Tax Avoidance and Evasion

Econ 325

Tax Avoidance and Tax Evasion

- While it's common to think of taxes as something that *must* be paid, people actually have some latitude in deciding how much they will actually pay
  - People can take efforts to *avoid* taxes (by contributing to RRSPs, by incorporating, to avoid high personal tax rates, etc.) *Avoidance* is legal.
  - People can take efforts to evade taxes (by hiding income from Revenue Canada) *Evasion* is illegal.
- The choice of how much to pay in taxes is another margin along which behavior can be distorted by taxes

Tax Avoidance and Tax Evasion

- General definitions:
  - Tax evasion: not reporting all of one's income
  - Tax avoidance: complying with tax laws, but working hard to reduce one's tax burden within the constraints of the law (i.e. exploiting loopholes)
  - While avoidance is legal, we may worry that lots of resources go into searching for and exploiting loopholes--where those resources might be better spent on "productive" activities rather than "rent-seeking" activities
    - Avoidance behaviour is essentially a manifestation of the substitution effect.

Tax Avoidance

3 Principles of Tax Avoidance

1) Postponement of taxes ($1000 in taxes paid tomorrow is preferred to $1000 in taxes paid today)
2) Tax arbitrage across individuals in different tax brackets.
3) Tax arbitrage across income streams facing different tax treatments

Tax avoidance often involves a combination of these 3 principles.

Tax Avoidance--Postponement

- Recall previous discussion of RRSPs
  - You can put up to $22,000 away each year tax deferred (meaning you don't pay taxes on it now, you pay taxes on it when you withdraw it for retirement)
  - Such postponement of tax liability is valuable for 2 reasons
    1) Bills paid later are cheaper than bills paid today (you can earn interest off the money you save now)
    2) If you're in a high tax bracket now, you can wait to pay taxes until you're in a lower tax bracket (like when your income falls in retirement)
  - RRSPs are a good example of a postponement strategy for tax avoidance

Tax Avoidance--Postponement

- Evidence that taxes affect timing of "non-economic" decisions
  - US tax system involved (until recently) a "marriage penalty" (married couples paid more than two single people cohabiting)
  - Evidence that marriage rates tended to fall in Nov-Dec. Couples would wait until Jan to marry, to postpone marriage penalty for an extra year

Tax Avoidance--Timing Activities

- Births
  - Under US tax system, you can claim a per-child exemption that amounts to a couple thousand dollars reduction in tax liability
    - Child must be born by Dec31 of tax year
    - Evidence that birth rates are higher in late December than in early January
    - Why? People have some control over birth timing (scheduled C-sections, inducements, etc.)
    - Speeding up a deduction is like postponing a tax liability

Tax Avoidance--Timing Activities

- Research by Slemrod and Kopczuk (2001) suggests that people varied the timing of their death to qualify for lower inheritance tax rates
  - Found that probability of death rose just prior to inheritance tax increases (i.e. people hurry up death to have estate taxed in low-tax regime)
  - Probability of death fell just prior to inheritance tax decreases (i.e. people wait for lower-tax regime)

Tax Avoidance--Tax Arbitrage Across Income Streams

- RRSPs also provide a means of tax arbitrage
  - People have the choice of putting savings in a savings account or an RRSP
  - Both accounts produce interest income, but they are taxed at different rates
  - Interest income in savings account is taxed at whatever your top marginal rate is
  - RRSP income is untaxed
  - Hence people have an incentive to shift money from taxable savings accounts to RRSPs
  - In fact, if interest payments are tax deductible, one could arbitrage further by borrowing to contribute to RRSP (borrow at tax deductible rate; lend at tax-free lending rate)

Tax Avoidance--Tax Arbitrage Across Income Streams

- Home production: Simple tax arbitrage
  - If you go to work and hire a nanny, you pay tax on the income you earn at work
  - If you stay home and take care of your child yourself, you get childcare (a form of in-kind income) that is not subject to income tax
  - Same with home improvements
    - Do-it-yourself work is not subject to income tax, labour component is not subject to GST
    - Basic theory of comparative advantage argues that people should hire contractors to do work in their home
      - Tax system causes distortionary incentives that induce people to do this work themselves.
      - This wouldn’t be a problem if home production were taxable

Tax Avoidance--Tax Arbitrage Across Income Streams

- U-Brew beer and wine
  - High commodity taxes are charged for beer and wine
    - Some of this may be justified on efficiency grounds if there are externalities associated with alcohol consumption
    - But that doesn't mean people won't try to avoid the tax
  - Alcoholic beverage taxes only apply to alcoholic beverages
    - Grape juice is tax-free (no GST…because it's food; no excise tax, because it's alcohol free)
    - Provides incentive for wine producers to sell juice plus yeast packet
    - Unfermented wort (for beermaking) is treated as a food product, so same rules apply

Tax Avoidance--Tax Arbitrage Across Income Streams

- In Canada, there's a huge U-Brew industry
  - Some of this is due to hobbyists who like "Do-it-Yourself" for its own sake
  - Much is due to taxation of alcoholic beverages
  - It would be much more efficient, to let the professionals make and bottle the wine and beer (economies of scale, comparative advantage, etc.)
  - But because of the tax, many of us produce these commodities ourselves

Tax Avoidance--Tax Arbitrage Across Individuals Facing Different Marginal Tax Rates

- Income-splitting is a common feature in the Canadian income tax system
  - Suppose my wife has a small business and makes $75,000 per year
  - Suppose I take care of the cat and cook meals, so my annual income is zero
  - Suppose income over $60,000 is taxed at 35% marginal rate
  - Suppose income under $20,000 is taxed at 15% marginal rate
  - By paying me to be the cook and catsitter for her business, my wife could transfer (say $15,000 from her to me) note: this isn't quite legal!

Tax Avoidance--Arbitrage Across Individuals With Different MTRs

- My wife's tax liability falls by $15,000*0.35, or $5,250
- My tax liability rises by $15,000*0.15, or $2,250
- Overall household liability falls by $3000!
- While you can't fake employ a member of your household, it might be easy to overpay a member of the household who truly works for the family business
- Or, my wife could transfer income-earning assets into my name, thereby legally shifting income from her to me (note: attribution rules in Canada limit one's ability to do this)

Tax Avoidance--Arbitrage Across Individuals With Different MTRs

- The US avoids the income-splitting problem by treating the family as the taxable unit (Canada treats the individual as the taxable unit)
  - But this may provide a strong disincentive for secondary income earner to work
  - If I took job in the US (rather than taking care of the cat) my first dollar would be taxed at my wife's highest marginal rate

The Problem with Tax Avoidance

- This attempt to find and exploit loopholes takes time (yours, and your tax lawyer's), so you end up with highly educated, productive people running around engaging in rent-seeking
  - Rent-seeking is activity that seeks to transfer economic surplus from others (e.g. the government) to oneself
  - It's unproductive. That lawyer could be designing bridges or finding a solution to global warming somewhere if she wasn't tied up helping you avoid taxes

Tax Evasion

- Examples
  - Not reporting self-employment income (especially when payments are in cash)
    - People babysit, do yardwork, give piano lessons, earn tips, etc. without reporting the income to the Canada Customs and Revenue Agency
  - Falsely claiming deductions
    - Donating rags to charity, and claiming that you really donated Versace gowns
  - Businesses keeping 2 sets of books
    - So they report lower income to tax authorities than they really earn; fail to report cash transations, etc.
  - Bartering (to avoid GST)

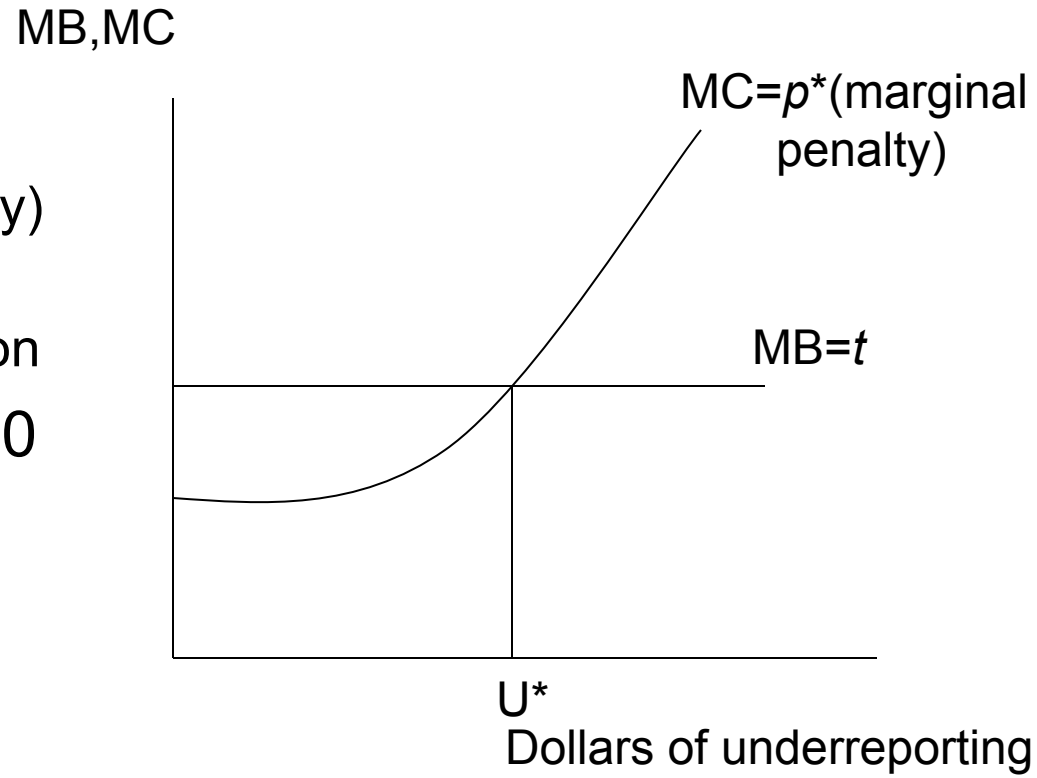
Modeling Tax Evasion

- Since evasion is illegal there are penalties (costs) associated with it
  - Arguably people will engage in tax evasion up to the point where the MC=MB to that individual
  - If the marginal tax rate is 0.3, the marginal benefit of hiding a dollar of income is $0.30
    - This is constant so long as the person remains in the same tax bracket…it would fall if they evade so much that they drop to the next lower bracket
  - marginal cost determined by the penalty and the probability of getting caught
    - MC is increasing in both the penalty and the probability of getting caught

Modeling Tax Evasion

- If *t* is marginal tax rate and *p* is probability of capture
  - MB=*t*
  - MC=*p**(marginal penalty)
  - MC is the marginal expected cost of evasion
- If *t*=0.3, then MB=$0.30

"Optimal" Tax Evasion



Predictions of the Model

- Tax evasion should increase for higher marginal tax rates (MTRs)
  - Rich will evade more than poor
  - Increases in MTRs will lead to more evasion
- Increased penalties will reduce evasion
- Increased auditing (monitoring) will reduce evasion
  - Which of these policy levers is less costly to use?

Evasion

- People may not just evade more as MTRs rise, may choose work that facilitates evasion
  - Lemieux, Fortin, and Frechette (1994) find that people are more likely to work in underground economy when MTRs increase
  - Essentially the ability to evade allows for higher MTRs to change wage differentials between different types of work
    - Take 2 jobs that pay $10 an hour and a MTR of .2; if evasion is easy in one job then, effective after tax wages are $10 for the job with easy evasion, and $8 for the other job.
    - If the MTR rises to 0.4, then the wage differential rises from $2 to $4; may cause some to switch jobs.

Evidence on Evasion

- Degree of evasion depends on ease of evasion (expected penalties)
  - In US, wage and salary income is generally reported by employers to the IRS
    - Estimates suggest that people report 99.5% of wage and salary income (because they know the IRS has a record)
    - Estimates suggest that only 41.4% of self-employment income is reported
  - Studies of taxpayers in US earning between 50k and 100k per year suggests 60% understated their tax liability, 26% reported correctly, and 14% overstated their liability (probably due to errors)

Example of Evasion in US

- The IRS suspected many taxpayers were claiming exemptions for dependents (kids) that didn't exist
  - In 1987 changed tax form to require that taxpayers list social security number of each dependent
  - Number of exemptions claimed fell by 7 million that year

Problem With Evasion

- As with avoidance, people may engage in "rent-seeking" activities to get out of paying taxes
  - This creates excess burden (DWL), because rent-seeking just transfers rents around…it is a costly activity that doesn't produce anything new for society
- Also, for both avoidance and evasion, horizontal equity is violated
  - Similar people end up paying different taxes
- If wealthy evade/avoid more, this undoes some of the progressivity in the tax system

Taxing the Rich

- Ayn Rand Atlas Shrugged (1957)
  - Depicts a world in which the “prime movers” go on strike to show how essential their contribution to society is, and to expose the obstacles society places in their way
  - In 1957 top MTR in US was 91% (for incomes higher than the equivalent of $2.3 million in $1997)

Taxing the Rich

- Are the rich really incredibly productive? Or are they just lucky? How important are they?
  - Taxes on luck are a great idea (people can't alter their luck); taxes on productive activity are more likely to have associated DWL.
  - George Gilder (1981) "a successful economy depends on the proliferation of the rich…to help the poor and middle classes, one must cut the taxes of the rich"
  - Peter Drucker (1997) "If all the super-rich people disappeared, the world economy would not even notice. The super-rich are irrelevant to the economy."

Why Are the Rich Rich?

- Possible reasons
  - Endowed with high ability, so they're very productive
    - This argues for lower MTRs to encourage that productivity
  - Lucky
    - This argues for higher MTRs
    - high MTRs can serve as insurance. People can be insured against bad luck by paying low tax rates if they don't become rich; govt can finance these low tax rates by having rich pay high tax rates
    - In this case, a progressive tax system provides a form of income insurance for everyone; if people are risk averse, this can be social welfare enhancing

Why Are the Rich Rich?

- May have different tastes for consumption vs. leisure or consumption today vs. consumption tomorrow (maybe they just work harder or save more)
  - Taxing rich more would violate horizontal and vertical equity, in this case
- Maybe they inherited
  - From a one-generation perspective taxing them doesn't seem problematic (inheritance tax doesn't change relative prices)
  - But it may deter parents from accumulating wealth; could cause them to reduce labour supply or to save less

Why Are the Rich Rich?

– Maybe they have unique skills.
  - Entrepreneurial?
  - If this is the case, these people have rare skills that we might want to be careful about deterring them with high MTRs

Rich and Avoidance/Evasion

- Rich may be particularly likely to engage in avoidance/evasion activities
  - Evidence suggests that evasion rises with income
  - They have the most to gain from finding loopholes
  - They likely know (and learn from) others who do it
- If rich are more able to wriggle away from taxes than poor, this may be an argument against very high MTRs (or stiffer penalties)
- A simpler tax code might reduce the ability of rich to wriggle away, and make progressivity less costly to implement.