1. INTRODUCTION

This paper investigates the desirability of tax evasion as a mechanism for reducing the time-inconsistency problem in fiscal policy. It endogenises the auditing rates and punishment rates and shows that when the government cannot commit to future tax rates, tolerating tax evasion is optimal. The government can, by committing to low auditing and punishment rates, limit the effectiveness of income taxes in the future. Furthermore we seek to establish which types of economies that would rely on evasion as a "disciplinary mechanism."

The contribution of the paper, apart from endogenising the enforcement system, is to provide answers to several issues that have been raised in the evasion literature. We list the most important achievements of the paper below:

(1) Previous literature studying tax evasion and optimal auditing mechanisms generally concludes that maximum enforcement and consequently zero tax evasion are optimal (e.g. auditing everyone, or auditing very few and setting the punishment very high). However, despite the findings of the theory, actual governments seem to tolerate tax evasion. This paper provides an answer to the following question: Why
is tax evasion tolerated in equilibrium? We argue that an optimal outcome lies between the zero and the maximum enforcement. This is so because tax evasion may act as partial solution to the time inconsistency problem. The reason is that evasion makes the tax base more elastic and as a consequence the optimal tax rate lower. So by making the tax base more elastic the optimal tax rate without precommitment gets closer to the optimal tax rate with precommitment. Infact Boadway and Keen (1998) independently reached similar conclusions in a slightly different model than ours.¹

(2) Standard models of tax evasion view the fiscal policy decision, at the time when it is taken, as distinct from the auditing-punishment decision. More precisely, when the tax system is decided upon the enforcement structure is taken as given. This reflects the idea that changing size of (or influencing) the inspection authority, or changing penalty structure, etc. can be done less frequently or less rapidly than changing fiscal policy. That is, the tax system is viewed as more discretionary than the enforcement system. However one could criticise this view by saying that a government could arrange differently, having a system with more discretion in enforcement. But if the tax system itself is discretionary (i.e. the tax rates cannot be precommitted to in advance) it may actually be desirable to operate the enforcement system under less discretion than the fiscal system. In this way the government strategically precommit to an enforcement system such that evasion occurs in equilibrium. This helps solving in part the precommitment problem in fiscal policy.

(3) As pointed out by some authors, theoretically an increase in the tax rate may reduce the evaded amount. This may happen when the income effect (from a tax increase) makes the evader less willing to take on risk, and therefore declares more income (i.e. distribute consumption possibilities more evenly across the risky states). However, this result depends entirely on the enforcement system. However, as we argue in this paper, such an enforcement system may not be desirable. That is, it may not be optimal to operate an auditing and punishment system such that when taxes are increased there is a reduction in tax evasion. Precisely because the evaded income has to increase as the tax rate increases, for tax evasion to act as a partial solution to a time-inconsistency problem. Therefore we would expect governments to arrange their enforcement systems accordingly.

¹ I was not aware that Boadway and Keen were working on this topic until Mick Keen sent me their paper just before the IIPF Kyoto conference.