



Tax progressivity, income distribution and tax non-compliance

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ABSTRACT

This article examines the determinants of tax non-compliance when we recognise the existence of an imperfectly competitive “tax advice” industry supplying schemes which help taxpayers reduce their tax liability. We apply a traditional industrial organisation framework to model the behaviour of this industry. This tells us that an important factor determining the equilibrium price and hence, the level of non-compliance, is the convexity of the demand schedule. We show that in this context, this convexity is affected by the distribution of pre-tax income, the progressivity of the tax-schedule and the way in which monitoring and penalties vary with income. It is shown that lower pre-tax income inequality as well as a less progressive tax code may cause more tax minimisation activities. Therefore, the frequently advocated policy of reducing the highest tax rate may fail as a policy directed at improving tax discipline. One way of offsetting the possible harm to tax compliance from a less progressive tax could be an adjustment of the penalty and monitoring functions.

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1. Introduction

Tax non-compliance—avoidance and evasion—is a problem of great importance for many countries. For example, the US Internal Revenue Service estimated that about 17% of due income taxes are not paid (IRS, 2007), while according to the HM-Treasury report (HMRC, 2007), the VAT gap is about 14.2% in the UK.

Tax non-compliance does not only reduce tax revenue (*ceteris paribus*) but also has a number of other welfare-reducing consequences.²

- The loss of tax revenue means that governments either have to spend less on desirable publicly provided goods and services or else are forced to increase the tax burdens on compliant tax payers, thus amplifying the deadweight loss.³
- The government's inability to collect sufficient tax revenue may result in a higher deficit and a deterioration of the financial environment. In extreme cases, it may cause financial crises, as in Russia in 1998 and Argentina in 2002.
- Significant amounts of real resources are devoted to both devising tax reducing schemes and to the monitoring and enforcement of tax compliance.

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² For a detailed overview of the main problems related to tax compliance, see Andreoni et al. (1998).

³ Feldstein (1999) estimates the deadweight loss from income tax in the US to be more than 12 times larger than it would have been without tax avoidance.

- Non-compliance typically results in otherwise identical taxpayers facing arbitrarily different effective marginal tax rates—which violates a standard condition of efficient taxation and thus increases the distortions of the tax system.
- Since rich individuals are probably more likely to employ avoidance practices,⁴ the government levies heavier taxes on those who are less well-off, which will not only increase vertical inequality but may also slow down the development of small businesses and economic growth.
- It is also important to recognise that non-compliance can have a multiplier effect to the extent that non-compliance by a small group of individuals diminishes the social norm of tax compliance in the wider population of otherwise compliant taxpayers. The importance of such norms has been emphasised in a number of behavioural and experimental studies (Gordon, 1989; Cowell, 1992; Myles and Naylor, 1996; Kim, 2003).

While it is thus important to more fully understand the drivers of tax non-compliance, much of the literature has focused on taxpayer behaviour—the demand side of non-compliance—using either the conventional Allingham–Sandmo model or some other decision-theoretic approach. It is now generally recognised that non-compliance has both a supply side and a demand side, and that more attention needs to be paid to the supply side. Indeed, Slemrod (2004) considers the ignorance of the supply side of tax non-compliance to be a significant shortcoming of traditional economic models, especially in relation to corporate tax behaviour, and points out that the market for tax abusive schemes has grown substantially in recent years.⁵

One aspect of the supply side that has been widely studied is the role of agents/tax preparers who may inform the clients of tax saving opportunities. For example, Erard (1993) shows that the non-compliance on returns prepared by certified public accountant and lawyers is approximately 4.5 times larger than it would have been had their clients prepared their own tax returns. Another aspect focuses on how taxes could be evaded by bribing the tax inspector⁶ or even a member of parliament to issue the right tax exemption.⁷

In this paper, the focus is on another aspect of supply—the existence of an imperfectly competitive industry that devises and sells tax minimisation schemes. Certainly, in many advanced economies, the market seems to be dominated by a relatively small number of large players. For instance, in the UK, this would be the “Big Four” accountancy firms (KPMG, Ernst and Young, PricewaterhouseCoopers and Deloitte), which often face criticism for the provision of tax shelters for wealthy individuals and business corporations (see, for example, *The Financial Times*, May 10, 2004).

Within such a perspective, a crucial factor determining the amount of non-compliance is the equilibrium price for these schemes. Now, it is well known from the traditional Industrial Organization literature that the equilibrium price depends on certain features of the industry demand curve. For example, Anderson and Régis (2003) show that the more convex is the industry demand function, the lower will be the equilibrium price and the higher the equilibrium quantity. Similarly, Sandmo (1971) and Coes (1977) have shown that the supplier reduces the quantity when facing higher uncertainty/inequality in demand.

The aim of this paper is to explore what factors affect the shape of the demand curve for the tax minimisation industry and hence, the equilibrium price and output. We will investigate how the shape of the demand curve depends on

- (i) the progressivity of the tax schedule;
- (ii) the level of inequality of the pre-tax distribution of income;
- (iii) the shape of penalty and monitoring functions.

A number of important implications will be discussed.

- One of the most important issues is that in a wide class of cases, a greater progressivity of the tax schedule may reduce the supply of tax avoidance/evasion schemes. Conversely, the flatter the schedule, the lower is the equilibrium price of tax minimisation schemes and hence, the greater is the level of non-compliance. This result is very important because the presumption is often the other way around—the response to avoidance/evasion is to have a very flat schedule (see, for example, Tanzi and Zee, 2000).

⁴ Lang et al. (1997), which is based on German data, concluded that “the difference between legislative and effective tax rate increases in gross income up to the eight income decile and remains at the maximum difference of about 16% for the ninth and the tenth decile”. See also Agell and Persson (2000) for the avoidance practice within the different income groups in Sweden, while Feinstein (1991) finds a similar relation for TCMP audit findings in 1982 and 1985. Desai et al. (2006) and Desai (2005) also indicate that corporate tax avoidance activities are more likely to be undertaken by larger firms.

⁵ The large importance of the disclosure of the tax avoidance schemes has been recognised by HMRC and postulated in Part 7 of the Finance Act 2004. Similarly, the Internal Revenue Service proclaimed that one of its priorities in 2009 is to combat abusive tax avoidance schemes and the individuals who promote them (IRS, 2009).

⁶ Chander and Wilde (1992) and Hindriks et al. (1999) cite different sources and provide outrageous evidence of tax corruption in India, Nepal, Thailand and Taiwan. Hindriks et al. (1999), for example, write that surveys in Taiwan “report 94% of interviewees as having been ‘led to’ bribe corrupt tax administrators and 80% of certified public accountants as admitting to bribing tax officials” and “confidential survey as finding that 76% of all government tax auditors took bribes and 68% of taxpayers had paid bribes”. For the tax moral in Latin America, see Torgler (2005).

⁷ The harm from legal tax exemption could be very significant for a national tax revenue. For example, according to Åslund (1999), three tax exemptions only cost the Russian federal budget more than 7% of GDP: the tax grant to the natural gas monopoly company Gazprom at the end of 1993 (2% of GDP); the secured tax exemptions for the metallurgical industry (2% of GDP) and the National Sports Fund’s right to import alcohol and tobacco without tax (3% of GDP).

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