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Status Seeking Taxpayer and Tax Evasion

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Status Seeking Tax Payer and Tax Evasion

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Abstract

This paper explores whether tax compliance would be affected if the tax payers are “status” seekers. If relative income is a symbol of relative status in a society, status concerned individuals would evade paying taxes more relative to the case where status is not a concern. However, such an outcome would not hold if the symbol of relative status is relative consumption of the “status” good and not relative income. We generalize the scenario by introducing a measure of relative status which depends on both relative income and consumption of the status good.

Key Words: Status-seeking behaviour; Tax evasion; Relative income; Conspicuous consumption; Inequality

JEL Classifications: H26, D31, D91, O15, H21

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I. Introduction

Economics of status dealing with status seeking behaviour of individuals and its consequences in terms of consumption, investment, poverty, inequality, growth, etc. has been discussed in various contexts. The overall literature is quite voluminous. A representative and compelling sample would be Frank (1985), Shivanathan and Petit (2010), Easterlin (2001), Corneo and Jeanne (2001), Moav & Neeman (2010), Long & Shimomura (2004), Marjit, Santra, & Hati (2015), Dwibedi & Marjit (2017), Beladi, Marjit, Oladi, & Yang (2021), Beladi, Marjit, & Hati (2024), etc. However, the relationship between status seeking behaviour and tax evasion have not been discussed much in the literature.

Status seeking behaviour is directly related to inequality which is a driving force behind conspicuous consumption and aspirational outcomes. In the most recent theoretical paper dealing with Status effect on growth, Beladi, Marjit and Hati (2024) show that if relative consumption of the status good replaces relative income as the symbol of status, status seeking behaviour cannot generate additional growth impact beyond the standard golden rule, an erstwhile foregone conclusion in many papers in the literature which have considered only relative income as the symbol of status such as **Kwamoto(Economic Theory). Long and Shimomura (2004)** The Beladi, Marjit and Hati (2024) result is significant in the sense that the positive impact of accumulation due to the status seeking behaviour, presumably among the poor, energized by the concern of status, does not materialize when only relative consumption of status good becomes pivotal as a signal of social status. If the median income of the reference group which triggers status seeking behaviour is difficult to guess, individuals may rest their perception on observed consumption of the status good. That may nullify the growth effect.

Interestingly in this paper we have a result similar in spirit which demonstrates that if relative income is the status driving variable, tax evasion would increase with status seeking behaviour relative to the standard outcome without any concern for status. However, again if we replace the status symbol with only relative consumption of the status good, the standard outcome remains unaltered i.e. the status augmenting impact does not affect the extent of tax evasion. We do have a monotonicity result. As we increase the weight of relative income as a status symbol, the extent of evasion moves up.

Our paper is most closely related to Goerke (2013) who shows that if tax payers are sensitive to relative consumption, labour supply is likely to be positively affected and increase in tax base might make evasion more attractive. Our purpose is different in many ways.

First, we approach the problem drawing from the recent literature on status seeking behaviour and show that the symbol of such status is critical in determining the extent of evasion. This result is without any explicit income effect of the emphasis on relative consumption and being concerned about the relative consumption of the status good does not affect the incentive of the tax payers to evade more

Second, the literature on economics of status has flourished quite a bit in recent years and one needs to contextualize the problem. If the tax payers only care about relative income not relative consumption, evasion must increase with status seeking behaviour and in the polar opposite case if it is guided by the relative consumption of the status good, evasion remains neutral to such a change. The secular impact of having a greater relative income compared to the median of the reference group, by itself would lead to greater evasion even when the tax payer is not bothered about relative consumption. On the other hand, just increasing relative consumption of the status good would not increase tax evasion.

Third, the Beladi, Marjit and Hati (2024) proves the growth neutrality result of relative consumption of status good. If people care to increase their consumption of status good, they may just reallocate consumption from the non-status to status good at the maximized level of the absolute level of income. There is no additional reason to invest more to expand their income. In a different context we produce a similar type of neutrality result. If boosting relative income explicitly pampers status seeking behaviour, tax payers would evade more, otherwise not.

Literature on tax evasion is quite extensive. One may look at (Slemrod & Yitzhaki (2002), Myles (2012), Hillman (2009) etc. for extensive discussion on the literature. Recent works of Epstein & Gang (2024) and Marjit, Mishra, & Mitra (2021) also contain an overview of the updated and context specific literature. Section II deals with the model and results. Section III talks about implications of other related policies. Last section concludes.

II. Model and Results

We consider income tax payers each having the following status augmented utility function

$$u(N, S) = \frac{Z}{Z} \left(\log N + \left(\frac{Z}{Z} \right) \log S \right) = \left(\frac{Z}{Z} \right) \log N + \log S \dots\dots\dots (1)$$

Where z is the variable that signals status in the society. The relative status is denoted by the status of the individual relative to the status of the median agent of the reference group, higher is the ratio, for the same level of consumption of the status good S and the non-status good N , the individual enjoys higher level of satisfaction, a kind of “Feel Good” impact. This positively affects the overall utility level. Note that \bar{Z} may not refer to the set of tax payers under consideration. It is possible that people compare themselves with the median income of the “Upper Class” of people, however defined. Whatever it is \bar{Z} is exogenous to the system.

The other term inside the bracket in equation (1) states that greater is the perceived inequality of status in the society, which is indicated by a relatively low value of Z , the marginal utility of engaging in consumption of S is higher. More unequal society stimulates status seeking behaviour as the left behind wants to mimic the consumption of the privileged more intensively. This utility function was first introduced by Marjit, Santra and Hati (2015) and has been used later focusing on various problems.

Note that in the reduced form of the above utility function, the relative status effect or the trade-off between having a higher status versus a lower status on S is symmetric and hence cancels out. Thus, having a lower status accentuates the “Feel Bad” syndrome in proportion to consumption of N . The Higher your consumption of N , the greater is your dissatisfaction.

The features of the utility function in spirit are drawn from many scattered empirical studies such as Sivanathan and Pettit (2010), Waselake, Bhatia and Brown (2018), Fafchamps and Shilpi (2008) and have been used subsequently in the papers by Dwibedi & Marjit (2017), Beladi, Marjit, Oladi, & Yang (2021) and Beladi, Marjit, & Hati (2024) etc.

Relative Z is defined as follows

$$\frac{\alpha(Y-t\tilde{Y})+(1-\alpha)S}{\bar{Z}} = \frac{Z}{\bar{Z}} \dots\dots\dots (2)$$

Status variable is a weighted average of after-tax net income where Y is actual income and \tilde{Y} is reported income. Since we do not deal with the determination of \bar{Z} we treat this as a constant. It is instructive to note that if $Z = \bar{Z}$, (1) boils down to a simple standard utility function. If $\alpha = 0$ in (2), the measure of status is entirely determined by S , if $\alpha = 1$, entirely in terms of after-tax net income.

From (1), the utility maximization subject to the budget constraint with P as the relative price of the status good, yields (3)

$$\text{Max } L \equiv \frac{\alpha(Y-t\tilde{Y})+(1-\alpha)S}{\bar{Z}} \log N + \log S + \lambda[(Y - t\tilde{Y}) - (PS + N) - F(Y - \tilde{Y})q] \dots\dots(3)$$

$0 < q = \text{Audit Probability} < 1, F(.) \text{ penalty function } F' > 0, F'' > 0$

Optimally choosing $\tilde{Y} \rightarrow$ reported income

$$\frac{dL}{d\tilde{Y}} = \left[\frac{\delta L}{\delta N} \frac{dN}{d\tilde{Y}} + \frac{\delta L}{\delta S} \frac{dS}{d\tilde{Y}} + \frac{\delta L}{\delta \lambda} \frac{d\lambda}{d\tilde{Y}} \right] + \lambda[-t + F' \times q] - \frac{\alpha t \log N}{\bar{Z}} = 0 \dots\dots (4) \quad ; Y, t \text{ given}$$

$\left[\frac{\delta L}{\delta N} \frac{dN}{d\tilde{Y}} + \frac{\delta L}{\delta S} \frac{dS}{d\tilde{Y}} + \frac{\delta L}{\delta \lambda} \frac{d\lambda}{d\tilde{Y}} \right] = 0$ due to envelope property when (S, N and λ) are chosen at the optimum level.

$$\frac{dL}{d\tilde{Y}} = 0 \Rightarrow (F'q - t)\lambda = \frac{\alpha t \log N}{\bar{Z}}$$

$$\text{Or, } F' = \frac{t}{q} \left(1 + \frac{\alpha \log N}{\bar{Z} \lambda} \right) \dots\dots\dots (5)$$

Observation - I

If status concern is not related to $(Y, t\tilde{Y})$ i. e. $(\alpha = 0)$ and only to S i. e. $(1 - \alpha = 1)$

$$(5) \text{ boils down to } F' = \frac{t}{q} \dots\dots (6)$$

$$\text{Now, } U = \left(\frac{S}{\bar{S}} \right) \log N + \log S \dots\dots\dots(7)$$

Follow (4) and envelope conditions which assume existence of optimal solutions, to derive

$$\frac{dL}{d\tilde{Y}} = 0 \Rightarrow (F'q - t) = 0 \dots\dots\dots(8)$$

As t/q is a constant and (8) is identical to (6)

$(Y - \tilde{Y})$ won't change².

With no status concern reflected in terms of relative income, the extent of evasion would be exactly equal to the one where only $\frac{S}{\bar{S}}$ enters as the symbol of status. Thus, status or no status the extent of evasion remains the same. Also note that from (8) as long as t/q does not change $(Y - \tilde{Y})$ won't change. The extent of evasion would not respond to the level of Y .

² If extra consumption of S alters Y via labour supply impact, there is an additional effect on Y as in Goerke (2013). But that would raise the penalty cost of evasion and reduce evasion, the Goerke (2013) result. Here, there is no labor supply effect, hence that avenue is closed down. As long as Y is exogenous the neutrality of secular impact of $\frac{S}{\bar{S}}$ on E would prevail.)

Obrvation - II

Since only $\frac{S}{\bar{S}}$ as a symbol of status does not serve our current purpose i.e. determination of optimal evasion we work with $\alpha = 1$ when only relative income features as a status variable to highlight our conjecture.

From (5), using FOC for optimal N and substituting for λ we get,

$$F' = \frac{t}{q} \left(1 + \frac{\alpha}{A} \right) \quad (9)$$

where $A = \alpha(Y - t\tilde{Y}) + (1 - \alpha)S$

For $\alpha = 1$, (9) finally boils down to

$$F' = t/q \left[1 + \frac{1}{(Y-t\tilde{Y})} \right] \quad \dots\dots\dots (10)$$

Thus, we have following proposition

Proposition: Given the parameters, the extent of evasion $(Y - \tilde{Y})$ is greater with status concern driven by relative income as $F' > 0, F'' > 0$.

Proof - From (10), $F' > t/q$, hence $(Y - \tilde{Y})$ is greater compared to (9) as $F'' > 0$. QED

Without the status effect $(Y - \tilde{Y})$ is constant as evident from (8). Any increase in Y would be matched by an increase in \tilde{Y} such that $(Y - \tilde{Y})$ doesn't change. With status effect captured by relative after-tax income, the result changes substantially. Now for each level of true or actual income, the extent of evasion is greater.

Various interesting ramifications are being worked out to highlight the relationship between status and tax evasion. One such case is the impact of a rise in P_s . One can easily show that more expensive status good would induce tax payers to evade more if relative income is the signalling device of status. Hence more expensive status good would intensify status seeking behaviour. However, when signalling device is relative expenditure on status good. that effect would vanish.

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