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Austerity and tax compliance*

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Abstract

Relying on a novel measure of VAT compliance in a panel of 35 countries, we document a robust negative response of tax compliance to changes in tax rates. In order to rationalize this finding, we develop a theoretical framework where heterogeneous firms adjust the share of declared activity. We calibrate the model using firm-level data in Greece, and find large leakages following the recent austerity plans. We then show how differences in financial development and the size of economic activity at the margin of informality are able to explain the heterogeneous response of tax compliance to tax rates across countries.

JEL Classification Codes: E02, E62, H26.

Key words: austerity, tax compliance, credit frictions.

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