
Killing two birds with one stone: Reducing fiscal and welfare loss of tax evasion

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Abstract

Tax evasion constitutes not only fiscal losses for governments, but also creates welfare losses by inducing socially wasteful activities, e.g. by making taxpayers spend real resources in order to conceal their taxable income. In this paper, we study how these fiscal and welfare losses are influenced by two parameters of the audit selection mechanism (ASM): The basic probability that a taxpayer is selected for audit and the sensitivity of a taxpayer's audit probability to income reported by her and by other taxpayers.

We formulate a model of tax compliance in a world where costly concealment activities are possible. In the model, each taxpayer decides how much of his income to declare and how much to invest into the concealment activities. The concealment investment determines the probability that tax evasion is verifiable by the tax authority. The model predicts that increasing sensitivity of the ASM reduces both the fiscal and social loss of tax evasion, while increasing the basic audit probability reduces the fiscal loss but increases the social loss of tax evasion.

We test predictions of the model in an economic experiment. We used two levels for the basic audit probability and three levels for the sensitivity parameter in order to study how the ASM affects reported incomes and concealment investment chosen by the experimental taxpayers. Thus, the experiment tests six treatments, one for each combinations of the ASM parameters. Each experimental session consists of 20 rounds. The subjects were divided into pairs of peer taxpayers, so the audit probability was a function of the difference of their reported incomes. We ran 6 sessions, one session per treatment, with 15-20 participants each. The total number of participants was 110. The experimental results confirm that increasing sensitivity of the ASM leads to better outcomes than increasing the audit probability.

Keywords: tax evasion, audit selection mechanism, tournament

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