in an era marked by a renaissance of diverse and evolving populations, these mechanical measures alone fall short. Modern societies are driven by psychological and social motivators, necessitating a shift from punitive approaches to strategies that resonate with individuals' behavioural attributes. [3]It is here that behavioural economics emerges as a transformative tool, bridging the gap between policy design and the desired outcomes of increased tax compliance.

Behavioural economics challenges the classical assumptions of rationality in economic

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[1] Marziana Mohamad Noor, Tax Compliance and the Dynamics of Voluntary Tax Systems, 12 J. Tax Pol'y 245 (2023).

[2] *Constitution of India art. 266. Ministry of Finance, Government of India, Budget Division, "Understanding the Consolidated Fund of India" (2024).*

[3] *OECD, Behavioural Insights and Public Policy: Lessons from Around the World (2017).*

decision-making by incorporating psychological insight[4]s. Its evolution gained momentum as crises underscored the need for innovative policy approaches. By acknowledging deviations from standard assumptions, behavioural economics reshapes traditional conclusions about tax policy's effectiveness, emphasizing the importance of integrating psychology and economics into policymaking.

This integration is particularly relevant in taxation, where individuals' responses to taxes are deeply mediated by psychological factors. For instance, the behaviour of imperfectly rational taxpayers highlights how deviations from rational actor models influence tax compliance. By examining these deviations, behavioural economics provides policymakers with invaluable insights into crafting tax policies that are not only effective but also aligned with human behaviour.

The relevance of behavioural economics in taxation extends beyond theoretical significance. It addresses a pressing need to reconsider and redefine economic policy foundations to ensure adaptability and efficacy in a rapidly changing world. As this paper explores, behavioural economics holds the potential to revolutionize tax policy design, fostering a more nuanced, efficient, and people-centric approach to governance.

Evolution of Behavioural Economics

Behavioural Economics (BE) has emerged as a vital field to understand human interaction with systems like tax policies[5]. It is essential for incorporating taxes as an element of policy design, as the tax code often serves as an operational tool to influence behaviour. BE highlights deviations from standard economic assumptions by integrating psychological insights, demonstrating that individuals' responses to taxes are far more complex than traditional models suggest. In essence, BE examines psychological, cognitive, and emotional factors that affect rational decision-making.

The core principles of BE include bounded rationality, which acknowledges that limited

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[4] *Richard H. Thaler & Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness (Penguin Books 2009).*
Daniel Kahneman, Thinking, Fast and Slow (Farrar, Straus and Giroux 2011)
[5] Richard H. Thaler & Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (Penguin Books 2009).

information and cognitive capacities lead to non-optimal decisions[6]. Heuristics and biases result in systematic errors, such as mental accounting or loss aversion, which refers to the tendency to avoid losses over equivalent gains. Time inconsistency reflects the overvaluation of immediate rewards compared to future benefits, while social preferences reveal that decisions are influenced by both self-interest and concern for others. Nudge theory highlights the impact of subtle changes in the environment on behaviour without restricting freedom of choice, while framing effects emphasize how the presentation of choices affects decisions. Other principles include the anchoring effect, where initial information disproportionately influences subsequent decisions, and status quo bias, which explains the preference for default options despite better alternatives.

Theoretical frameworks within BE provide deeper insights into decision-making processes. The Prospect Theory, introduced by Kahneman and Tversky, explores how individuals evaluate gains and losses, asserting that losses loom larger than gains and outcomes are assessed relative to a reference point. [7]The Endowment Effect demonstrates that individuals assign a higher value to owned items than to identical items they do not own. Mental Accounting reveals how people categorize and treat money differently based on subjective criteria[8]. The Behavioural Life Cycle Hypothesis examines savings and spending behaviour, while Hyperbolic Discounting explains the tendency to heavily discount future rewards in favor of short-term benefits. [9]Inequity Aversion shows how individuals sacrifice personal gains to reduce inequality. The Overconfidence Bias leads individuals to overestimate their knowledge or abilities, while the Dual-System Theory proposes that decision-making involves both an automatic and a reflective system. Finally, Choice Overload indicates that an excess of options can lead to suboptimal decisions, and Default Theory highlights the tendency of individuals to stick with default options.

The historical background of BE reflects its evolution from classical economic principles to a robust interdisciplinary framework. During the Classical Foundations (18th–19th Century), the concept of Homo Economicus was introduced, positing that individuals act as rational agents

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[6] Herbert A. Simon, *Models of Man: Social and Rational* (Wiley 1957).
[7] Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision under Risk*, 47 Econometrica 263 (1979).
[8] Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. Econ. Persp. 193 (1991).
[9] David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q.J. Econ. 443 (1997).

seeking to maximize utility. Classical economists, led by Adam Smith, proposed Utility Theory, emphasizing rational decision-making based on perfect information. Interestingly, Smith's *Theory of Moral Sentiments* also explored empathy, fairness, and moral judgments, hinting at the behavioural elements that would later define BE.

In the Early Behavioural Roots (19th–20th Century), behavioural insights gained prominence. Smith's exploration of empathy and fairness was gradually expanded, introducing the notion that economic decisions could be influenced by psychological factors. The Rise of Psychology and Decision-Making (1900–1950) further advanced the field, with studies examining the unconscious mind's role in consumption patterns and economic behaviour. The emergence of Game Theory in the 1950s provided a strategic perspective on decision-making, while the Theory of Cognitive Dissonance illuminated how individuals resolve inconsistencies between beliefs and actions.

The Behavioural Evolution (1970s–1980s) marked a significant shift, with groundbreaking theories such as the Prospect Theory and Mental Accounting challenging traditional assumptions. The 1990s saw the rise of Experimental and Applied Behavioural Economics, where experimental methods tested behavioural hypotheses and integrated them into real-world economic analysis.

In the 2000s, Behavioural Economics achieved institutional recognition. The awarding of the 2002 Nobel Prize in Economics to Daniel Kahneman validated the field, spurring its adoption in public policy and institutional frameworks[10]. Governments and organizations began employing behavioural insights to design policies that effectively influence behaviour, particularly in areas like taxation, healthcare, and financial decision-making.[11]

Behavioural Economics, thus, represents an interdisciplinary bridge between economics and psychology, providing a nuanced understanding of human behaviour in economic contexts. Its evolution underscores the growing recognition of non-rational factors in decision-making, redefining how economic policies are designed and implemented.

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[10] The Royal Swedish Academy of Sciences, Press Release: The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2002 (2002).
[11] OECD, *Behavioural Insights and Public Policy: Lessons from Around the World* (2017).

Incorporating Results from Behavioural Economics into Tax Policy

Behavioural economics introduces a new dimension to the design and implementation of tax policies by integrating psychological insights into economic decision-making. [12]Unlike classical theories that assume rational behaviour, behavioural economics recognizes the systematic biases, emotional influences, and cognitive limitations that affect human actions. Applying these findings to tax policy offers a transformative approach to designing systems that align better with human behaviour, ensuring compliance, fairness, and efficiency.

Key theories like prospect theory and mental accounting form the backbone of behavioural insights into taxation[13]. Prospect theory highlights how individuals value losses more than equivalent gains, which can influence how they perceive taxes. For example, taxpayers often view tax refunds positively because they frame it as a gain, while owing taxes—even for the same amount—feels like a loss. Mental accounting further explains how people compartmentalize finances, treating tax payments and refunds as separate from regular expenditures. The concept of "tax salience" is particularly important in understanding compliance. Policies can be designed to either hide or highlight the visibility of taxes, depending on the desired outcomes. [14]For instance, reducing the salience of certain taxes might prevent overreaction to minor levies, thus maintaining economic stability. Conversely, making environmental taxes highly visible can encourage environmentally conscious behaviour.The introduction of libertarian paternalism by Richard Thaler emphasizes the role of choice architecture in guiding taxpayers[15]. Nudges are small, deliberate changes in the way choices are presented—can influence behaviour without restricting freedom. For example, setting default options for retirement savings plans or pre-filling tax forms increases compliance rates by reducing cognitive effort.Nudges are especially effective in addressing common biases such as the endowment effect and loss aversion[16]. Tax systems could offer incentives for behaviours like saving or investing in renewable energy, framed as gains rather than penalties. Similarly,

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[12] Richard H. Thaler & Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* 6–8 (Penguin Books 2009)

[13] Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision under Risk*, 47 Econometrica 263, 274 (1979); Richard H. Thaler, *Mental Accounting Matters*, 12 J. Behav. Decision Making 183, 183–85 (1999).

[14] Raj Chetty, Adam Looney & Kory Kroft, *Salience and Taxation: Theory and Evidence*, 99 Am. Econ. Rev. 1145, 1146 (2009).

[15] Richard H. Thaler & Cass R. Sunstein, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. Chi. L. Rev. 1159, 1162–63 (2003).

[16] Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. Econ. Persp. 193, 197–98 (1991).

taxpayers are more likely to respond positively to deductions presented as "rewarding contributions to society. "Behavioural insights reveal that people often fail to optimize their financial decisions due to lack of attention, procrastination, or cognitive overload. [17]Tax policies can counteract these tendencies through simplification and automation. For instance, providing clear, concise instructions and automated filing systems reduces barriers to compliance. The concept of fairness plays a crucial role. Research indicates that individuals are more willing to pay taxes if they perceive the system as equitable and the benefits as tangible[18]. Transparent communication about how taxes fund public goods—like schools, healthcare, or infrastructure—can build trust and encourage voluntary compliance. Policies like incentivized savings accounts or tax credits for delayed consumption can help individuals align their actions with future benefits. One example is the "house money effect," where unexpected income leads to riskier financial decisions.[19] Policymakers can design tax systems that channel such windfalls into beneficial uses, such as compulsory savings or investments in social welfare programs. Behavioural economics offers invaluable tools to enhance tax policy by addressing real-world behaviours. [20]By leveraging these insights, governments can craft tax systems that are not only efficient and equitable but also aligned with the psychological and emotional realities of taxpayers.

How Far Behavioural Economics is Incorporated into the Present Tax Regime in India

Behavioural Economics (BE) principles are increasingly influencing tax regimes worldwide, including in India. [21]By focusing on human behaviour rather than assuming purely rational decision-making, these principles address cognitive biases, improve compliance, and enhance fairness. Below, we explore some impressive concepts of BE incorporated into India's tax framework, supported by illustrative examples.

1. Importance of Ease of Compliance and Default Effects

 Making tax compliance easier by providing prefilled tax forms or offering default filing

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[17] Shlomo Benartzi & Richard H. Thaler, *Heuristics and Biases in Retirement Savings Behaviour*, 21 J. Econ. Persp. 81, 85 (2007).

[18] *Erzo F.P. Luttmer & Monica Singhal, Tax Morale, 28 J. Econ. Persp. 149, 150 (2014).*

[19] Richard H. Thaler & Eric J. Johnson, *Gambling with the House Money and Trying to Break Even: The Effects of Prior Outcomes on Risky Choice*, 36 Mgmt. Sci. 643, 645 (1990).

[20] Cass R. Sunstein, *How Behavioural Economics Could Improve Regulation*, 43 Oxford Rev. Econ. Pol'y 108, 109–10 (2016).

[21] Richard H. Thaler & Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* 6–8 (Penguin Books 2009)

options encourages taxpayers to comply with minimal effort.[22] Defaults often leverage inertia, where taxpayers stick to the easiest path—filing the prefilled form instead of ignoring the process.

Illustration:

The Indian Income Tax Department's initiative of **pre-filled tax forms** is a significant example of BE in action. These forms automatically populate details like income, deductions, and investments, reducing the cognitive load on taxpayers and nudging them toward timely filing.

2. Loss Aversion – TDS to Reduce the Pain of a Large Lump Sum Payment Later

Tax Deducted at Source (TDS) mitigates the psychological discomfort of paying a large tax amount at once by spreading the burden over time. Loss aversion explains why individuals feel the pain of losing money more acutely than the pleasure of gaining it[23]. By dividing payments, the loss becomes less noticeable. Loss aversion explains why individuals feel the pain of losing money more acutely than the pleasure of gaining it. By dividing payments, the loss becomes less noticeable.

Illustration:

Employers deduct TDS from salaries monthly, ensuring that taxpayers do not experience the financial and emotional strain of making a lump-sum payment during tax season.

3. Fairness and Social Norms – Higher Tax Slabs for Higher Income

Progressive taxation reflects the societal norm of fairness, where those with higher incomes contribute more. People are more likely to comply when they perceive the system as fair, fostering voluntary compliance.[24]

Illustration:

India's tax system features **progressive slabs**, with rates increasing for higher income brackets (e.g., 5%, 20%, and 30% for ascending income levels). This aligns with social norms that emphasize fairness and equity in sharing the tax burden.

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[22] Shankar Vedantam, *The Hidden Brain: How Our Unconscious Minds Elect Presidents, Control Markets, Wage Wars, and Save Our Lives* 162 (Random House 2010)

[23] Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision under Risk*, 47 Econometrica 263, 274 (1979); Richard H. Thaler, *Mental Accounting Matters*, 12 J. Behav. Decision Making 183, 183–85 (1999).

[24] Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *The Endowment Effect, Loss Aversion, and Status Quo Bias*, 51 J. Econ. Perspectives 193, 194 (1997).

4. Framing Effect – Framing Tax Refunds as Benefits

Presenting tax refunds as a reward rather than a repayment can increase compliance. Framing refunds as benefits leverages the cognitive bias where taxpayers perceive a gain rather than focusing on the overpayment.[25]

Illustration:

The **income tax refund system** in India, where overpaid taxes are reimbursed promptly, is often framed as a "benefit." Clear communication on how refunds are processed fosters positive reinforcement among taxpayers.

5. Nudge Theory and Present Bias – Higher Taxes on Harmful Products

Increasing taxes on goods like alcohol, tobacco, and sugary drinks nudges individuals toward healthier choices by exploiting present bias (the tendency to prioritize immediate gratification). Higher costs dissuade immediate consumption, addressing present bias while framing the tax as a health-related measure.[26]

Illustration:

The **sin tax on cigarettes and alcohol** under GST discourages consumption of harmful products while increasing government revenue.

6. Loss Aversion and Deterrence Effect – Highlighting Potential Penalties

Emphasizing penalties for non-compliance motivates taxpayers to fulfill their obligations to avoid losses. The fear of losing money through penalties is a strong motivator for timely compliance.[27]

Illustration:

The **Income Tax Department's warnings** about penalties for late filing or evasion, such as fines under Section 234F, leverage loss aversion to encourage compliance.

7. Anchoring and Fresh Start Effect – Reduced Penalties for Past Non-Compliance

Offering reduced penalties for past non-compliance provides taxpayers a psychological anchor and a fresh start, motivating future compliance. Anchoring taxpayers on reduced penalties

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[25] George Loewenstein, *Emotions in Economic Theory and Economic Behaviour*, 18 Am. Econ. Rev. 429, 431 (2008).

[26] Raj Chetty, Adam Looney & Kory Kroft, *Salience and Taxation: Theory and Evidence*, 99 Am. Econ. Rev. 1145, 1146 (2009).

[27] John A. List, *The Behaviouralist as Tax Collector: Using Natural Field Experiments to Enhance Tax Compliance*, 92 J. Pub. Econ. 1232, 1235 (2008).

makes compliance appear more attractive, while the fresh start motivates a change in behaviour.[28]

Illustration:

The **Vivad Se Vishwas Scheme** allowed taxpayers to settle disputes with reduced penalties, encouraging defaulters to resolve issues and start afresh with clean records.

8. Social Norms and Peer Influence – Publishing Defaulters' Names

Creating social pressure by publishing the names of tax defaulters adds a social cost to non-compliance. Social norms and the fear of reputational damage act as powerful motivators for compliance[29].

Illustration:

The Indian government periodically **publishes lists of major tax defaulters**, creating public awareness and pressure on individuals and organizations to comply.

9. Reciprocity – Increased Compliance Due to Input Tax Credit (ITC)

Providing benefits like ITC fosters a sense of reciprocity, encouraging compliance. When taxpayers see direct benefits, they are more likely to reciprocate with honest compliance.

Illustration:

Under GST, businesses claim **input tax credits** on purchases, which reduces their tax liability and incentivizes accurate reporting.

10. Salience Effect – Immediate Reminders

Timely reminders about filing deadlines or upcoming tax payments increase salience and improve compliance. Immediate reminders ensure tax obligations stay top-of-mind, reducing the likelihood of procrastination.[30]

Illustration:

The **Income Tax Department's SMS and email reminders** about deadlines ensure that taxpayers remain aware of their obligations.

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[28] Thaler & Sunstein, *Nudge*, supra note 1, at 45–50.
[29] Robert Cialdini, *Influence: The Psychology of Persuasion* 25–28 (Harper Business 2007).
[30] Shankar Vedantam, *The Hidden Brain*, supra note 2, at 163.

Comparing Traditional Tax Regimes with BE-Informed Tax Regimes

Aspect	Traditional Tax Regime	Behavioural Economics-Informed Tax Regime
Assumption About Behaviour	Taxpayers are rational, self-interested individuals.	Taxpayers are subject to cognitive biases and social influences.
Compliance Strategy	Enforcement through audits and penalties.	Simplification, nudges, and framing to encourage voluntary compliance.
Complexity of Tax System	High complexity, requiring significant taxpayer effort.	Simplified systems, including pre-filled forms and automated processes.
Penalty Framework	Harsh penalties for non-compliance.	Reduced penalties for past non-compliance to encourage future adherence.
Incentive Structure	Focused solely on individual gain.	Incorporates social norms, reciprocity, and collective benefits.
Communication	Technical and information-heavy.	User-friendly, emphasizing benefits and fairness.
Aspect	Traditional Tax Regime	Behavioural Economics-Informed Tax Regime
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Incentive Structure	Focused solely on individual gain.	Incorporates social norms, reciprocity, and collective benefits.
Communication	Technical and information-heavy.	User-friendly, emphasizing benefits and fairness.

"The Limitations of Behavioural Economics: Why It Alone Cannot Achieve the Ideal Tax Policy

Behavioural Economics (BE) has undeniably played a crucial role in addressing global challenges, particularly in areas such as the COVID-19 pandemic response and climate change mitigation[31]. However, despite its widespread application, the concept of BE has not been afforded equal prominence across the globe, and its effectiveness and outcomes vary based on several factors. Notably, demographic, cultural, and ethnic differences contribute to the complexities of its implementation[32]. For example, in India, significant regional disparities exist across zones such as the North, South, East, West, and North-East. While it is easy to assume that economic behaviours might be uniform in remote and less industrialized regions, the reality is quite different[33]. The economic behaviours in these areas are often influenced by tribal customs, insurgency issues, and limited infrastructure[34]. The tribal system tends to prioritize collective well-being over individual profit, a stark contrast to the individualistic goals that dominate urbanized areas.

For instance, younger tribal members, especially those from communities like the Santhals who migrate to metropolitan cities, show a shift towards individualistic goals due to increased education, exposure, and economic necessity[35]. This marks a departure from their previous collectivist orientation. Such variations highlight a significant limitation of BE: it cannot predict or comprehensively capture the full spectrum of human behaviour across different regions and cultural contexts.[36] While BE suggests that economic behaviour deviates from standard assumptions in certain areas, it cannot fully explain these deviations, nor can it account for the complexity of these cultural, ethnic, and regional variations.[37]

Therefore, this paper explores the critical question: can BE alone help us understand the most

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[31] Thaler, R. H., & Sunstein, C. R. (2008). *Nudge: Improving decisions about health, wealth, and happiness*. Penguin Books.

[32] Hausman, D. M., & Welch, B. (2010). *Debate: To Nudge or Not to Nudge*. *Journal of Political Philosophy*, 18(1), 1-19. https://doi.org/10.1111/j.1467-9760.2009.00353.x

[33] Chatterjee, P. (2004). *The Politics of the Governed: Reflections on Popular Politics in Most of the World*. Columbia University Press

[34] Ghosh, S. (2012). *Development and Regional Disparities in India: A Study of the North-East Region. Asian Economic Policy Review*, 7(2), 238-256. https://doi.org/10.1111/j.2041-4162.2012.01107.x

[35] Ramaswamy, S., & Khandelwal, S. (2007). *Migration and Labor Market Shifts in India. Journal of Asian Economics*, 18(3), 329-342. https://doi.org/10.1016/j.asieco.2007.02.003

[36] Tversky, A., & Kahneman, D. (1981). *The Framing of Decisions and the Psychology of Choice*. *Science*, 211(4481), 453-458. https://doi.org/10.1126/science.7455683

[37] Kahneman, D. (2011). *Thinking, Fast and Slow*. Farrar, Straus and Giroux.

effective means of achieving the intended outcomes of policy? The answer to this question is not straightforward, as BE, though influential, cannot offer a one-size-fits-all solution. [38]Its application and outcomes remain context-dependent, highlighting the necessity of integrating BE with other policy approaches for a holistic and effective solution.[39]

Differential Application of BE

To fully understand the differential application of Behavioural Economics (BE), it is essential to first examine the standard deviations from the classical economic model. These deviations have significant and inevitable effects on policies, as policies crafted based on standard economic assumptions have, in reality, only a very slim chance—roughly a 0.5% probability—of achieving their intended goals. The major areas of deviation from the classical model include several key factors:

1. Influence of Decisions: Traditional economics assumes that decisions are based on rational self-interest and optimal information processing. However, behavioural economics demonstrates that the factors influencing decisions are far more complex. These factors often include contradictory considerations, with individuals using mental shortcuts, biases, and heuristics that do not always align with traditional models.

2. Shift from Self-Interest to Social Preferences: While classical economics emphasizes that individuals act out of self-interest, BE acknowledges the profound influence of social preferences. People often make decisions that reflect concern for others, prioritize collective well-being, or adhere to social norms, which may run counter to self-interest maximization.

3. Selective Utilization and Comprehension of Information: In traditional models, the assumption is that individuals have access to all relevant information and make decisions based on it. However, BE points out that people often selectively utilize information, or may not fully comprehend all available information, leading to suboptimal decisions.

4. Diminished Fear of Uncertainty and Control over the Future: Classical models assume that individuals weigh the uncertainty of future events carefully. In contrast, BE shows that people often underestimate or dismiss uncertainties, placing less importance on future risks and consequences, especially when immediate gratification is at stake.

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[38] Thaler, R. H., & Sunstein, C. R. (2003). *Libertarian Paternalism is Not an Oxymoron*. *University of Chicago Law Review*, 70(4), 1159-1202.

[39] Diamond, P. A., & Saez, E. (2011). *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*. *The Journal of Economic Perspectives*, 25(4), 165-190. https://doi.org/10.1257/jep.25.4.165

5. <u>Emotions Overriding Market Reality</u>: While traditional economics assumes that people make decisions based solely on objective market realities, BE reveals how emotions significantly influence market behaviours. Emotions like fear, greed, and anxiety can overshadow rational economic decisions, distorting the true value of assets or investments.

6. <u>Unpredictability in Shaping Behaviour</u>: Classical economics posits that behaviour can be predicted and modeled with precision. However, BE shows that human behaviour, especially in complex and dynamic contexts, can take unpredictable turns. Individuals may act in ways that deviate significantly from the predictions of traditional models, making it difficult to shape behaviour through conventional policy measures.

7. <u>Complete Defiance of Rationality</u>: Traditional economics assumes that humans are rational agents who always act to maximize utility. Behavioural economics, however, challenges this by highlighting that human decision-making often contradicts the notion of rationality. People are frequently influenced by cognitive biases, emotions, and social contexts, leading them to make decisions that are not in line with rational utility maximization.

8. <u>Dissolution of Conventional Reference Points</u>: The classical economic model assumes fixed reference points for decision-making. BE, however, demonstrates that people's reference points can shift due to various factors such as framing, emotions, or social influences, making traditional predictions of behaviour based on stable reference points largely unreliable.

These major deviations from the classical economic model lead to a fundamental shift in how we perceive human behaviour in economic contexts. Traditionally, humans were treated as "Econs," rational actors who made decisions to maximize their own utility. However, the rise of BE has introduced a more nuanced understanding of economic behaviour, where individuals are now recognized as "Humans"—complex, emotional, social beings whose decisions are influenced by a variety of factors beyond the simple rational calculations of classical economics. This transformation underscores the need for policies that account for these deviations, as ignoring them could lead to ineffective or even counterproductive outcomes.

While Behavioural Economics (BE) provides valuable insights into taxpayer behaviour, relying solely on its principles to craft tax policies may not yield optimal results. An effective tax policy must go beyond general behavioural assumptions and delve into the differential application of provisions across diverse taxpayer categories. This approach ensures fairness, equity, and inclusivity while addressing specific economic and social objectives.

To make Behavioural Economics principles more impactful, their application must be tailored to specific categories of taxpayers.

Step 1: *Ascertaining Categories*

The foundation of a nuanced tax policy lies in identifying and categorizing taxpayers based on factors that influence their obligations, benefits, and compliance mechanisms[40]. In this paper, we analyze tax provisions that demonstrate exclusive applicability to specific groups, establishing categories using the following criteria:[41]

1. **Applicable Rates and Access to Deductions**
2. **Exemptions**
3. **Incentives**
4. **Schemes**
5. **Exposure to Penalties**
6. **Input Tax Credit (ITC) Availability**
7. **Procedural Immunities**
8. **Assessment Mechanisms**
9. **Commercial Objectives**

Step 2: *Establishment of Categories*

Based on the factors outlined in Step 1, the following categories have been established to reflect the differential applicability of tax provisions. These classifications are crucial for tailoring tax policies that accommodate diverse taxpayer profiles, ensuring equity, compliance, and economic efficiency.[42]

1. Income-Based Categories

Segregation Basis: Taxpayer income levels (low income, middle income, high income).

Relevance: Tax policies such as progressive tax slabs are directly tied to income levels, with higher earners contributing a larger share to public revenue.[43] Deductions like Section 80C are more accessible to middle-income taxpayers, whereas low-income groups often qualify for rebates

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2. Age-Based Categories

Segregation Basis: Age groups (senior citizens, super senior citizens, working-age individuals).

Relevance: Senior and super senior citizens benefit from higher exemption limits and procedural relaxations, acknowledging their reduced earning capacity.

[44]3. Residency-Based Categories

Segregation Basis: Resident individuals, Non-Resident Indians (NRIs), and Residents but Not Ordinarily residents

Relevance: NRIs are subject to specific provisions such as **taxation of income earned or accrued in India** and eligibility for deductions like Section 80C. RNOR status allows temporary expatriates to avoid global income taxation while ensuring India-centric compliance[45]

4. Occupation-Based Categories

Segregation Basis: Salaried individuals, business owners and professionals, agricultural workers.

Relevance: Professionals and businesses can claim deductions on expenses incurred for earning income, while agricultural workers enjoy income tax exemptions under Section 10(1)[46]

5. Gender-Based Categories

Segregation Basis: Male, female, and other gender taxpayers.

Relevance: Emerging policies for gender inclusivity may introduce targeted benefits for women-led businesses or underrepresented groups[47]

6. Urban vs. Rural Divide

Segregation Basis: Taxpayers from urban and rural regions.

Relevance: Rural taxpayers often qualify for special schemes or exemptions, such as agricultural income tax exemptions. [48]Urban taxpayers benefit from broader access to deductions for housing loans and savings instruments.

7. Taxpayer Awareness Levels

Segregation Basis: Taxpayers categorized by awareness and understanding of tax provisions.

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8. Regional Differences

Segregation Basis: Regions with high savings culture vs. high consumption culture.

9. Tax Compliance-Based Categories

Segregation Basis: Regular taxpayers vs. defaulters and non-compliant individuals.

10. ITC-Specific Segregation

Segregation Basis: Businesses eligible for Input Tax Credit (ITC) under GST.

11. Special Incentive-Based Categories

Segregation Basis: Start-ups, manufacturing companies, charitable institutions.

12. Filing and Compliance Requirement-Based Categories

Segregation Basis: Regular taxpayers, tax deductors and collectors, start-ups.

13. Assessment Mechanism-Based Categories

Segregation Basis: Self-assessed taxpayers and those under scrutiny.

14. Audit Obligation-Based Categories

Segregation Basis: Businesses exceeding turnover thresholds and small taxpayers.

Step 3: *Tailored Behavioural Interventions for Optimized Tax Compliance*

This stage delves into the differential application of behavioural economics (BE) principles across various taxpayer categories, integrating insights from their traits, tax regime impacts, and compliance motivators[49]. The consolidated table presented here highlights the nuanced needs and preferences of diverse groups, categorized by income type, employment type, regional influences, and other factors. By analyzing the traits that shape taxpayer behaviour, such as present bias, complexity aversion, and mental accounting, this step identifies both the advantages and gaps within current tax regimes[50]. It emphasizes a tailored approach, combining simplicity and targeted incentives to enhance compliance while fostering equity and inclusivity.[51] This step is pivotal as it translates theoretical BE concepts into actionable policy interventions, ensuring that tax reforms resonate with distinct taxpayer demographics[52]. It also highlights the potential of hybrid frameworks to accommodate diverse preferences, address systemic inequities, and drive long-term adherence to tax compliance frameworks.[53]

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Basis of Classification	Category	Important Traits Relevant to Tax Code	Behavioral Economics (BE) Principle	Positive Impact of Current Regime	Negative Impact of Current Regime	Illustrations and Reforms
Income Levels	Low-Income Earners	Present bias, limited savings, high disposable income preference	Simplification to reduce cognitive overload, nudges for instant benefits	Easier understanding under the new tax regime, higher disposable income focus	Limited long-term benefits; misses out on encouraging savings like in the traditional regime	Introduce hybrid deductions (e.g., matching contributions to savings plans for lower income) to balance immediate benefits and long-term financial security.
	Middle-Income Earners	Savings-oriented, aware of exemptions, risk-averse	Mental accounting to leverage exemptions, choice architecture	Both regimes offer flexibility; middle-income earners can evaluate based on their saving habits.	Complexity of traditional regime may deter some; new regime often disregards their preference for savings benefits.	Simplify exemptions in the traditional regime to retain savings-oriented taxpayers while offering simplified guidance in new regime for moderate income earners.
	High-Income Earners	Financially literate, optimize exemptions, consult professionals	Sophisticated framing of tax-saving avenues	Traditional regime aligns well with their ability to leverage exemptions fully.	High compliance burden under traditional regime; simplification efforts in the new regime are less relevant.	Reduce compliance paperwork under the traditional regime for deductions; offer AI-based optimization of deductions and exemptions.
Age Groups	Senior Citizens	Stable income, loss aversion, need for predictable benefits	Salience of stable benefits, cognitive ease	Higher exemptions in traditional regime; predictable and age-specific benefits (e.g., health).	New regime lacks focus on their unique needs (e.g., pensioners).	Provide tailored exemptions under the new regime (e.g., automatic higher deduction limits for senior citizens).
	Super Senior Citizens	Higher reliance on pensions and savings, lower cognitive bandwidth	Simplified compliance rules	Exemptions on pensions and deposits in the traditional regime align with their needs.	The new regime doesn't address unique benefits for this group, making adoption unlikely.	Introduce auto-calculated benefits during filing, nudging higher participation in simplified regimes while protecting pensioner-specific exemptions.
	Working-Age Individuals	Present bias, consumption-focused	Choice architecture encouraging early tax planning	New regime appeals to younger individuals seeking simplicity and flexibility.	Fails to incentivize long-term savings, especially among younger taxpayers.	Mandatory opt-in savings schemes under the new regime to nudge toward financial discipline while preserving freedom.
Residency	Residents	High awareness of domestic exemptions, consumption-driven	Default setting and simplification	Both regimes cater to their needs depending on awareness and income.	Higher reliance on exemptions in the traditional regime leads to complexity.	Simplify traditional regime filings for resident individuals to reduce complexity while retaining exemptions.
	Non-Resident Indians (NRIs)	Currency arbitrage focus, limited domestic income streams	Anchoring exemptions to residency benefits	Special provisions for NRI income under traditional regime; consistency of rules.	Complex rules for NRI-specific exemptions can deter compliance.	Offer tailored filing portals for NRIs with pre-validated exemptions based on residency status to improve compliance and clarity.
	Resident But Not Ordinarily Resident (RNOR)	Limited global income, transitioning residency status	Salience of transitional exemptions	Exemptions on specific foreign incomes under the traditional regime.	Complexity in navigating residency-based tax implications.	Simplify transitional filings for RNOR individuals with automated calculators for exemptions and deductions.
Occupation	Salaried Individuals	Savings-oriented, rely on exemptions, predictable income streams	Defaults and pre-populated tax benefits	Both regimes cater to their needs based on exemption preferences.	New regime lacks sufficient incentive for savings-oriented salaried individuals.	Simplify deduction categories under the traditional regime for salaried individuals, preserving its attractiveness.
	Business Owners and Professionals	Profit optimization, expense-based deductions, risk tolerance	Simplified compliance rules, heuristics for choice	Exemptions in the traditional regime are aligned with expense-based deductions.	New regime doesn't provide avenues for expense-based deductions, limiting adoption.	Extend selective deductions in the new regime for business-specific expenses like equipment depreciation or professional licenses.
	Agricultural Workers	Exempt from most taxes, trust-dependent	Nudges to encourage formal financial inclusion	Indirect tax nudges like schemes encouraging participation in financial systems (e.g., PM-Kisan).	Minimal engagement with direct tax frameworks due to exemption; limited inclusion opportunities.	Introduce formal inclusion schemes with incentives linked to agricultural income thresholds, nudging voluntary participation in tax systems.
Gender	Women Taxpayers	Higher savings propensity, conservative risk approach	Tailored nudges to encourage higher financial participation	Gender-based schemes like Sukanya Samriddhi Yojana align with traditional regime benefits.	New regime does not cater to gender-specific financial goals like education-related savings.	Offer gender-specific benefits in simplified regimes such as additional deductions for women professionals and entrepreneurs.
Urban vs Rural	Urban Taxpayers	Higher financial literacy, consumption-oriented	Defaults emphasizing consumption benefits	Both regimes appeal based on financial literacy levels.	Simplified new regime may reduce long-term savings incentives.	Strengthen urban-specific deduction categories such as housing loans in the traditional regime while preserving the simplicity of the new regime.
	Rural Taxpayers	Trust-oriented, limited awareness	Simplified default filing, nudges for formal inclusion	PM-Kisan and similar schemes encourage formal participation.	Minimal direct tax engagement due to exemptions and lack of awareness.	Improve rural outreach with simplified tax filing systems and localized language support.
Taxpayer Awareness	Low Awareness	Limited literacy, reliance on defaults	Simplification and defaults as nudges	New regime is easier to understand and adopt.	Lack of awareness reduces potential benefits of the traditional regime.	Introduce AI-powered tax assistants and outreach programs for taxpayers with low awareness.
	High Awareness	Leverages complexity for benefits	Mental accounting to optimize deductions	Traditional regime caters well with its extensive deductions and exemptions.	Complexity in filing processes can deter compliance for high-deduction taxpayers.	Streamline exemptions under traditional regime while maintaining their availability.
Regional Differences	High Savings Culture	Savings-oriented, long-term planning focus	Salience of long-term benefits	Traditional regime aligns with preferences for deductions like 80C.	Complexity of the traditional regime may deter compliance.	Simplify deduction eligibility under the traditional regime for savings-focused taxpayers.
	High Consumption Culture	Immediate gratification focus, consumption-driven	Defaults emphasizing short-term liquidity	New regime aligns well with consumption-focused taxpayers.	Lack of long-term financial planning incentives in the new regime.	Incorporate consumption-based deductions in simplified regimes to nudge toward balanced financial planning.

Conclusion

Behavioural Economics (BE) has emerged as a transformative tool in reshaping tax policy by addressing cognitive biases and enhancing taxpayer compliance. While traditional economic models rely on rational assumptions, BE complements these frameworks by integrating human psychology into tax administration. By employing strategies such as nudges, framing, and loss aversion, governments can foster voluntary compliance and ensure a more inclusive tax regime. However, as this paper underscores, the sole reliance on BE principles cannot create an ideal tax policy. Effective tax administration demands a differential approach that recognizes the unique socio-economic, demographic, and behavioural characteristics of taxpayers. Establishing granular categories based on income, age, occupation, regional differences, and compliance levels ensures equitable application of tax provisions and incentives. Furthermore, integrating BE principles into these differentiated frameworks can maximize efficiency and fairness, driving policy outcomes that are both pragmatic and just.

The juxtaposition of traditional economic assumptions with BE insights, as outlined in this paper, demonstrates the transformative potential of hybrid models in tax policymaking. While traditional assumptions provide structural rigidity, BE introduces behavioural flexibility, making tax systems more dynamic and adaptable to real-world complexities. Ultimately, the integration of these frameworks represents a paradigm shift, positioning tax regimes to balance revenue objectives with equity, efficiency, and taxpayer engagement.

This comprehensive approach underscores the need for policymakers to combine theoretical insights with empirical data, ensuring that tax policies are not only rooted in sound economic principles but also reflect the diverse realities of taxpayers. As tax systems evolve, this balanced integration of BE and traditional approaches will play a pivotal role in fostering compliance, driving growth, and building public trust in governance.