



A dynamic portfolio choice model of tax evasion: Comparative statics of tax rates and its implication for economic growth

Wen-Zhung Lin^a, C.C. Yang^{b,*}

^a*Department of International Trade, Lunghwa Institute of Technology, Tauryuarn, Taiwan*

^b*Institute of Economics, Academia Sinica, Nankang, Taipei 115, Taiwan*

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Abstract

This paper extends the portfolio choice model of tax evasion from a static to a dynamic setting. It is shown that while higher tax rates *repress* tax evasion in the static model, they *encourage* tax evasion in the dynamic model. We explore a novel implication of this result and show that while growth is *decreasing* in tax rates in the absence of tax evasion, it is *U-shaped* in tax rates in the presence of tax evasion. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Starting from the seminal paper by Allingham and Sandmo (1972), the standard approach to tax evasion has been based on the economics of decision

* Corresponding author. Tel.: 886-2-27822791; fax: 886-2-27853946.

E-mail address: ccyang@ieas.econ.sinica.edu.tw (C.C. Yang).

making under risk. In particular, declaring income is viewed as being analogous to purchasing a safe asset, while concealing income is viewed as being analogous to purchasing a risky asset. The tax evasion problem facing an individual then essentially becomes a portfolio selection issue.

In the Allingham–Sandmo model, taxpayers are assumed to pay a penalty on their *concealed income* if the act of evasion is caught. This assumption leads to the result that a tax rate change will have an ambiguous impact on evasion, for there exist two opposing effects, an income effect and a substitution effect. Following Yitzhaki's (1974) modification of the Allingham–Sandmo model, most models of tax evasion now assume that the penalty is levied on the *evaded tax*, as it is under most tax laws. This modification yields no substitution effect, and hence leads to an unambiguous result that an increase in tax rates reduces tax evasion.

It is intuitively appealing, however, to speculate that higher tax rates will *encourage* rather than *repress* evasion. This commonly held view comes from both academic and nonacademic circles. In a report by *The Economist* (May 28, 1994) on how to reduce tax evasion, lowering tax rates is regarded as one of the best ways of accomplishing this goal. Ching (1996) reported in the *Far Eastern Economic Review* (April 20, 1996) that tax rates would be greatly reduced to lessen the incentives for tax evasion, according to a tax reform bill that Philippine President Fidel Ramos had in mind. Roubini and Sala-i-Martin (1995, Eq.(4)) simply impose a positive relation between evasion and tax rates in their study of the effect of financial repression on growth. Using panel data that trace the tax returns of the same individuals before and after the 1986 Tax Reform Act, Feldstein (1995, p. 555) suggests: “high marginal tax rates may induce taxpayers to take more ‘aggressive’ interpretations of tax rules (e.g., claiming questionable deductions) or even to evade taxes by understating income or claiming unjustified deductions”.

Though not unanimous, there is much evidence in support of the intuition that higher tax rates encourage rather than repress tax evasion.¹ Several authors, including Cowell and Gordon (1988), Gordon (1989), Yaniv (1994), and Myles and Naylor (1996) have tried to build theoretical models which are capable of producing a prediction that is consistent with this evidence.

In this paper we extend the portfolio choice model of tax evasion from a static to a dynamic setting. The dynamic model, as will be seen, enables us to reverse the counterintuitive prediction of the static model regarding the impact of a tax rate change on evasion. A novel implication of our finding for economic growth is also explored.

¹ See, for example, Clotfelter (1983), Tanzi (1983), Crane and Nourzad (1986), Baldry (1987), Poterba (1987), Alm et al. (1991), Pommerehne and Weck-Hannemann (1996), and Blacksmore et al. (1996).

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