Lecture 7: Tax Enforcement

Stefanie Stantcheva

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GOALS OF THIS LECTURE

1) Theoretically model tax enforcement, tax evasion, and avoidance in simple ways.

2) Study empirical evidence on tax avoidance and evasion and effects of policies.
Most models of optimal taxation (income or commodity) assume away enforcement issues. In practice:

1) Enforcement is costly (eats up around 10% of taxes collected in the US) when combining costs for government (tax administration) and private agents (tax compliance costs)

2) Substantial tax evasion (15% of under-reported income in the US federal taxes). Tax evasion much worse in developing countries

Two widely used surveys:

Andreoni, Erard, Feinstein JEL 1998

Slemrod and Yitzhaki Handbook of PE, 2002
Seminal in the theoretical tax evasion literature. Uses the Becker crime model

Individual taxpayer problem:

$$\max_{\bar{w}} \quad (1 - p) \cdot u(w - \tau \cdot \bar{w}) + p \cdot u(w - \tau \cdot \bar{w} - \tau (w - \bar{w})(1 + \theta)),$$

where $w$ is true income, $\bar{w}$ reported income, $\tau$ tax rate, $p$ audit probability, $\theta$ fine factor, $u(.)$ concave.

Let $c^{No\, Audit} = w - \tau \cdot \bar{w}$ and $c^{Audit} = w - \tau \cdot \bar{w} - \tau (w - \bar{w})(1 + \theta)$

FOC in $\bar{w}$: $-\tau (1 - p) u'(c^{No\, Audit}) + p \theta \tau u'(c^{Audit}) = 0 \Rightarrow$

$$\frac{u'(c^{Audit})}{u'(c^{No\, Audit})} = \frac{1 - p}{p \theta}$$

SOC $\Rightarrow \tau^2 (1 - p) u''(c^{No\, Audit}) + p \tau^2 \theta^2 u''(c^{Audit}) < 0$


**ALLINGHAM-SANDMO JPUBE’72 MODEL**

**Result:** Evasion $w - \bar{w}$ ↓ with $p$ and $\theta$

Proof of $d\bar{w}/dp > 0$: Differentiate FOC with respect to $p$ and $\bar{w}$:

$\left[-dp \cdot \tau u'(c^{\text{No Audit}}) - d\bar{w} \cdot \tau^2 (1 - p) u''(c^{\text{No Audit}}) = dp \cdot \theta \tau u'(c^{\text{Audit}}) + d\bar{w} \cdot p \theta^2 \tau^2 u''(c^{\text{Audit}})\right]$

$\Rightarrow d\bar{w} \cdot \left[-\tau^2 (1 - p) u''(c^{\text{No Audit}}) - p \theta^2 \tau^2 u''(c^{\text{Audit}})\right] = dp \cdot \left[\theta \tau u'(c^{\text{Audit}}) + \tau u'(c^{\text{No Audit}})\right]$

Similar proof for $d\bar{w}/d\theta > 0$

Huge literature built from the A-S model [including optimal auditing rules]
Why is tax evasion so low in OECD countries?

Key puzzle: US has low audit rates ($p = .01$) and low fines ($\theta \simeq .2$). With reasonable risk aversion (say CRRA $\gamma = 1$), tax evasion should be much higher than observed empirically.

Two types of explanations for puzzle

1) **Unwilling to Cheat:** Social norms and morality [people dislike being dishonest and hence voluntarily pay taxes]

2) **Unable to Cheat:** Probability of being caught is much higher than observed audit rate because of 3rd party reporting:

Employers double report wages to govt (W2 forms), companies and financial institutions double report capital income paid out to govt (US 1099 forms)
DETERMINANTS OF TAX EVASION

Large empirical literature studies tax evasion levels and the link between tax evasion and (a) tax rates, (b) penalties, (c) audit probabilities, (d) prior audit experiences, (e) socio-economic characteristics.

Early literature relies on observational [non-experimental] data which creates serious identification and measurement issues:

(1) Evasion is difficult to measure

(2) Most independent variables [audits, penalties, etc.] are endogenous responses to evasion and also difficult to measure

⇒ Requires to use experimental data or to find good instruments: (a) IRS Tax Compliance Measurement Studies (TCMP), (b) lab experiments, (c) field experiments
TCMP: IMPACT OF THIRD PARTY REPORTING

IRS Tax Compliance Measurement Study (TCMP) is a thorough audit of stratified sample of tax returns done periodically. TCMP shows that:

1) Tax Gap is about 15%

2) Tax Gap concentrated among income items with no 3rd party reporting (such as self-employment income)

- tax gap over 50% when little 3rd party reporting [consistent with Allingham-Sandmo]

- Tax Gap very small (< 5%) with 3rd party reporting
Tax Gap “Map”
Tax Year 2006 ($ billions)

Total Tax Liability
$2,660

Nonfiling
$28

Individual Income Tax
$235

Corporation Income Tax
$67

Employment Tax
$72

Estate Tax
$2

Excise Tax
#

Underpayment
$46

Individual Income Tax
$36

Corporation Income Tax
$4

Employment Tax
$4

Estate Tax
$2

Excise Tax
$0.1

Categories of Estimates
- Actual Amounts
- Updated Estimates
- No Estimates Available

Gross Tax Gap: $450
(Voluntary Compliance Rate = 83.1%)

Underreporting
$376

FICA Tax on Wages
$14

Self-Employment Tax
$57

Unemployment Tax
$1

Small Corporations (assets < $10m)
$19

Large Corporations (assets ≥ $10m)
$48

Non-Business Income
$68

Business Income
$122

Credits
$28

Net Tax Gap: $385
(Tax Never Collected)
(Net Compliance Rate = 85.5%)

Enforced & Other Late Payments of Tax
$65

Underreporting
$376

Federal Income Tax
$28

Credits
$28

Enforcement
$65

Tax Paid Voluntarily & Timely: $2,210

Internal Revenue Service, December 2011

Source: IRS (2012)
Chart 1: Effect of Information Reporting on Taxpayer Compliance

Tax Year 2006 Individual Income Tax Underreporting Gap and Net Misreporting Percentage, by “Visibility” Category

Underreporting Gap

<table>
<thead>
<tr>
<th>Category</th>
<th>Gap</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Amounts subject to substantial information reporting</td>
<td>$11B</td>
<td>1%</td>
</tr>
<tr>
<td>(Wages &amp; salaries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>II. Amounts subject to substantial information reporting</td>
<td>$12B</td>
<td>8%</td>
</tr>
<tr>
<td>(Pensions &amp; annuities, unemployment compensation, dividend income,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>interest income, Social Security benefits)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>III. Amounts subject to some information reporting</td>
<td>$84B</td>
<td>11%</td>
</tr>
<tr>
<td>(Deductions, exemptions, partnership/S-Corp income, capital gains,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>alimony income)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IV. Amounts subject to little or no information reporting</td>
<td>$120B</td>
<td>56%</td>
</tr>
<tr>
<td>(Nonfarm proprietor income, other income, rents and royalties,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>farm income, Form 4797 income, adjustments)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

NOTE: Net Misreporting Percentage is defined as the net misreported amount of income as a ratio of the true amount.

Internal Revenue Service, December 2011

Source: IRS (2012)
3) Tax Withholding further reduces tax gap: liquidity constraint effect is most likely explanation: some taxpayers can never pay the tax due unless it is withheld at source

⇒ wage income withholding is critical for enforcement of broad based income tax and payroll taxes

Numbers from TCMP are rough estimates because audits cannot uncover all evasion [IRS blows up uncovered evasion by factor 3-4] ⇒ Thorough audits detect evasion of only about 4% of income
LAB EXPERIMENTS

Multi-period reporting games involving participants (mostly students) who receive and report income, pay taxes, and face risks of being audited and penalized

1) Lab experiments have consistently shown that penalties, audit probabilities, and prior audits increase compliance (e.g., Alm, Jackson, and McKee, 1992)

2) But when penalties and audit probabilities are set at realistic levels, their deterrent effect is quite small [Alm, Jackson, and McKee 1992] ⇒ Laboratory experiments tends to predict more evasion than we observe in practice

Issues: Lab environment is artificial, and therefore likely to miss important aspects of the real-world reporting environment [3rd party information and social norms]
FIELD EXPERIMENTS

1) Blumenthal, Christian, Slemrod NTJ’01 study the effects of normative appeals to comply: treatment group receives letter encouraging compliance on normative grounds “support valuable services” or “join the compliant majority”, control group [no letter]

⇒ No (statistically significant) effect of normative appeals on compliance overall

2) Slemrod, Blumenthal, Christian JPubE’01 study the effects of “threat-of-audit” letters

⇒ Statistically significant effect on reported income increase, especially among the self-employed [“high opportunity group”] but very small sample size

Recently: (a) Hallsworth et al. (2014) show that normative appeals help in collecting overdue taxes [but small quantitatively], (b) Bott et al. 2014 for a randomized experiment in Norway on foreign income [threat of audit more effective than normative appeal], (c) see survey Luttmer-Singhal ’14
Does Normative Appeals Affect Tax Compliance?

Table 2

<table>
<thead>
<tr>
<th></th>
<th>Federal Taxable Income</th>
<th>MN Tax Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Treated</td>
<td>Control</td>
</tr>
<tr>
<td>1994</td>
<td>$26,927</td>
<td>$26,940</td>
</tr>
<tr>
<td>1993</td>
<td>$26,346</td>
<td>$26,449</td>
</tr>
<tr>
<td>1994–1993</td>
<td>$580</td>
<td>$491</td>
</tr>
<tr>
<td>% with 94–93</td>
<td>54.3</td>
<td>53.9</td>
</tr>
<tr>
<td>n</td>
<td>31,149</td>
<td>15,624</td>
</tr>
</tbody>
</table>

Notes:
Number in parentheses is the standard error.
The mean of “Treated–Control” may differ from the mean of “Treated” minus the mean of “Control” due to rounding error.

Source: Blumenthal et al. (2001), p. 131
Table 4
Average reported federal taxable income: differences in differences for the whole sample and income and opportunity groups

### Whole sample (weighted)

<table>
<thead>
<tr>
<th></th>
<th>Treatment</th>
<th>Control</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>23,781</td>
<td>23,202</td>
<td>579</td>
</tr>
<tr>
<td>1993</td>
<td>23,342</td>
<td>22,484</td>
<td>858</td>
</tr>
<tr>
<td>94–93</td>
<td>439</td>
<td>717</td>
<td>–278</td>
</tr>
<tr>
<td>S.E.</td>
<td>464</td>
<td></td>
<td></td>
</tr>
<tr>
<td>%w/increase</td>
<td>54.4%</td>
<td>51.9%</td>
<td>2.5%***</td>
</tr>
<tr>
<td>n</td>
<td>1537</td>
<td>20,831</td>
<td></td>
</tr>
</tbody>
</table>

### Low income

<table>
<thead>
<tr>
<th></th>
<th>Treatment</th>
<th>Control</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>7473</td>
<td>3992</td>
<td>3481</td>
</tr>
<tr>
<td>1993</td>
<td>971</td>
<td>787</td>
<td>183</td>
</tr>
<tr>
<td>94–93</td>
<td>6502</td>
<td>3204</td>
<td>3298</td>
</tr>
<tr>
<td>S.E.</td>
<td>2718</td>
<td></td>
<td></td>
</tr>
<tr>
<td>%w/increase</td>
<td>65.4%</td>
<td>51.2%</td>
<td>14.2%*</td>
</tr>
<tr>
<td>n</td>
<td>52</td>
<td>123</td>
<td></td>
</tr>
</tbody>
</table>

Source: Slemrod et al. (2001), p.466
Kleven-Knudsen-Kreiner-Pedersen-Saez ’11 analyze bigger Danish income tax auditing experiment [stratified sample 40,000]

Overall detected evasion [no adjustment] is around 2.5% but:

1) Evasion rate for self-reported items is almost 40%

2) Evasion rate for third party reported items is only 0.3%

3) Overall evasion rate is so low because 95% of income is third party reported in Denmark

Role of 3rd party reports [information structure] seem to trump social factors and economic factors:

$$\text{Evade}_i = \alpha + \beta \text{Self Reported Income}_i + \gamma \text{Social Factors}_i + \varepsilon_i$$
# Self-Reported vs. Third-Party Reported Income

## Pre-audit net income

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Third-party</th>
<th>Self-reported</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount</td>
<td>206,038</td>
<td>195,969</td>
<td>10,069</td>
</tr>
<tr>
<td>Percent</td>
<td>98.38</td>
<td>98.57</td>
<td>38.18</td>
</tr>
</tbody>
</table>

## Under-reporting of income

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Third-party</th>
<th>Self-reported</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount</td>
<td>4,255</td>
<td>536</td>
<td>3,719</td>
</tr>
<tr>
<td>Percent</td>
<td>8.39</td>
<td>1.72</td>
<td>7.28</td>
</tr>
</tbody>
</table>

Source: Kleven et al. (2010)
### Determinants of the Probability of Audit Adjustment: Social, Economic, and Information Factors

<table>
<thead>
<tr>
<th></th>
<th>Social factors</th>
<th>Socio-economic factors</th>
<th>Information factors</th>
<th>All factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>14.42 (0.64)</td>
<td>11.92 (0.66)</td>
<td>1.44 (0.25)</td>
<td>3.98 (0.62)</td>
</tr>
<tr>
<td>Female</td>
<td>-5.76 (0.43)</td>
<td>-4.45 (0.45)</td>
<td></td>
<td>-2.05 (0.41)</td>
</tr>
<tr>
<td>Married</td>
<td>1.55 (0.46)</td>
<td>-0.36 (0.48)</td>
<td></td>
<td>-1.64 (0.44)</td>
</tr>
<tr>
<td>Member of church</td>
<td>-1.98 (0.59)</td>
<td>-2.67 (0.58)</td>
<td></td>
<td>-1.19 (0.54)</td>
</tr>
<tr>
<td>Copenhagen</td>
<td>-0.29 (0.67)</td>
<td>1.20 (0.67)</td>
<td></td>
<td>1.00 (0.62)</td>
</tr>
<tr>
<td>Age above 45</td>
<td>-0.37 (0.45)</td>
<td>-0.35 (0.45)</td>
<td></td>
<td>0.10 (0.42)</td>
</tr>
<tr>
<td>Home owner</td>
<td></td>
<td></td>
<td></td>
<td>-0.35 (0.46)</td>
</tr>
<tr>
<td>Firm size below 10</td>
<td></td>
<td></td>
<td></td>
<td>2.97 (0.76)</td>
</tr>
<tr>
<td>Informal sector</td>
<td></td>
<td></td>
<td></td>
<td>-0.99 (0.79)</td>
</tr>
<tr>
<td>Self-Reported Income</td>
<td></td>
<td></td>
<td>9.47 (0.53)</td>
<td>9.72 (0.54)</td>
</tr>
<tr>
<td>Self-Reported Income &gt; 20K</td>
<td></td>
<td></td>
<td>17.46 (0.91)</td>
<td>17.08 (0.92)</td>
</tr>
<tr>
<td>Self-Reported &lt; -10K</td>
<td></td>
<td></td>
<td>14.63 (0.72)</td>
<td>14.53 (0.72)</td>
</tr>
<tr>
<td>Audit Flag</td>
<td></td>
<td></td>
<td>15.48 (0.59)</td>
<td>15.32 (0.60)</td>
</tr>
<tr>
<td>R-square</td>
<td>1.1%</td>
<td>2.1%</td>
<td>17.1%</td>
<td>17.4%</td>
</tr>
<tr>
<td>Adjusted R-square</td>
<td>1.0%</td>
<td>2.1%</td>
<td>17.1%</td>
<td>17.4%</td>
</tr>
</tbody>
</table>

Source: Kleven et al. (2010)
Panel A displays the density of the ratio of evaded income to self-reported income (after audit adjustment) among those with a positive tax evasion, using the 100% audit group and population weights. Income is defined as the sum of all positive items (so that self-reported income is always positive). Panel A shows that, among evaders, the most common is to evade all self-reported income. About 70% of taxpayers with positive self-reported income do not have any adjustment and are not represented on panel A.

Panel B displays the fraction evading and the fraction evaded (conditional on evading) by deciles of fraction of income self-reported (after audit adjustment and adding as one category those with no self-reported income). Panel B also displays the fraction of third-party income evaded (unconditional). Income is defined as positive income.

In both panels, the sample is limited to those with positive income above 38,500 kroner, the tax liability threshold (see Table 1).
Figure 3. Anatomy of Tax Evasion

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In both panels, the sample is limited to those with positive income above 38,500 kroner, the tax liability threshold (see Table 1).
TAX AUDIT EXPERIMENT FROM DENMARK

Kleven et al. ’11 also provide experimental causal effects of:

1) Marginal tax rates: use bunching evidence before and after audit: Most bunching not due to evasion but avoidance ⇒ Effect of MTR on evasion is modest

2) Prior-audit effects: compare next year outcomes of 100% audit group and a 0% audit group [as audited tax filers may update upward beliefs on \( p \)]

⇒ Find significant effects on reported income increases, concentrated among self-reported items [nothing on 3rd party income]: Extra tax collected through this indirect effect is about 50% of extra taxes collected due to base year audits

3) Threat-of-audit letters: Find significant effects on self-reported income increases [as in Slemrod et al.] and letter prob matters
**Bunching at the Top Kink in the Income Tax**

A. Self-Employed

Source: Kleven et al. (2010)
Bunching at the Kink in the Stock Income Tax

B. Stock-Income

Source: Kleven et al. (2010)
## Effect of Audits on Subsequent Reporting

### Amount of income change from 2006 to 2007

<table>
<thead>
<tr>
<th></th>
<th>Total income</th>
<th>Total income</th>
<th>Self-reported income</th>
<th>Third-party income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net income</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Baseline audit adjustment amount</td>
<td>5629</td>
<td>2554</td>
<td>2322</td>
<td>232</td>
</tr>
<tr>
<td></td>
<td>(497)</td>
<td>(787)</td>
<td>(658)</td>
<td>(691)</td>
</tr>
<tr>
<td><strong>Total tax</strong></td>
<td>2510</td>
<td>1377</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(165)</td>
<td>(464)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Kleven et al. (2010)
### Effect of Audit Threats on Subsequent Reporting

#### Probability of adjusting reported income (in percent)

<table>
<thead>
<tr>
<th></th>
<th>Both 0% and 100% audit groups</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No-letter group</td>
</tr>
<tr>
<td></td>
<td>Baseline</td>
</tr>
<tr>
<td>Net income</td>
<td>13.37</td>
</tr>
<tr>
<td></td>
<td>(0.35)</td>
</tr>
<tr>
<td>Total tax</td>
<td>13.67</td>
</tr>
<tr>
<td></td>
<td>(0.35)</td>
</tr>
</tbody>
</table>

Source: Kleven et al. (2010)
## Effect of Audit Threats on Subsequent Reporting

Probability of upward adjustment in reported income (in percent)

<table>
<thead>
<tr>
<th></th>
<th>Letter – No Letter</th>
<th>50% Letter – No Letter</th>
<th>100% Letter – 50% Letter</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net income</strong></td>
<td>1.51</td>
<td>1.04</td>
<td>0.95</td>
</tr>
<tr>
<td></td>
<td>(0.28)</td>
<td>(0.33)</td>
<td>(0.33)</td>
</tr>
<tr>
<td><strong>Total tax</strong></td>
<td>1.54</td>
<td>0.99</td>
<td>1.10</td>
</tr>
<tr>
<td></td>
<td>(0.28)</td>
<td>(0.33)</td>
<td>(0.33)</td>
</tr>
</tbody>
</table>

Source: Kleven et al. (2010)
Income $w = w_t + w_s$ where $w_t$ is third party reported (observed by govt at no cost) and $w_s$ is self-reported (as in standard Allingham-Sandmo model). Individual reports $\bar{w}_t$ and $\bar{w}_s$

1) $\bar{w}_t = w_t$ because audit rate is 100% for this income category

2) Government audits $\bar{w}_s$ with probability $p < 1$ (costly):

$$\max_{\bar{w}_s} (1 - p)u(w - \tau w_t - \tau \bar{w}_s) + pu(w - \tau w_t - \tau \bar{w}_s - \tau (w_s - \bar{w}_s)(1 + \theta))$$

$$\Leftrightarrow \max_{\bar{w} = w_t + \bar{w}_s} (1 - p)u(w - \tau \bar{w}) + pu(w - \tau \bar{w} - \tau (w - \bar{w})(1 + \theta))$$

$\Rightarrow$ **3rd Party Irrelevance:** If no constraints on $\bar{w}_s$, 3rd party reporting does not help enforcement

Note: irrelevance result remains true if $p(\bar{w})$
BREAKING THE IRRELEVANCE RESULT

Irrelevance result depends on 2 strong assumptions:

(1) Self-reported losses are allowed

(2) Audit rate does not depend on (sign of) $\bar{w}_s$

More realistic models where irrelevance breaks down:

(1) Disallow self-reported losses

(2) Audit rate $p$ depends (negatively) on $\bar{w}_s$

$\Rightarrow$ 3rd party reporting helps government enforce taxes
EXPLAINING ACTUAL TAX POLICIES

Income $w = w_t + w_s$ where $w_t$ is third party reported (observed by govt at no cost) and $w_s$ is self-reported (as in standard Allingham-Sandmo model).

Incorporating 3rd party reporting solves puzzles of the Allingham-Sandmo model:

1) Evasion rates are high in $s$ sector (consistent with Allingham-Sandmo) and low in $t$ sector

2) IRS sets audit rate $p$ higher when $\bar{w}_s < 0$ (small business losses, undocumented deductions, etc.) to protect $w_t$ base

3) $\bar{w}_s$ losses not allowed against $w_t$ (example: US limits capital gain losses and passive business losses)

4) Use of schedular income taxes (tax separately various bases): Earliest income taxes (1800-1900) are schedular
SIMPLER MODEL OF TAX EVASION

\[ u = (1 - p(\bar{w}))[w - \tau \bar{w}] + p(\bar{w})[w(1 - \tau) - \theta \tau (w - \bar{w})] \]

FOC \( du/d\bar{w} = 0 \Rightarrow [p(\bar{w}) - p'(\bar{w})(w - \bar{w})](1 + \theta) = 1 \)

Introduce the elasticity of the detection probability with respect to undeclared income: \( \varepsilon = -(w - \bar{w})p'(\bar{w})/p(\bar{w}) > 0 \)

\[ 1 = p(\bar{w}) \cdot (1 + \theta) \cdot (1 + \varepsilon) \]

If \( \varepsilon = 0 \), then always evade if \( 1 > p \cdot (1 + \theta) \)

If \( \varepsilon > 0 \), then evading more increases risk of being caught on all infra-marginal evaded taxes \( \Rightarrow \) Even with \( \theta = 0 \), full evasion is not always optimal

Shape of \( p(\bar{w}) \) depends crucially on 3rd party-reported income
Figure 1: Probability of Detection under Third-Party Reporting

\[
detection \text{ probability } (p) = \frac{1}{1 + \theta}
\]

\[
report\text{-}income (w) = \frac{1}{[1 + \theta(1 + \epsilon)]}
\]

3rd-party reported income \(w_t\)  
self-reported Income \(w_s\)

Source: Kleven et al. (2010)
WHY DOES THIRD PARTY REPORTING WORK?

In theory, employer and employee could collude to evade taxes ⇒ third-party does not help (Yaniv 1992)

In practice, such collusion is fragile in modern companies because of combination of:

1) Accounting and payroll records that are widely used within the firm [records need to report true wages in order to be useful to run a complex business]

2) A single employee can denounce collusion between employer and employees. Likely to happen in a large business [disgruntled employee, honest newly hired employee, whistle blower seeking govt reward]

⇒ Taxes can be enforced even with low penalties and low audit rates [Kleven-Kreiner-Saez, 2016]
HISTORY OF TAX COLLECTION

Interesting to understand why taxes develop the way they do
[Webber-Wildavsky ’86 book, Ardant ’71 book in French]

During most of history, governments were under the tax enforcement constraint: they were collecting as much taxes as possible given the economic / informational conditions

Many developing countries today still face such tax enforcement constraints

States first arise through warfare and conquest in productive areas (e.g. Nile Valley) to extract taxes.

The Rosetta Stone is a tax document (granting tax exemption to priests).

Tax collectors and assessors were hugely important people (e.g. not buried with the pharaohs at their death because they were needed!).

Mark Twain: What’s the difference between a tax assessor and a taxidermist? The taxidermist will only take your skin.
HISTORY OF TAX COLLECTION

Earliest taxes are tributes: conquerors / rulers realize that it is more lucrative to raise periodic tributes than outright stealing

Alexander the Great (356 B.C. – 323 B.C.), as he moved through Persia, India, Egypt and other countries, left administrators with explicit instructions on how to implement property taxes. Prior to his conquest, the people were very heavily taxed, and the collected money typically went to the treasury of the king, not to public improvements. Alexander substantially cut taxes and used half of revenues for public improvements (water systems, roads, ports, etc.)

When Julius Caesar was preparing for the Gaulic campaign, one of his generals told him there was not enough money to pay for the needed materials. Caesar said “Send out the assessors!” Pothinus once asked Julius Caesar, “Is it possible that Caesar, the conqueror of the world, has time to occupy himself with such a trifle as our taxes?” Caesar’s response “My friend, taxes are the chief business of a conqueror of the world.”
ARCHAIC TAXES

Governments try to extract revenue through rules without destroying economic activity and without generating tax revolts

Colbert (17th century France) famous expression: “plucking the goose while minimizing hissing”

**Direct taxes:** taxes on property, businesses, or people

**Indirect taxes:** taxes on transactions and exchanges

Classification is no longer very meaningful: [estate tax is direct, inheritance tax is indirect but economically equivalent]
ARCHAIC DIRECT TAXES

**Poll tax** (fixed amount per person). Cannot raise much revenue as poor cannot pay much [people flee or rebel, serfdom is a way to prevent fleeing behavioral response]. Later differentiated by class (nobility, peasants, professions).

**Land tax** (amount per lot), later differentiated by quality. Cannot raise much unless carefully differentiated with expensive land registry [otherwise marginal lands abandoned]

**Product taxes** (such as tithe = fraction of gross agricultural product): Tax requires monitoring production. Tax on gross product can be overwhelming for marginal lands

⇒ Archaic direct taxes can hardly raise more than 5% of total product in primitive economies. Hard to collect in barter economies. Only minimal govt can be supported.
ARCHAIC INDIRECT TAXES

Indirect taxes require exchange economies

**Tolls** for use of roads, rivers, entering towns, crossing borders, harbors, mountain pass. Initially based on people, later based on goods transported [overused when no coordination across jurisdictions]

**Excise and Sales Taxes** on exchanged goods. In early economies, only few goods are traded: salt, metal, alcohol beverages. Fairs where exchanges are concentrated also allow governments to impose sales taxes

**Govt Monopoly** Some economic activities require use of heavy equipment (grinding wheat, pressing grapes) ⇒ Can be controlled/monitored by govt

⇒ Archaic indirect taxes can raise substantial additional revenue in jurisdictions with substantial trading activity
MODERN TAXES

Modern taxes exploit **accounting information** that is required in large/complex business activities and **withholding at source**

Shift from differentiated capitation and presumptive taxes (on businesses and individuals) toward modern income taxation

Shift from excise taxes toward general sales taxes and VAT

Modern taxes can collect 50% of GDP without harming growth

Modern taxes in rich countries today are threatened primarily by (a) tax havens [enforcement difficult], (b) international tax competition [requires international coordination], (c) marginally the informal sector

IMF recommendations for poor countries to switch from archaic tariffs to modern VAT reduced tax revenue bc VAT enforcement failed [Cage-Gadenne 13]
EMPIRICAL PATH OF GOVERNMENT GROWTH

1) Govt size is small (typically < 10% of GDP) in Western countries before industrialization (Flora ’83). Use archaic taxes: [poll taxes, land-property taxes, product taxes, excise taxes, tolls, tariffs]

2) Govt size increases sharply in all advanced economies during 20th century. Increase corresponds to the development of modern taxes enforced using business records [income taxes, payroll taxes, value added taxes]

3) Govt growth has slowed or stopped in most advanced economies over last 3 decades

This general historical pattern applies to almost all rich countries although timing and final govt size varies across countries
2A. Tax revenue/GDP in the US, UK, and Sweden

Source: statistics computed by the author
2B. US Tax Composition, 1902-2008

Source: statistics computed by the author
VARIOUS SALES TAXES

**Turnover taxes** used to tax all sales: business to consumer (B-C) and business to business (B-B):

Creates multiple layers of taxes along a production chain ⇒ Higher total tax when B-B-C than B-C

**Retail Sales Tax** is imposed on B-C sales only [B-B exempt]: difficult to distinguish B-B and B-C (shifting), strong evasion incentive for B-C [sales tax does not work well with small retailers]

**Value-Added-Tax (VAT)** taxes only value added [sales minus purchases] in all transactions (B-B and B-C): equivalent to retail sales economically but easier to enforce [automatic upstream enforcement]

VAT first introduced in France in 1950s, has spread to most countries [US only rich country without VAT] yet little research
NO EVASION: VAT ⇔ RETAIL SALES TAX

(1) Supplier $S$ produces material using only labor inputs and sells it for $s$, pays VAT $\tau \cdot s$

(2) Manufacturer $M$ buys material for $s$ and sells product for $m$, pays VAT $\tau \cdot (m - s)$

(3) Retailer $R$ buys product for $m$ and sells good to consumers for $r$, pays VAT $\tau \cdot (r - m)$

Total VAT is $\tau \cdot r$

Retail sales tax paid only by $R$: $\tau \cdot r$

VAT ⇔ Retail sales tax
INTRODUCING EVASION

Government matches the purchases and sales VAT reports: need to be consistent: $\tilde{s}$, $\tilde{m}$, $\tilde{r}$

If $M$ and $R$ truthfully report $\tilde{m} = m$, $\tilde{r} = r$: if $S$ decides to evade $\tilde{s} < s$, $M$ has to pay $\tau \cdot (m - \tilde{s})$, $M$ will only purchase at lower price $\Rightarrow$ No gain for $S$ to evade

Similarly, if $R$ truthfully reports $\tilde{r} = r$, then $M$ (and hence $S$) cannot evade

VAT compliance down the chain forces compliance upstream [even if upstream businesses are informal]

If $R$ is big and uses business records (Walmart) then $R$ cannot misreport $\tilde{r} \Rightarrow$ VAT will work well [but retail sales tax would also work]
WHY VAT WORKS BETTER?

If $R$ is small / informal, it can evade but needs to report at least $\bar{r} = \bar{m}$ [otherwise VAT credit would attract tax audit]

If $M$ is small / informal and if $R$ evades and sets $\bar{r} = \bar{m}$, then $M$ can evade VAT by colluding with $R$: both $R$ and $M$ can decide to lower both $\bar{r}$ and $\bar{m}$ equally

... $S$ can also evade if $M$ and $R$ evade

If all firms are small / informal, VAT enforcement is impossible

If bottom firm $R$ is small / informal $\Rightarrow$ Retail sales tax breaks down entirely but VAT does not:

If bottom firm $R$ is small / informal but $M$ is large / formal, VAT enforcement will work from $M$ and upstream
ENFORCEMENT OF VAT VS RETAIL SALES TAX

1) Sales tax enforcement depends critically on retailers. Sales tax can be enforced with large retailers but much harder with small retailers.

2) VAT: when there is a large/formal firm in the production chain, then enforcement upstream takes place automatically. Imports often play this role as they are easy to observe and tax [Keen ’07]

3) VAT Issues: (a) VAT evasion easier with international transactions [carousel fraud], (b) VAT cannot tax easily financial services.
POMERANZ AER’15 VAT EXPERIMENT

Randomized experiment with 445,000 firms in Chile: sent threat of VAT audit letters to sub-sample of businesses

Key Results:

1) Significant effect of letters on VAT collection (+10% over 12 months)

2) Smaller impact on reported transactions that already have a paper trail (intermediate sales) than on those which don’t (final sales)

3) Effect of random audit announcement is transmitted up the VAT chain, increasing compliance by firms’ suppliers
Figure 1: Impact of the three types of letters

Notes: This figure plots the monthly percent difference between the medians of the treatment and the control group for each type of letter: (median VAT treatment group - median VAT control group) / (median VAT control group), normalizing pre-treatment percent difference to zero. The y-axis indicates time, with monthly observations, and zero indicates the last month before the mailing of the letters. The vertical line marks mailing of the letters. The figure shows the first wave of mailing. For the second (much smaller) wave of mailing, see Figure A6.

Source: Pomeranz AER'14
Table 4: Letter Message Experiment: Intent-to-Treat Effects on VAT Payments by Type of Letter

<table>
<thead>
<tr>
<th></th>
<th>(1) Mean VAT</th>
<th>(2) Median VAT</th>
<th>(3) Percent VAT &gt; Previous Year</th>
<th>(4) Percent VAT &gt; Predicted</th>
<th>(5) Percent VAT &gt; Zero</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deterrence letter X post</td>
<td>-1,114</td>
<td>1,326***</td>
<td>1.40***</td>
<td>1.42***</td>
<td>0.53***</td>
</tr>
<tr>
<td></td>
<td>(2,804)</td>
<td>(316)</td>
<td>(0.12)</td>
<td>(0.10)</td>
<td>(0.09)</td>
</tr>
<tr>
<td>Tax morale letter X post</td>
<td>-1,840</td>
<td>262</td>
<td>0.40</td>
<td>0.30</td>
<td>0.44**</td>
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<td></td>
<td>(6,082)</td>
<td>(666)</td>
<td>(0.25)</td>
<td>(0.22)</td>
<td>(0.20)</td>
</tr>
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<td>Placebo letter X post</td>
<td>835</td>
<td>383</td>
<td>-0.11</td>
<td>-0.19</td>
<td>-0.14</td>
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<tr>
<td></td>
<td>(6,243)</td>
<td>(687)</td>
<td>(0.26)</td>
<td>(0.23)</td>
<td>(0.20)</td>
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<td>Constant</td>
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<td>17,518***</td>
<td>47.50***</td>
<td>48.27***</td>
<td>67.30***</td>
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<td>(1,799)</td>
<td>(112)</td>
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<td>(0.07)</td>
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<tr>
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<td>445,734</td>
<td>445,734</td>
<td>445,734</td>
<td>445,734</td>
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<tr>
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<td>0.40</td>
<td>0.14</td>
<td>0.28</td>
<td>0.47</td>
<td></td>
</tr>
</tbody>
</table>

Notes: Column (1) shows a regression of the mean declared VAT on treatment dummies, winsorized at the top and bottom 0.1% to deal with extreme outliers. Column (2) shows a median regression of average VAT before treatment and in 4 months after each treatment wave. Columns (3)-(5) show linear probability regressions of the probability of an increase in declared VAT compared to the same month in the previous year, the probability of declaring more than predicted and the probability of declaring any positive amount. Observations are monthly in Columns (1) and (3)-(5) for ten months prior to treatment and four months after each wave of mailing. The four months after the second wave excludes firms treated in the first. Coefficients and standard errors of the linear probability regressions are multiplied by 100 to express effects in percent. Monetary amounts are in Chilean pesos, with 500 Chilean pesos approximately equivalent to 1 USD. Standard errors in parentheses, robust and clustered at the firm level for Columns (1) and (3)-(5). *** p<0.01, ** p<0.05, * p<0.1.

Source: Pomeranz AER'15
<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent Sales &gt; Previous Year</td>
<td>1.17***</td>
<td>0.16</td>
<td>0.12</td>
<td>1.33***</td>
</tr>
<tr>
<td></td>
<td>(0.22)</td>
<td>(0.21)</td>
<td>(0.19)</td>
<td>(0.21)</td>
</tr>
<tr>
<td>Percent Input Costs &gt; Previous Year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>55.39***</td>
<td>53.25***</td>
<td>38.37***</td>
<td>45.04***</td>
</tr>
<tr>
<td></td>
<td>(0.13)</td>
<td>(0.13)</td>
<td>(0.12)</td>
<td>(0.12)</td>
</tr>
<tr>
<td>Month fixed effects</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Firm fixed effects</td>
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
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<td>Number of observations</td>
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<td>2,392,529</td>
<td>2,392,529</td>
<td>2,392,529</td>
</tr>
<tr>
<td>Number of firms</td>
<td>133,156</td>
<td>133,156</td>
<td>133,156</td>
<td>133,156</td>
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<tr>
<td>Adjusted $R^2$</td>
<td>0.25</td>
<td>0.22</td>
<td>0.30</td>
<td>0.32</td>
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</tbody>
</table>

Notes: Regressions of the probability of the line item (total sales, total input costs, intermediary sales, and final sales) being higher than in the same month the previous year. Sample of firms that have both final and intermediary sales in the year prior to treatment. The four months after the second wave excludes firms treated in the first wave. Coefficients and standard errors are multiplied by 100 to express effects in percent. Robust standard errors in parentheses, clustered at the firm level. *** $p<0.01$, ** $p<0.05$, * $p<0.1$.

Source: Pomeranz AER’15
## Table 6: Interaction of Firm Size and Share of Sales to Final Consumers

### Panel A:

<table>
<thead>
<tr>
<th></th>
<th>Percent VAT &gt; Previous Year</th>
<th></th>
<th></th>
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<th></th>
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<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
</tr>
<tr>
<td>Deterrence letter X final sales share</td>
<td>1.61***</td>
<td>1.48***</td>
<td>1.43***</td>
<td></td>
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</tr>
<tr>
<td></td>
<td>(0.26)</td>
<td>(0.27)</td>
<td>(0.26)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deterrence letter X size category</td>
<td>-0.17***</td>
<td>-0.10***</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.04)</td>
<td>(0.04)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deterrence letter X log employees</td>
<td>-0.45***</td>
<td></td>
<td>-0.29**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.11)</td>
<td></td>
<td>(0.12)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deterrence letter</td>
<td>0.68***</td>
<td>2.63***</td>
<td>1.66***</td>
<td>1.49***</td>
<td>0.92***</td>
</tr>
<tr>
<td></td>
<td>(0.16)</td>
<td>(0.29)</td>
<td>(0.13)</td>
<td>(0.35)</td>
<td>(0.19)</td>
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<td>47.50***</td>
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<td></td>
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<tr>
<td>Final sales share X post</td>
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<td>No</td>
<td>No</td>
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<td>Yes</td>
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<tr>
<td>Size measure X post</td>
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<td>Firm fixed effects</td>
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
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<td>Month dummies</td>
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<td>0.14</td>
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</tr>
</tbody>
</table>

Notes: Regression of the probability of monthly declared VAT being higher than in the same month of the previous year (Panel A) and on being higher than predicted (Panel B). Coefficients and standard errors are multiplied by 100 to express effects in percent. Sample includes all firms in the deterrence treatment and in the control group. The four months after the second wave excludes firms treated in the first. Number of observations vary due to missing observations for some variables. Final sales share is not defined for firms with zero sales in preceding year, size category is not available for new firms. Robust standard errors in parentheses, clustered at the firm level. *** p < 0.01, ** p < 0.05, * p < 0.1. Source: Pomeranz AER'15
Table 7: Spillover Effects on Trading Partners’ VAT Payments

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<td>&gt; Previous</td>
<td>&gt; Previous</td>
<td>&gt; Previous</td>
<td>&gt; Previous</td>
<td>&gt; Previous</td>
</tr>
<tr>
<td>Audit announcement X</td>
<td>2.41**</td>
<td>2.03*</td>
<td>4.28***</td>
<td>3.92***</td>
<td>4.14***</td>
<td>3.83***</td>
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<tr>
<td>post</td>
<td>(1.14)</td>
<td>(1.11)</td>
<td>(1.14)</td>
<td>(1.50)</td>
<td>(1.52)</td>
<td>(1.52)</td>
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<td></td>
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<td>-0.28</td>
<td>-0.14</td>
<td>-0.28</td>
</tr>
<tr>
<td>supplier X post</td>
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<td></td>
<td>(1.64)</td>
<td>(1.51)</td>
<td>(1.67)</td>
<td>(1.55)</td>
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<td>(1.64)</td>
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<td>Controls X audit</td>
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<td>announcement X post</td>
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<td>Month fixed effects</td>
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<tr>
<td>Firm fixed effects</td>
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<td>2,768</td>
<td>2,768</td>
</tr>
<tr>
<td>Adjusted $R^2$</td>
<td>0.05</td>
<td>0.11</td>
<td>0.05</td>
<td>0.11</td>
<td>0.05</td>
<td>0.10</td>
</tr>
</tbody>
</table>

Notes: Regressions for trading partners of audited firms. Column (1), (3) and (5) shows the probability of an increase in declared VAT since the previous year, Column (2), (4) and (6) shows the probability of declaring more than predicted. The controls in Columns (5) and (6) are firm sales, sales/input-ratio, share of sales going to final consumers, and industry categorized as “hard-to-monitor.” Observations are monthly for ten months prior to treatment and six months after the audit announcements were mailed. Coefficients and standard errors are multiplied by 100 to express effects in percent. Robust standard errors in parentheses, clustered at the level of the audited firm. *** p<0.01, ** p<0.05, * p<0.1.

Source: Pomeranz AER'15
Official statistics substantially underestimate the net foreign asset positions of rich countries because they do not capture most of the assets held by households in off-shore tax havens.

Example: Wealthy US individual opens a Cayman Islands account and buys mutual fund shares (composed of US corporate stock): Cayman Islands record a liability but US do not record an asset (because this is not reported in the US).

⇒ Total world liabilities are larger than world total assets.

Zucman compiles all financial stats and estimates that around 8% of the global financial wealth of households is held in tax havens (three-quarters of which goes unrecorded = 6%).

If top 1% hold about 50% of total financial wealth, then about 12% of financial wealth of the rich is hidden in tax heavens.
CURBING OFF-SHORE TAX EVASION

Off-shore tax evasion possible because of bank secrecy: US cannot get a list of US individuals owning Swiss bank accounts from Switzerland

⇒ No 3rd party reporting makes tax enforcement very difficult

In principle, problem could be solved with exchange of information across countries BUT need all countries to cooperate

Johannesen-Zucman AEJ-EP’14 analyze tax haven crackdown: G20 countries forced number of tax havens to sign bilateral treaties on bank information sharing

Key result: Instead of repatriating funds, tax evaders shifted deposits to havens not covered by treaty with home country.
CURBING OFF-SHORE TAX EVASION

FATCA’13 US regulations try to impose info exchange for all entities dealing with US:

If foreign bank B does not provide list of all its US account holders, any financial transaction between B and US will carry 30% tax withholding ⇒
Interesting to see what it will do

Long-term solution will require:

a) Systematic registration of assets to ultimate owners [already exists within countries for domestic tax enforcement]

b) Systematic information exchange between tax countries with no exceptions for tax heavens

⇒ Could be enforced with tariffs threats on tax heavens [Zucman JEP’14 and book ’15]
REFERENCES


IRS, 2012 “Tax Gap for Tax Year 2006: Overview” (web)


