Chapter 3

Attitudes toward Tax Evasion and the Choice of Self-Employment

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ABSTRACT

It is generally believed that self-employment offers ample opportunities for tax evasion. Therefore, this paper examines whether attitudes toward tax evasion has any influence on the choice of self-employment. Our analysis, based on a random sample of Americans, indicates that an individual who believes that tax evasion is “not wrong and a bit wrong” is more likely to be self-employed as compared to an individual who believes that tax evasion is “wrong and seriously wrong.” This decision is not affected by gender. In addition, our analysis finds that a self-employed person earns more income than a person who works for someone else. However, an individual who believes that tax evasion is “wrong and seriously wrong” earns more than an individual who believes that tax evasion is “not and a bit wrong”. Moreover, a self-employed person who believes that tax evasion is “not and a bit wrong” earns less than all other people, with all other parameters being the same.

INTRODUCTION

The purpose of this paper is to investigate the link between attitudes toward tax evasion and the choice of self-employment. Tax evasion involves falsification of the true state of affairs to tax authorities with a view to reduce taxes. Taxes evaded can be both direct taxes such as income tax and indirect taxes such as excise duties and sales tax. Falsifications typically include understating incomes and profits or gains and overstating deductions. Other forms of tax evasions include transfer of assets or incomes to others, recording personal expenses as business expenses, paying employees off-the-books, farming out work to small firms, or paying the self-employed or illegal immigrant to do the work for below-minimum wages. Tax evasion is pervasive as long as taxes exist. It is a growing problem in most countries (Torgler, 2002). It is an important problem to investigate for several reasons. Tax evasion can reduce governments’
Attitudes toward Tax Evasion and the Choice of Self-Employment

revenue forcing them to consider other forms of proceeds. It can also increase tax burden of the people who comply with the tax laws. Furthermore, it can also increase the cost of tax collection. Tax evasion has significant economic impacts. For example, tax evasion can lead to misallocation of resources by encouraging individuals to invest in activities that have tax evasion opportunities. Since individuals generally make decisions based on after-tax returns, tax evasion can cause unacceptable behavioral changes. For example, people will prefer to work off-the-books if they can get higher wages.

People are attracted to self-employment because of many conveniences it provides to the self-employed. However, self-employment also involves considerable risks. For example, wage and salary employment provides certain income whereas self-employment income is uncertain. The taxation of wage incomes is different from taxation of self-employment income in the U.S.

As a result, tax rates have significant impact on the decision whether to go for self-employment. In addition, self-employment provides ample opportunities for tax evasion. The purpose of this paper is to examine the relationship between attitudes towards tax evasion and decisions to work as self-employed.

This paper is organized into five sections. We provide a brief review of literature in the next section followed by a set of hypothesis. We then provide the methodology and results of our analysis. This paper is closed with discussions and conclusions.

LITERATURE REVIEW

Tax Evasion

The tax evasion problem in economics is modeled as a problem of decision making under uncertainty. A person who cheats on taxes gains because of lower taxes. However, if he is caught, he loses because of penalty and other sanctions. One of the earliest economic analyses of crimes that include tax evasion developed as a decision making problem under uncertainty is by Becker (1968). His model minimizes the sum of losses due to damages of crimes and costs of catching, convicting and punishing for crimes. Allingham and Sandmo (1972) provide a theoretical model based on Becker (1968)'s analysis. Theoretical models, including those by Yitzhaki (1974), Graetz and Wilde (1985), and Pestieau and Possen (1991), indicate that reported income is positively related to income, detection rate, and penalties. In addition, if penalty structure is based on the amount of taxes underreported, then lower tax rates will lead to more evasion.

Taxes and evasion have been subjects of extensive research. Morality, justice, fairness, and a variety of factors have been used to justify and attack taxes and tax evasion. People have always protested against taxes. They have used revolts (Edwards & Mitchell, 2008), demanded tax reforms (Schlaes, 1999), proposed new tax system such as flat tax or consumption tax (Boortz & Linder, 2005; Hall & Rabushka, 1985; Hultberg, 1996) and used other means to mitigate the impact of taxation. There is also extensive research questioning whether the tax burden is shared equitably by different income groups. Most of these analyses focus on whether higher income people should pay a higher share of their income and whether they are paying a fair share or not (see for example Thorndike and Ventry, 2002; McGee, 2012). Blum & Kalven (1953) challenge whether progressive taxation is desirable as it is detrimental unless diminishing marginal utility of money can be proved. Some have even questioned taxes on legal grounds. On the other hand, many scholars have come up with creative arguments in favor of taxes and