



Targeting occupations with varying reputations to increase tax revenue[☆]

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ABSTRACT

If the government's goal is to raise tax revenue in a cost-effective manner, which (if any) occupation categories could be targeted with a higher probability of an audit to yield increased revenue? Looking beyond mere *opportunity to evade* (e.g., self-employment) and starting from the premise that taxpayers in certain occupations evade more than others, the issue is whether these taxpayers respond to a change in the audit rate. Theory suggests that compliance increases in response to higher audit rates; the occupations with the higher evaders could therefore be targeted. This theory is tested by drawing a connection between occupation, reputation, and tax compliance. We assume that taxpayers in occupations with high need for reputation respond to a lower extent to increased tax audits than taxpayers whose achievement does not depend on reputation. The results support the effectiveness of raising tax revenue by targeting specific occupations, non-managers, with a higher probability of an audit.

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1. Introduction

Theory suggests that a rise in the probability of a tax audit should trigger increased compliance by individuals. Allingham and Sandmo (1972) and Srinivasan (1973) provide the foundation for this assumption. To back up the theory, Dubin et al. (1990) offer empirical evidence on a macro-economic level of the positive relation between audit rates and compliance. With evidence from laboratory experiments, both Spicer and Thomas (1982) and Alm et al. (1992) similarly find that – holding other determinants of compliance constant – increasing audit activities increase compliance.

With a contrary view, some scholars have alluded to a flaw in assuming that high audit rates will decrease evasion, rather, audits can have opposite than the intended effects (Andreoni et al., 1998). Slemrod et al. (2001, p. 482) concluded that *high-income* taxpayers might not respond because of “a perception that an audit will not automatically detect and punish all evasion . . .” With such a perception, any taxpayer incentive (to reduce the chance of an

audit by reporting truthfully) diminishes as the probability of audit approaches one.¹ Pestieau and Possen (1991) find a similar *theoretical* result for taxpayers deemed less risk averse (i.e., entrepreneurs); tax revenue initially increases with the audit probability, but then revenue starts to fall for sufficiently high audit probabilities. Moreover, audits and imposed pressure upon taxpayers through coercive power practiced by authorities not only signal distrust to taxpayers but can lead to reactance and non-cooperation (Kirchler, 2007).

A particularly interesting question regards the effect of audits on different occupational groups whose achievement heavily depends on their reputation. For instance, Arachi and Santoro (2007) discuss the differential effect of audits and enforcement strategies on different business sectors (see also Ashby et al., 2009a,b). One criterion for different effects on different occupational groups may be due to varying dependence on reputation. If the success of a particular occupational group depends on reputation, then being caught evading taxes may bear the risk of being socially blamed and stigmatized. Social stigmatization may be even more of a deterrent to evasion than the menace of audits (Porcano and Price, 1993). Those occupational groups that depend on reputation may cooperate by paying their tax share because evasion bears the risk of social

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¹ See Slemrod et al. (2001, p. 480).

blaming; increased audit probabilities would not affect tax honesty. On the other hand, those occupational groups who are not dependent on reputation and tempted to evade taxes would defer only if audit probability and detection of evasion probability are high or increased. The findings in this paper are consistent with these assumptions showing that greater enforcement may not necessarily yield greater revenue from all groups of taxpayers, but targeting specific groups may be effective. This paper explores the theoretical and empirical connection between an individual's occupation, and the potential reaction to increased scrutiny by tax authorities.

2. Occupation, reputation, and audit rates

As reported in *The Wall Street Journal*, "States Publicize Late Taxpayers' Names Online," (January 8), 2004:

"Threatening public humiliation may be a nasty way to collect overdue taxes. But growing numbers of states are finding it can be a remarkably effective way to raise badly needed cash."²

Recognizing that taxpayers respond to threats of public humiliation (e.g., Wenzel et al., 2008), this paper focuses on the hypothesis that different occupation categories respond differently to such threats, i.e., the importance of a good reputation varies with different occupations. The question posed is whether tax authorities could increase tax revenue by targeting specific occupations.

We assume that managers are more dependent (than others) on reputation for success in their chosen occupation. This general proposition is not new; in *The Theory of Moral Sentiments* (Smith, 1976 [6th ed. 1790], p. 63), Adam Smith states that "[t]he success of ... [most] people ... almost always depends upon the favour and good opinion of their neighbours and equals ..."³ "Good" managers are expected to display a high degree of honesty.⁴

If managers were audited and found to have evaded taxes, and if evasion was made public, then their reputation would likely suffer. By contrast, if non-managers were audited and found to have evaded taxes, their career would not necessarily be harmed. For example, a salesperson may be successful, despite a poor personal reputation, as long as the reputation of the product they are selling is not tarnished. Assuming non-managers have less to lose if caught evading and shamed in public, they are less sensitive to government enforcement efforts and evade more than managers who may risk harming their reputation if caught evading. We hypothesize that targeting non-managers that are less dependent on reputation with a higher probability of an audit would reduce their tendency to evade more.⁵

Let "taxpayer" refer to filers (i.e., individuals who file a tax return).⁶ In this paper, "tax evasion" refers to a taxpayer knowingly failing to report their correct taxable income. For example, a taxpayer may be considered a tax evader by knowingly (i) overstating deductions or expenses (e.g., medical, charitable, or business deductions), or (ii) leaving some reportable income off of a tax return.

If the government's goal is to raise tax revenue in a cost-effective manner, which (if any) occupation categories should be targeted with a higher probability of an audit? We proceed to analyze a theoretical model similar to the one presented by Allingham and Sandmo (1972) and Yitzhaki (1974); each taxpayer chooses the amount of income to declare (x) in order to maximize their expected utility ($E(U)$):

$$E(U) = (1 - p) \cdot u(w - \theta \cdot x) + p \cdot u(w - \theta \cdot x - F \cdot \theta \cdot (w - x) - s). \quad (1)$$

In Eq. (1), p ≡ probability of being audited by tax authorities; w ≡ actual income; θ ≡ income tax rate; F ≡ fine rate; s ≡ reputation-loss variable equals zero if reputation does not matter (i.e., non-manager), and is greater than zero otherwise (i.e., manager).

The proposed connection between reputation and occupation is new, i.e., if occupation success is dependent on a good reputation, then the magnitude of tax evasion should be less than if occupation success is not dependent on a good reputation. Therefore, as a policy matter, occupations and the connected relevance of reputation could be used as a distinguishing factor in categorizing groups to be targeted for income tax audits.

Deriving the condition for a person to declare less than their actual income (i.e., evade), for both a manager and a non-manager, yields the following comparison assuming (i) $u' > 0$ (derivative with respect to income is positive, i.e., more income is preferred), and (ii) $u'' < 0$ (second derivative with respect to income is negative, implying risk aversion):

$$p \cdot F < \underbrace{\left[p + (1 - p) \cdot \frac{u'(w \cdot (1 - \theta))}{u'(w \cdot (1 - \theta) - s)} \right]}_{\text{(Manager: } u'(w \cdot (1 - \theta)) < u'(w \cdot (1 - \theta) - s)}} < \underbrace{1}_{\text{(Non-manager: } u'(w \cdot (1 - \theta)) = u'(w \cdot (1 - \theta) - s)}}. \quad (2)$$

Eq. (2) illustrates that the minimum expected fine necessary to cause managers to declare their actual income (i.e., $x = w$) is less than the minimum expected fine necessary to cause non-managers to declare their actual income. The tax authority could, for example, impose the same fine (F) on all evaders, but increase the probability of an audit (p) for those (e.g., non-managers) with an occupation where success is not dependent on a good reputation and keep constant the audit probability for those fearing loss of reputation if caught cheating. The issue is whether such an action to target occupations will achieve a greater level of income declared. Theoretically the answer is yes.

To combat the higher expected evasion by non-managers, raising the audit rate may be effective.⁷ Assuming decreasing absolute risk aversion⁸:

$$\underbrace{\frac{\partial x}{\partial p} \Big|_{s=0}}_{\text{(Non-manager)}} < \underbrace{\frac{\partial x}{\partial p} \Big|_{s>0}}_{\text{(Manager)}}. \quad (3)$$

Eq. (3) in words: if reputation matters (i.e., $s > 0$), then an individual is more sensitive to a change in the probability of an audit. Therefore

States Code Service, Title 26, Internal Revenue Code (2008).

⁶ As discussed later, due to data limitations, nonfilers were dropped from the sample analyzed.

⁷ A similar argument could be made for levying different fines (rather than changing the audit rate) depending on the occupation category.

⁸ See Allingham and Sandmo (1972, pp. 327–328).

² Herman (2004, p. D1).

³ For more recent theoretical discussions, see Akerlof (1980), Bernheim (1994), and Fershtman and Weiss (1998). See also Becker (1976), Chapter 12, "A Theory of Social Interactions."

⁴ For a discussion of social norms (e.g., managers are honest because they believe most managers are honest), see Wenzel (2004, p. 225).

⁵ An argument can be made that harm to reputation is unlikely, due to the "confidentiality" of tax noncompliance investigations (see Mason and Calvin (1978, p. 75, 87), and Klepper and Nagin (1989, p. 131)); but we assume that "confidentiality" is not guaranteed. See Merry (1997 [1984]) for a discussion of gossip. The Internal Revenue Code §6103(h)(4) (disclosure in judicial and administrative tax proceedings), and §6103(k)(6) (disclosure by certain officers and employees for investigative purposes) tend to diminish the expectation of "confidential" tax investigations. United

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