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Tax evasion, fiscal competition and economic integration

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Abstract

This paper examines the implications of tax evasion for fiscal competition and tax harmonization policies in an economic union. First, for symmetric countries, it proves that the equilibrium values of the tax and audit rates are less than optimal. Tax harmonization alone will also lead to a less than optimal audit rate. Second, for asymmetric countries, the paper shows that integration may turn an honest country into an evading one. It argues that tax harmonization alone may be a bad policy in that it can make both countries worse off. It may also cause an otherwise honest country to turn to evasion. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

An important policy aspect of the recent trends towards international economic integration, both in Europe and North America, is its fiscal implications.

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A central concern has been that tax competition would lead to a lowering of tax revenues and suboptimal levels of expenditures on public goods and social policies. The solution to this problem has then been sought in some form of tax coordination among countries. The purpose of this paper is to take a fresh look at the tax competition problem, and the effectiveness of fiscal coordination policies, in the presence of tax evasion.

Economic integration enhances mobility of goods, capital and people. This increases the potential for movements of tax bases among nations. Consequently, member states may attempt to expand their individual tax base by engaging in tax competition. It is this process that is often expected to lead to less than optimal tax rates and public expenditure levels.¹ It is also naturally believed that one can prevent such inefficiencies by following certain tax harmonization policies. The results mirror earlier such results in the fiscal federalism literature. It has long been recognized in that literature that mobility of tax base between lower level jurisdictions, creates a potential for an efficiency loss due to non-cooperative tax setting, and which can be corrected through policy coordination.²

The literature has thus far ignored the problem of tax evasion.³ This is a serious omission as tax evasion has important implications for tax competition and fiscal coordination. In the presence of tax evasion, tax revenues are not determined solely by the different countries' 'legislated' tax rates but also by their enforcement policies. This observation implies that the audit strategy becomes an *added* policy tool for tax competition. To avert this inefficiency, the two countries must thus harmonize their tax rates *and* audit strategies. This is an important policy implication which has gone unnoticed.

Whether or not full coordination would take place is of course an open question. However, it is important to bear in mind that coordinating in audit strategies may prove more problematic than harmonizing tax policies. It is true that full coordination would generally benefit all parties. Nevertheless such a policy may never take hold. Any attempt at harmonizing audit strategies would face a particular difficulty. Legislated tax rates are publicly observable. As such, adherence to agreed upon tax policies can easily be checked and verified by all countries concerned. This is clearly not the case for audit strategies. The

¹ Mintz and Tulkens (1986) have pointed out that tax competition may also result in 'excessive' tax rates. However, it is the less-than-optimal-tax-rates result which has received the greatest share of attention. See, e.g., Sinn (1994) and Edwards and Keen (1996).

² The recent literature on tax competition and tax harmonization also include Keen (1989), Sinn (1990) and Kanbur and Keen (1993). On the earlier literature on fiscal federalism, see, among others, Stigler (1957), Oates (1972), Zodrow and Mieszkowski (1986), Wilson (1986) and Wildasin (1989).

³ In a recent paper, Xiwen and Wilson (1996) study the implications of tax evasion for the structure of optimal taxes on capital incomes from home and abroad.

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