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Income distribution and equilibrium multiplicity in a stigma-based model of tax evasion

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Abstract

This paper incorporates continuous income distribution into the stigma-based model of tax compliance. The paper investigates the effect of income distribution on the existence of multiple equilibria, and characterizes the conditions under which multiple equilibria emerge. Precisely, multiple equilibria exist if taxpayer incomes are sufficiently homogeneous, because the 'social coordination effect' dominates the 'individual characteristics effect'. Numerical simulations show that the main proposition is robust to allowing two-step audit policies on the part of the tax agency, under the presumption that the best (or good) equilibrium is selected whenever there are multiple equilibria. As a byproduct, the effect of various forms of tax reforms on the optimal two-step audit policy, the equilibrium compliance, and fiscal revenue is analyzed.
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1. Introduction

Tax evasion is as old as taxes themselves. In economic models of tax evasion, taxpayers decide how much income to report by solving a standard expected

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uitility maximization problem that trades off the tax savings from fraud against the risks of penalties for detected cheating. This view, the so-called portfolio approach, was the main idea of the seminal work by Allingham and Sandmo (1972). The portfolio approach has been extended in various directions (see Cowell, 1990; Andreoni et al., 1998, for comprehensive surveys). Nevertheless, close empirical scrutiny has revealed important inconsistencies between theory and evidence.

A couple of facts and findings motivate this paper. First, the rate of tax compliance is paradoxically high, relative to the expected punishment. Empirical studies, such as Graetz and Wilde (1985) and Skinner and Slemrod (1985), have documented the high rate of tax compliance in most countries. It seems puzzling that so many households behave honestly and that cheaters do not cheat more, considering that most taxpayers face a low probability of detection and expect a small penalty when caught.[1] The experimental evidence (Baldry, 1986; Alm et al., 1992a) also suggests that some people never evade, even when the tax evasion gamble is clearly better than fair. To explain the apparent paradox, researchers have appealed to ethical norms (Bordignon, 1993), moral sentiments and misperceived audit probabilities (Erard and Feinstein, 1994a), and the orders of risk aversion (Benasconi, 1998). This study incorporates social stigma directly into the specification of taxpayer utility, hypothesizing that people may fear social stigma or damage to their reputation if they are to be disclosed as cheaters.[2] An important feature of the model is the interdependence of individual behavior. That is, the larger the population share of taxpayers who evade tax, the smaller is the social stigma felt by an individual who attempts to cheat.

Second, it is known from experience that there are close relationships among income, tax policy, and evasion. Clotfelter (1983) and Poterba (1987) report that evasion increases with the tax rate. Experimental studies (e.g. Alm et al., 1992b) typically find that higher tax rates are associated with greater evasion. Most empirical findings suggest that the affluent are much more responsive to structural changes in the tax scheme and thus are suspected of more evasion. In statistical analyses of the historical impact of U.S. tax reforms, Feenberg and Poterba (1993) and Auerbach and Slemrod (1997) suggest that higher marginal tax rates lead the

[1]Based on the U.S. Internal Revenue Service estimates, only 1.7 percent of all U.S. tax returns were audited during the 1995 fiscal year and only 4.1 percent of all taxpayers whose federal returns were reassessed following an audit received some penalty. Refer to Andreoni et al. (1998) for more concrete figures.

[2]The assumption that behavior is influenced by social stigma or the desire for status has a long tradition in economics. Examples include Akerlof (1980), Moffitt (1983), Gordon (1989), Besley and Coate (1992), Cole et al. (1992), Bernheim (1994) and Lindbeck et al. (1999).

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