

Tax evasion and social interactions[☆]

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Received 12 January 2005; received in revised form 6 November 2006; accepted 8 March 2007
Available online 21 March 2007

Abstract

The paper extends the standard tax evasion model by allowing for social interactions. In Manski's [Manski, C.F. (1993). Identification of Endogenous Social Effects: The Reflection Problem. *Review of Economic Studies* 60(3), 531–542.] nomenclature, our model takes into account *endogenous interactions*, *i.e.*, social conformity effects, *exogenous interactions*, *i.e.*, fairness effects, and *correlated effects*. Our model is tested using experimental data. Participants must decide how much income to report given individual and group tax rates and audit probabilities, and given a feedback on the other members' reporting behavior. Myopic and self-consistent expectations are considered in the analysis. In the latter case, the estimation is based on a two-limit simultaneous tobit with fixed group effects. A unique social equilibrium exists when the model satisfies coherency conditions. In line with Brock and Durlauf [Brock, W.A., Durlauf, S.N. (2001b). Interactions-Based Models, in J. Heckman and E. Leamer, eds., *Handbook of Econometrics* 5, Elsevier Science B.V., 3297–380.], the intrinsic nonlinearity between individual and group

[☆] The authors are grateful to Charles Bellemare, Jordi Brandts, Leonard Dudley, Guillaume Fréchette, Thierry Magnac, Charles Manski, Jean-Marc Robin, Jean-Louis Rullière and John Rust for useful discussions. They are also grateful to seminar participants at the University Autònoma of Barcelona, at Aarhus School of Business, at Pompeu Fabra University, University of Aix-Marseille, University Lyon 2, University Paris-I Sorbonne, and participants at the 2004 Economic Science Association Conference in Amsterdam, the 2004 Public Economic Theory conference in Beijing, the 2005 Experimental Public Economic Conference at Georgia State University, and to seminar participants at the 2004 AEA Meetings in San Diego. They also wish to thank Romain Zeiliger for programming the experiment. The research was supported by the Région Rhone-Alpes, the Fonds FQRSC and the Canada Chair on the Economics of Social Policies and Human Resources. The paper was partly written while Lacroix was visiting the Instituto de Análisis Económico de Barcelona, whose hospitality and financial support are gratefully acknowledged. He also received financial support from the Consejo Superior de Investigaciones Científicas.

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responses helps identify the model. Our results provide evidence of fairness effects but reject social conformity.

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JEL classification: H26; D63; C24; C92; Z13

Keywords: Social interactions; Tax evasion; Simultaneous tobit; Laboratory experiments

1. Introduction

In the standard model of tax evasion first proposed by Allingham and Sandmo (1972) and Yitzhaki (1974), the taxpayer is treated as an isolated expected utility maximizer who makes a portfolio decision under uncertainty. Cheating on taxes boils down to a risky activity whose payoff is either a lower tax burden or a penalty imposed by the tax authority. This theoretical framework assumes that the taxpayer is completely individualistic and amoral. His willingness to underreport income is not affected by social norms nor by any form of social interactions. Consequently, predicting the effects of tax or fraud prevention policies can be seriously misled if social interactions do indeed play a significant role in tax evasion behavior. Thus, as is well known since Shelling (1978) and Akerlof (1980), interdependent behavior may generate multiple equilibria and exhibit contagion and epidemic features through a “social multiplier effect” [see Glaeser et al. (2003) for a recent discussion].

There are many reasons to believe that individual tax evasion decisions are affected by social norms and social interactions (e.g., Andreoni et al., 1998). First, Erard and Feinstein (1994) insist on the role of guilt and shame in tax compliance behavior. Alm, McClelland and Schulze (1999) show that social norms play a crucial role and that voting on fiscal rules or communication can affect these norms. Likewise, Gordon (1989) and Myles and Naylor (1996) argue that an individual can derive a psychic payoff from adhering to the standard pattern of reporting behavior in his reference group (*social conformity effect*). Second, through learning from his peers, a taxpayer may find less costly ways to underreport income, to lower the risk of being caught or to reduce penalties associated with tax audits (*social learning effect*). Finally, the individual's perception of the fairness of his tax burden may influence his tax evasion decisions. Indeed, Spicer and Becker (1980) have provided evidence that those who believe they are treated unfairly by the tax system are more likely to evade taxes to restore equity (*fairness effect*).

While most economists probably agree with this taxonomy, there is certainly no consensus as to the magnitude of social interaction effects. Indeed, the very existence of these effects has become a controversial area of research in economics. Measuring social interactions effects raises difficult identification problems (Manski, 1993) and they may prove hard to estimate when they are identifiable (Moffitt, 2001; Blume and Durlauf, 2005). Yet, even when appropriate data and econometric methods are used, they often turn out to be small or negligible determinants of individual outcomes (e.g., Spicer and Hero, 1985; Evans et al., 1992; Aaronson, 1998; Krauth, 2006).

The identification problem arises from the fact that interdependent behavior takes different forms that are difficult to isolate. In Manski's (1993) terminology, the propensity of an individual to evade may genuinely vary according to the behavior of the group (*endogenous interactions* such as social conformity and social learning effects), but it may also vary with the exogenous characteristics of the group members (*exogenous interactions* such as fairness effects). Further, correlated outcomes need not arise from interdependent behavior alone. Indeed, members of a

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