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# A quantitative view on policymakers' goal, institutions and tax evasion

Maurizio Bovi · Roy Cerqueti

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**Abstract** We develop a general theoretical model to compare two different policymakers both facing tax evasion. Policymakers differs in that they aim to maximize either the fiscal revenues ( $T$ ) as in a social-democracy as, e.g., Sweden, or the GDP as in a capitalistic country as, e.g., the USA. Both Bureaus can manoeuvre the tax rate and the share of tax receipts spent to fight the tax evasion rather than to increase the public capital. Our model merges the indications of two distinct, and sometimes conflicting, approaches to the analysis of tax evasion in that reconciling them. We also find that the feedbacks between the private and public sector are linked to some Laffer-type relationships usually unexplored by the existing literature. As compared to capitalistic systems, then, our results show that social-democracies end up imposing higher tax rates and, possibly, more pervasive regulations. Consequently, they are likely to suffer from larger tax-evasion-to-GDP ratios. This notwithstanding, social-democracies spend relatively more to contrast tax dodgers. On the other hand,  $T$ -maximizing governments have better institutional settings and greater employment rates. Whichever the preferred target, however, no policymaker is able to erase totally the tax evasion, which may explain why this latter is so pervasive and persistent even among the richest countries.

**Keywords** Quantitative model · Bureaucracy · Tax evasion · Regulations · Taxation

## 1 Introduction

A well-known anecdote states that tax evasion is as old as taxation. By the same token one may also add that since taxation is as old as State, the same can be said for the tax evasion.

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19 In the words of [Klepper and Nagin \(1989, p. 1\)](#) “Three things are certain in life: death, taxes,  
20 and mankind’s unrelenting effort to evade both.” The spiral “higher tax rates, higher tax  
21 evasion” is cited as one of the main reasons why the Roman Empire fell ([Bernardi 1970](#)).  
22 More recently, according to the cross section evidence collected by [Porta and Shleifer \(2008\)](#),  
23 the share of tax evasion on official GDP varies, to mention the most conservative figures,  
24 from almost 30 % in poorest countries to up 8 % in richest economies. Otherwise stated, the  
25 tax evasion is an immanent fact of life around the world.

26 The shadow economy<sup>1</sup> has some positive effects. For instance, it provides an alternative  
27 social safety net and may be the necessary first-step for training the new firms. This said, in  
28 both political and economic circles it is usually seen more as a problem than as a resource,  
29 and “zero-tolerance” announces are commonly heard. The presence of hidden activities, in  
30 fact, may affect the design of national tax systems and trigger links between legal and illegal  
31 activities. It may then impose constraints on public revenues generation and, therefore, limit  
32 the provision of necessary public goods/services. Moreover, e.g. due to unfair competition,  
33 shadow activities are likely to hamper the GDP. Finally, it has been observed a strong positive  
34 correlation between tax morale and institutional quality ([Frey and Torgler 2007](#); [Hug and  
35 Spörri 2011](#)).

36 The pervasiveness and persistence of the tax evasion side-by-side with better and better  
37 anti-evasion technology and worldwide zero-tolerance announces suggests to examine (i)  
38 why the phenomenon is so hard to eradicate practically in all economic environments and,  
39 accordingly, (ii) its effects in different economic systems.

40 In this paper, we attempt to shed some light on these issues by developing a general equi-  
41 librium model aimed at examining the theoretical links between tax evasion, macro policies  
42 and institutions. Specifically, we study the persistence and the effects of the tax evasion when  
43 policymakers pursue two alternative macroeconomic targets, namely maximizing fiscal rev-  
44 enues (T) or the GDP. The logic of this clear-cut in policymakers’ goal is to more easily  
45 compare these two distinct situations which, by and large, can be thought of as representa-  
46 tive of, respectively, social-democracy and capitalism. Thus, our analysis can also be useful  
47 for the understanding of what a developing or transition country may expect to face should  
48 it follow a social-democratic rather than a capitalistic road to develop. On the other hand,  
49 anticipating one of our results, we find that governments cannot be revenues—and GDP-  
50 maximizers at the same time so that a political dilemma emerge. Though this is a somewhat  
51 expected outcome, as far as we know ours is the first model to formalize it. Even more so  
52 because ours is a general equilibrium framework. In building our model we have borrowed  
53 from both the portfolio choice tradition ([Allingham and Sandmo 1972](#); [Yitzhaki 1974](#) and  
54 followers) and the recent institutional approach ([Johnson et al. 1998, 1999](#)). As we will say,  
55 these strands of research have different views about the sign of the correlation linking tax  
56 rate and tax evasion. Therefore, our model allows to reconcile this dissonance. We have also  
57 opted to keep the model rather general. The idea is that the abstractness of our setting avoids  
58 limiting the study to a peculiar analytical setting. In fact, we can afford to not rely on explicit  
59 functions for the parameters which, as e.g. in the case of variables describing the institutional  
60 setting, may turn out to be tricky. The generality of the setting means that our model nests  
61 several specifications and, accordingly, it is very robust.

62 Other contributions of our paper that we want to stress are the following. Comparing two  
63 different economic systems—such as, say, Sweden and the USA—with a special focus on tax  
64 evasion allows us to uncover and discuss some new Laffer-type non linearities. These latter

<sup>1</sup> While the shadow (unofficial, irregular...) economy takes many forms—e.g., illegal activities, unreported income (tax evasion) and the informal sector—the focus of this paper is the tax evasion.

65 come from the feedbacks between the private and public sector and are typically neglected  
66 in the existing literature (Section 2). Then, we offer a theoretical framework that could  
67 help to better understand the empirical findings reported by several papers often based on  
68 just sketched theoretical considerations (see, e.g., [Friedman et al. \(2000\)](#) and [Johnson et al.](#)  
69 [\(1999\)](#) just to mention two papers dealing with the set of variables here under scrutiny). In fact,  
70 given the easy-to-imagine data problems affecting variables such as tax evasion, institutional  
71 efficiency, etc. (low quality, reduced time series and cross section comparability, etc.), our  
72 conceptual robust setting can act like a map that gives coherence to empirical inquiry.

73 Side by side with the mentioned policy dilemma, other results stem from our analy-  
74 sis. As compared to GDP-maximizing states, social-democracies tend to impose higher tax  
75 rates, more pervasive regulations and, consequently, to suffer from larger tax-evasion-to-GDP  
76 ratios. All this in spite of the fact that social-democracies spend relatively more to contrast tax  
77 dodgers than capitalistic countries. On the other hand, revenues maximizing governments can  
78 afford to have better institutional settings and greater participation rates. In no case, however,  
79 the Bureau is able to erase totally the tax evasion, which may explain why this latter is so  
80 pervasive and persistent all around the world.

81 The rest of the paper is organized as follows. Section 2 briefly reviews some literature  
82 related to our topic. Section 3 contains the constitutive elements of the theoretical model.  
83 Sections 4 and 5 deal with the optimization problems of the private sector and the State,  
84 respectively. In Sect. 6 the theoretical findings are discussed with a focus on two representative  
85 cases. Some supporting evidence is also presented. The last section collects concluding  
86 remarks. The proofs of the main results are reported in the Appendix.

## 87 2 A brief literature review

88 Despite its sheer magnitude and ever-lasting presence, the macroeconomic consequences of  
89 tax evasion on revenues and, especially, on output loss, has received relatively little attention.  
90 As for public revenues loss, in a simple Keynesian model, [Peacock and Shaw \(1982\)](#) were  
91 the first to show that, provided the marginal net propensity to spend is less than unity, tax  
92 evasion decreases the tax revenue. In a more general framework, [Ricketts \(1984\)](#) confirms  
93 the negative effect of tax evasion upon the tax revenue. Years later, [Lai and Chang \(1988\)](#);  
94 [Zameck \(1989\)](#), and [Lai et al. \(1995\)](#) showed that tax evasion may even lead to an increase in  
95 the tax revenue. A common problem with these papers is the lack of microfoundations. More  
96 recently, [Turnovsky and Basher \(2009\)](#) have developed a microfounded two-sector model and  
97 have examined the role of the informal sector in limiting the government's ability to increase  
98 tax revenues. As for more direct links between growth and tax evasion, [Caballé and Panadés](#)  
99 [\(2000\)](#) have analyzed how the tax compliance policy affects the rate of economic growth.  
100 They consider a microfounded overlapping generations model in which the paths of all the  
101 involved macroeconomic variables are endogenously determined and perform comparative  
102 statics analyses of changes in both the probability of inspection and the penalty fee imposed on  
103 tax evaders. They show the nonoptimality from the growth viewpoint of an inspection policy  
104 inducing truthful revelation of income for exogenously given levels of both the penalty and the  
105 tax rates. Alike, [Chen's \(2003\)](#) microfounded model of endogenous growth has inquired into  
106 the effects of three government policies on tax rate, tax evasion, and economic growth. These  
107 three policies are as follows: increasing the unit cost of tax evasion, raising punishment  
108 and fines, and increasing the probability of detection. He finds that the three policies are  
109 quantitatively effective in discouraging tax evasion, but have small growth effects. These  
110 latter increase when the public capital has very strong positive externalities. [Ihrig and Moe](#)

(2004) have analyzed a simple dynamic model of an agent who chooses to allocate time between the formal and informal sector while accounting for taxation policies. They argue that their model explains why, as an economy grows from a low level of real GDP per capita, changes in informal employment are large. From the normative standpoint these authors suggest that while reductions in the tax rate, combined with increased enforcement, reduce the size of the informal sector, tax rate reductions and penalties for evasion are the most effective. Another strand of research (Johnson et al. 1998, 1999; Friedman et al. 2000) has been pointing out the role of institutions in explaining the presence/influence of the tax evasion in/on economic systems. Basically, it argues that the efficiency of the public sector is connected with the tax evasion because the low quality of bureaucracy reduces the probability to detect tax dodgers and this increases, other things being equal, the optimal share of hidden income chosen by agents. In turn, this stops achieving sufficient revenues to fund good institutions. Furthermore, bad governments offer low quality and insufficient public services, making people less willing to pay for them and more willing to search for alternative, hidden, service networks.<sup>2</sup> These studies underline that another stable equilibrium, opposite to the bad one, is possible. This is why this “institutional” literature is sometimes referred to as the two-equilibria framework. Rich countries cluster in this second polar situation, which can be labeled “good equilibrium” because small hidden sectors, large fiscal revenues, high tax rates and honest/appreciated institutions consistently coexist. Thus, in sharp contrast with the Allingham and Sandmo (1972) traditional result, tax rate and tax evasion may be negatively related. Yet, recently Bovi and Dell’Anno (2010), focusing exclusively on good equilibria, have found empirical evidence that tax rate and tax evasion are significantly positively related.<sup>3</sup>

Other papers establishing multiple equilibria are those of Myles and Naylor (1996), Rosser et al. (2003) and Cule and Fulton (2009). Myles and Naylor (1996) develop a social custom and conformity model of tax evasion and obtain two equilibria: one with no evasion and one with total evasion. According to Rosser et al. (2003), then, the returns to labor of participating in shadow activities are increasing for a while as the relative size of the hidden sector increases and then decrease beyond some point. This can create a critical threshold that can generate two distinct stable equilibrium states, one with a small underground sector and one with a large underground sector. Finally, in Cule and Fulton (2009) the source of the multiple equilibria is the externalities created by business and tax inspection cultures. Specifically, in bad equilibria (high cheating and corruption), increases in penalties or auditing can have perverse impacts and increase cheating. Somewhat mirroring the institutional literature these papers deal especially with bad equilibria, whereas the tax evasion is likely to be persistent.

### 3 The theoretical framework

In building our model we have borrowed from both the portfolio choice tradition (Allingham and Sandmo 1972; Yitzhaki 1974 and followers) and the recent institutional approach. Our aim is to study the tax-evasion-related links between these two agents when the Bureau is either GDP—or revenues-maximizing. In our model there are two players, a representative private agent and the government. The former solves standard consumption-leisure

<sup>2</sup> This spiral is in line both with the results of Hanousek and Palda (2004), and with the observed strong positive correlation between tax morale and institutional quality (Frey and Torgler 2007).

<sup>3</sup> In fact, in a sub sample analysis targeted to richer countries, even Friedman et al. (2000) did not find evidence against the traditional positive correlation between tax rate and tax evasion. Results by Pommerehne and Weck-Hannemann (1996) support the positive correlation.

152 optimization problems, with the exception that she may hide some income. It is worth notic-  
 153 ing that, should the representative agent hide or declare all of her income, the economic  
 154 system would be, respectively, totally under—or totally overground. As we will see, our  
 155 model enables the informal sector to remain part of the economy in equilibrium. Since,  
 156 mature or not, data inform that all economic systems have shadow sectors, the mixed equilib-  
 157 rium is consistent with empirical observations. The optimal share of tax evasion chosen by  
 158 individuals is constrained by the expected penalty and tax evasion-related costs [e.g., shel-  
 159 tering efforts. See [Cross and Shaw \(1982\)](#)]. As in [Barro \(1990\)](#), the private sector benefits  
 160 from public capital.

161 In order to maximize either fiscal receipts or the GDP, the State decides the tax rate  
 162 and the share of public outlay devoted to fight the tax evasion rather than to increase the  
 163 public capital.<sup>4</sup> These two goals should be seen as representative of the policies usually  
 164 implemented, respectively, in mature social-democratic (say, Sweden) and capitalistic (say,  
 165 the USA) countries. Several Laffer-type relationships emerge in our context.

166 Beyond the usual mnemonic  $L$  (labor input),  $Y$  (output),  $G$  and  $T$  (respectively, public  
 167 outlays and revenues), throughout the paper we will use the following notations:

- 168 •  $r \in [0, 1]$  is the probability to detect a tax dodger<sup>5</sup>;
- 169 •  $t \in [0, 1]$  is the tax rate;
- 170 •  $y \in [0, 1]$  is the share of undeclared income on total income;
- 171 •  $e$  is an index that measures the level of regulations. For homogeneity,  $e$  is assumed to  
 172 vary between  $[0, 1]$  with  $e = 0$  indicating the case of no regulation (disorder), and  $e = 1$   
 173 the case of totally regulated economy (dictatorship);
- 174 •  $\alpha \in [0, 1]$  is the share of the public expenditure  $G$  spent to increase  $r$ . It represents the  
 175 fraction of public money directly devoted to fight the tax evasion.<sup>6</sup> This kind of outlay  
 176 should be meant as comprehensive of both “sticks”, e.g. providing for tax inspectors, and  
 177 “carrots”, e.g. reducing the complexity of the tax system. Instead,  $1 - \alpha$  is the fraction  
 178 of  $G$  devoted to increase/improve the public capital, the only other outlay available for  
 179 policymakers. As in [Barro \(1990\)](#), we assume that public capital has positive external  
 180 effects on GDP.

181 For simplicity, in our model  $T = G$  and we define  $r$  as an increasing continuous function of  
 182  $\alpha$  that we will write as  $r = r(\alpha)$ . Therefore,  $r$  is invertible, i.e. there exists a function  $p$  such  
 183 that:

$$184 \quad r(\alpha) = \tilde{r} \Leftrightarrow \alpha = p(\tilde{r}). \quad (1)$$

185 It is important to note since now that good institutions (i.e. those with both large  $r$  and,  
 186 as we will see,  $\alpha$ ) can afford to collect and, in turn, to spend, large amounts of revenues.  
 187 Accordingly, despite their relatively lower  $1 - \alpha$ , good institutions have higher levels of  
 188 public capital than bad ones.

189 Following both traditional and institutional approaches, we argue that the share of unde-  
 190 clared income depends on  $t, e, r$ :

$$191 \quad y = y(t, e, r). \quad (2)$$

<sup>4</sup> The term “public capital” contains all the growth-enhancing items potentially available for policymakers.

<sup>5</sup> Our model examines the situation in which, ex post, tax dodgers are not detected but, ex ante, there is a probability  $r > 0$  that this happens. Consequently, though taxpayers take into account the expected penalty in their optimization problem, no evader actually pays the penalty. It turns out that the State collects no money via penalties. Considering this extra gain, however, just complicates the model leaving our conclusions unaffected.

<sup>6</sup> For a paper focusing on this topic see [Slemrod and Yitzhaki \(1987\)](#) and [Mayshar \(1991\)](#).



In our context regulations can be thought of as the level of social control of business (Glaeser and Shleifer 2003). From the taxpayer's standpoint fulfilling regulations is costly and, therefore, they can be thought of as a tax in disguise. As a consequence, regulations affect positively the share of tax evasion. As we shall explain in Sect. 5, the Bureau cannot afford to freely manage the level of regulations. This is why we do not put regulations among the policymakers' instruments. The output  $Y$  depends on labor input and on  $\alpha$

$$Y = g(L, \alpha). \quad (3)$$

Detailed comments on this function are collected in the next section.

#### 4 The private sector

Households maximize their utility, under the budget constraint, pinning down both the optimal share of undeclared income ( $y^*$ ), and the optimal quantity of labor ( $L^*$ ). The utility function of the private sector depends on  $L$  and  $C$ , and can be defined as  $U(L, C)$ .  $U$  satisfies the usual properties:

$$\frac{\partial U(L, C)}{\partial C} > 0; \quad \frac{\partial U(L, C)}{\partial L} < 0. \quad (4)$$

The consumption function depends on  $y$ ,  $Y$  and  $t$ , it is defined as  $C(t, y, Y)$  and, obviously:

$$\frac{\partial C(t, y, Y)}{\partial y} > 0; \quad \frac{\partial C(t, y, Y)}{\partial Y} > 0; \quad \frac{\partial C(t, y, Y)}{\partial t} < 0. \quad (5)$$

Tax evasion is costly both because of the expected penalty to be caught and because hiding an ever growing income level is a more and more tricky activity (Cross and Shaw 1982). The cost function is  $K(r, y, Y)$ , with

$$K(r, 0, Y) = 0; \quad \frac{\partial K(r, y, Y)}{\partial y} > 0; \quad \frac{\partial K(r, y, Y)}{\partial r} > 0; \quad \frac{\partial K(r, y, Y)}{\partial Y} > 0. \quad (6)$$

The household must solve the following problem:

$$\begin{cases} \max_{y, L} & U(L, C(t, y, g(L, \alpha))) - K(r(\alpha), y, g(L, \alpha)) \\ \text{s.t.} & H(C(t, y, g(L, \alpha))) = 0, \end{cases} \quad (7)$$

where  $H = 0$  is the budget constraint.

It is worth noting that the role of  $y$  as decision variable does not contrast with the definition of  $y$  provided in (2): indeed, the dependence of  $y$  on the triple  $(t, e, r)$  states simply that the decisions taken by the private sector are affected also on the institutional (exogenous) parameters  $t, e, r$ . More specifically, we hypothesize that taxpayers take  $t, r, e, \alpha$  as given and that they are indifferent in paying the same amount of different combinations of taxes, expected penalties, license fees, and the like. Let us fix  $t, e, \alpha \in [0, 1]$  and assume that the functions  $U, K$  and  $H$  behave well, so that there exists a solution of the optimization problem (7) given by the couple  $(y^*(t, e, r(\alpha)), L^*)$ . The optimal level of output depends<sup>7</sup> on  $\alpha$ , and will be denoted as  $Y^* = Y^*(\alpha) = g(L^*, \alpha)$ .

How are  $\alpha$  and  $L^*$  related? From the macroeconomic point of view, Munnell (1992) has claimed that the correlation between  $(1 - \alpha)$  and  $Y/L$  is positive. That is to say, for any

<sup>7</sup> See also the discussion in Acemoglu et al. (2005).

226 given  $Y$ ,  $\alpha$  and  $L^*$  are positively related. From the microeconomic standpoint, then, it has  
 227 been argued that a lower  $\alpha$  is associated to a bigger evasion. It, in turn, increases expected  
 228 consumption for any given amount of leisure, this latter increases, and labor supply declines  
 229 (Slemrod and Yitzhaki 2002). Thus, once again,  $L^* = L^*(\alpha)$  may be thought of as an  
 230 increasing function of  $\alpha$ .

231 As for the optimal output level, it is a function of  $\alpha$ , i.e.  $Y^* = Y^*(\alpha) = g(L^*(\alpha), \alpha)$  and  
 232 we assume that  $Y^*$  and  $\alpha$  are linked such a way to produce a Laffer-shaped curve, i.e. there  
 233 exists  $\bar{\alpha} \in (0, 1)$  such that:

$$234 \left\{ \begin{array}{l} \frac{\partial g(L^*(\alpha), \alpha)}{\partial \alpha} > 0, \quad \text{for } \alpha < \bar{\alpha}; \\ \frac{\partial g(L^*(\alpha), \alpha)}{\partial \alpha} < 0, \quad \text{for } \alpha > \bar{\alpha}; \\ \frac{\partial g(L^*(\alpha), \alpha)}{\partial \alpha} = 0, \quad \text{for } \alpha = \bar{\alpha}. \end{array} \right. \quad (8)$$

235 The rationale behind is that countries severely lacking in public capital (i.e. with a very high  
 236  $\alpha$ ) or fiscal apparatuses (i.e. with a very low  $\alpha$ ) are likely to have lower  $Y$  than those with less  
 237 extreme situations. We now turn our attention to the links between  $y^*$  and  $t$ . A logical, and  
 238 traditional (Allingham and Sandmo 1972), assumption is that the optimal undeclared income  
 239  $y^*(t, e, r)$  is an increasing function of  $t$ . We postpone the discussion on the relationship  
 240 between  $y^*$  and the parameters  $e$  and  $r$  (or  $\alpha$ ) to the next section.

241 As for the relationship between  $Y^*$ ,  $L^*$  and the tax rate  $t$  we are able to prove that they  
 242 are directly related. In fact, since  $C$  is continuous and increasing with respect to  $Y$  *ceteris*  
 243 *paribus*, then it is also invertible, i.e. given  $e$  and  $\alpha$ , there exists a function  $R_{Y_{e,\alpha}}$  such that

$$244 C_t^* = C(t, y^*(t, e, r(\alpha)), Y^*) \Leftrightarrow Y_{e,\alpha}^* = R_{Y_{e,\alpha}}(C_t^*).$$

245 Given  $e, \alpha \in [0, 1]$ , we can write  $Y_{e,\alpha}^*$  as a function of the tax rate as follows:  $Y_{e,\alpha}^* =$   
 246  $Y_{e,\alpha}^*(t) = R_{Y_{e,\alpha}}(C_t^*)$ .

247 By the same token of Eq. (8), we write the lafferian relation between  $Y_{e,\alpha}^*$  and  $t$ , i.e. there  
 248 exists  $\bar{t}_{e,\alpha} \in (0, 1)$  such that

$$249 \left\{ \begin{array}{l} \frac{dY_{e,\alpha}^*(t)}{dt} > 0, \quad \text{for } t < \bar{t}_{e,\alpha}; \\ \frac{dY_{e,\alpha}^*(t)}{dt} < 0, \quad \text{for } t > \bar{t}_{e,\alpha}; \\ \frac{dY_{e,\alpha}^*(t)}{dt} = 0, \quad \text{for } t = \bar{t}_{e,\alpha}. \end{array} \right. \quad (9)$$

250 Furthermore, since  $g$  in (3) is continuous and increasing with respect to  $L$ , then it is also  
 251 invertible. For a fixed  $\alpha \in [0, 1]$ , we denote  $d_\alpha$  as the inverse of  $g$  with respect to  $L$  at the  
 252 level  $\alpha$ , and write:

$$253 Y_{e,\alpha}^* = g(L^*, \alpha) \Leftrightarrow L_\alpha^* = d_\alpha(Y_{e,\alpha}^*). \quad (10)$$

254 Equation (10) allows us to write  $L^*$  as a function of  $t$ :  $L_\alpha^* = L_\alpha^*(t) = d_\alpha(Y_{e,\alpha}^*(t))$ .

## 255 5 The state

256 In our model, policymakers have two instruments to pursue one of two alternative targets.  
 257 The government decides (i) the tax rate and (ii) the share of revenues devoted to fight the tax  
 258 evasion rather than to increase the public capital in order to maximize either its revenues or  
 259 the GDP. These goals should be seen as representative of the policies usually implemented

in, respectively, social-democratic and capitalistic countries. We will show that, as expected, policymakers cannot maximize both  $T$  and  $Y$  contemporaneously. Another potential policy tool in our context is the level of regulation. We have chosen not to consider it as a device because, to some extent, the Bureau cannot afford to freely manage the level of regulations. In fact, as fairly noted by Glaeser and Shleifer (2003), the American and European societies are much richer today than they were a century ago, yet they are also vastly more regulated. The structural factor behind this is that modern good, financial and labor markets inevitably need regulations to protect weaker agents (respectively, consumers, savers and workers). The recent developments in financial markets and the following, strong, reaction of the Bureaus are an undisputable example of what we are talking about. Our model points out that there are threshold values activating non linear associations among the variables under scrutiny. In this section we explain the rich relationships between the involved variables from the ruler's standpoint, and how these connections affect the performances of  $T$ - or  $Y$ -maximizing governments.

We model the quality of the institutional setting as depending on the levels of regulation,  $e$ , and the probability to be detected,  $r$ . Specifically, we define a function  $a$  of the variables  $e$  and  $r$  such that  $a(e, r)$  describes the institutional setting of a country with regulation level  $e$  and probability of detection  $r$ .  $a$  is a continuous function with respect to  $e$  and  $r$ . Henceforth we use the convention that a country with institutional index  $a_1$  has a weaker institutional setting than a country with institutional index  $a_2$  if and only if  $a_1 < a_2$ .

As already mentioned, there are reasons to think that  $r$  is positively correlated with the efficiency of the Bureau. Thus,  $a(e, r)$  is an increasing function of  $r$ . Moreover, since  $r$  increases with respect to  $\alpha$ , then  $a(e, r(\alpha))$  increases with respect to  $\alpha$  as well. Therefore,  $a$  is an invertible function of  $\alpha$ , and there exists an increasing function  $b$  such that

$$a = a(e, r(\alpha)) \Leftrightarrow \alpha = b(a). \quad (11)$$

In contrast, the behavior of  $a$  with respect to  $e$  is more complicated. The parameter  $e$  is non linearly linked to the bureaucratic structure of the State. The idea is that both disorder ( $e = 0$ ) and dictatorship ( $e = 1$ ) are bad institutional settings. More in general, we claim that above a certain critical value of  $e$  the government's activity becomes so intrusive ("from the cradle to the grave") that the Bureau just cannot avoid over-regulating. For instance, public goods and services might be offered at prices lower than the market ones, giving rise to an excess of demand that needs to be regulated. In addition, the government's size may trigger over-regulations simply to justify its own presence. So we assume that, for any  $\alpha \in [0, 1]$ , the institutional index  $a(e, r(\alpha))$  admits a global maximum in a critical threshold  $e = \bar{e}_\alpha \in (0, 1)$ . More formally:

$$\begin{cases} \frac{\partial a(e, r(\alpha))}{\partial e} > 0, & \text{for } e < \bar{e}_\alpha; \\ \frac{\partial a(e, r(\alpha))}{\partial e} < 0, & \text{for } e > \bar{e}_\alpha; \\ \frac{\partial a(e, r(\alpha))}{\partial e} = 0, & \text{for } e = \bar{e}_\alpha. \end{cases} \quad (12)$$

Substantially, relation (12) means that the maximum level of the institutional setting index can be obtained in countries with neither too light nor too heavy regulation frameworks. The dependence of  $y^*$  on regulation  $e$  and on the probability of detection  $r$  can be explicated through the institutional parameter  $a$ . To this end, we write  $y^*(t, e, r) = y^*(t, a(e, r))$ , assuming that  $y^*$  decreases with respect to the institutional setting parameter  $a$ . Consequently,  $y^*$  decreases as  $\alpha$  increases. Finally, in view of the optimization problems assessed in the next section, we note that tax revenues can be written both as:

$$T = t[(1 - y^*)Y^*]. \tag{13}$$

and as

$$T = T(a, t). \tag{14}$$

Equation (13) includes one of the two policy instruments, namely the tax rate  $t$  (the other is  $\alpha$ ), and the three policy variables ( $T$ ,  $y^*$ , and  $Y^*$ ) we are focusing on. In the following sections we will study how the instruments affect these variables. Finally, note that formula (14) emphasizes the relation between tax revenues, the institutional setting ( $a$ ) and the tax rate.

### 5.1 The optimizing state

This section is devoted to the analysis of the two optimization problems faced by the State.

The first goal consists in solving the following:

$$\max_{t, \alpha} T(a(e, r(\alpha)), t). \tag{15}$$

In order to tackle the problem, we first analyze the behavior of the tax revenues with respect to both  $t$  and  $\alpha$ .

Following the standard literature, there exists a threshold for the tax rate  $\tilde{t}_{e, \alpha} \in (0, 1)$  such that:

$$\begin{cases} \frac{\partial T(a(e, r(\alpha)), t)}{\partial t} > 0, & \text{for } t < \tilde{t}_{e, \alpha}; \\ \frac{\partial T(a(e, r(\alpha)), t)}{\partial t} < 0, & \text{for } t > \tilde{t}_{e, \alpha}; \\ \frac{\partial T(a(e, r(\alpha)), t)}{\partial t} = 0, & \text{for } t = \tilde{t}_{e, \alpha}. \end{cases} \tag{16}$$

It is important to observe that (16) comes out from the model. Indeed we argue that, *ceteris paribus*, a change in the tax rate creates two opposite effects: (i) the tax revenues  $T(a(e, r(\alpha)), t)$  increases linearly with respect to  $t$  (see (13)); (ii) the tax revenues are reverse U-shaped with respect to  $t$ , as (9) and (13) state. Formula (16) gives the usual Laffer-type relation between tax revenues and tax rate when the latter is stronger than the former.

Yet we also stress that, unlike the mainstream literature, condition (16) implies that the government revenues of a country with institutional parameter  $a(e, r(\alpha))$  follow an institutions-conditional Laffer curve,  $\tilde{t}_{e, \alpha}$  being the optimal Laffer tax rate. Now, consider  $e, t \in [0, 1]$ . There exists a threshold  $\underline{\alpha}$  such that:

$$\begin{cases} \frac{\partial T(a(e, r(\alpha)), t)}{\partial \alpha} > 0, & \text{for } \alpha < \underline{\alpha}; \\ \frac{\partial T(a(e, r(\alpha)), t)}{\partial \alpha} < 0, & \text{for } \alpha > \underline{\alpha}; \\ \frac{\partial T(a(e, r(\alpha)), t)}{\partial \alpha} = 0, & \text{for } \alpha = \underline{\alpha}. \end{cases} \tag{17}$$

Even the relation (17) stems from the model. As, *ceteris paribus*, the parameter  $\alpha$  changes, two contrasting behaviors emerge: (i) tax revenues  $T(a(e, r(\alpha)), t)$  are reverse U-shaped with respect to  $\alpha$  (see Eqs. (8) and (13)); (ii) tax revenues increase, since  $y^*$  decreases. Similarly to the previous reasoning, we argue that the former effect is more relevant than the latter, hence formula (17). An excessive  $\alpha$ , in fact, while reducing tax evasion also hampers the public capital accumulation and, hence, output. Due to the diminished taxable income, tax collection shrinks.

337 *Remark 1* Due to the presence of the *ceteris paribus* positive effect of the tax rate on tax  
 338 revenues, it is immediate to see that the threshold for the tax rate  $\tilde{t}_{e,\alpha} \in (0, 1)$  defined in (9)  
 339 cannot be greater than  $\tilde{t}_{e,\alpha}$ . By the same token, we have  $\underline{\alpha} > \bar{\alpha}$ , where  $\bar{\alpha}$  is defined in (8). As  
 340 we shall see, this outcome will turn out to be useful when comparing different policies.

341 Following the argument above, it also turns out that, if  $a_1 < a_2$ , then  $T(a_1, t) < T(a_2, t)$ ,  
 342 for any  $t \in (0, 1]$ .

343 The optimization problem (15) is then solved by the pair  $(t^*, \alpha^*) = (\tilde{t}_{e,\underline{\alpha}}, \underline{\alpha})$ , i.e.:

$$344 \max_{t,\alpha} T(a(e, r(\alpha)), t) = T(a(e, r(\alpha^*)), t^*) = T(a(e, r(\underline{\alpha})), \tilde{t}_{e,\underline{\alpha}}). \quad (18)$$

345 Let us now examine the second goal. By (3) and (10), the problem can be formalized as  
 346 follows:

$$347 \max_{t,\alpha} g(\alpha, L_{\alpha}^*(t)). \quad (19)$$

348 The solution of the optimization problem (19) comes out from the analysis of the household's  
 349 output. In this case, formulas (8) and (9) give that  $Y^*$  is reverse U-shaped both with respect  
 350 to both  $t$  and  $\alpha$ . Therefore, the solution of the optimization problem is  $(t^*, \alpha^*) = (\tilde{t}_{e,\bar{\alpha}}, \bar{\alpha})$ ,  
 351 and we have:

$$352 \max_{t,\alpha} g(\alpha, L_{\alpha}^*(t)) = g(\alpha^*, L_{\alpha^*}^*(t^*)) = g(\tilde{t}_{e,\bar{\alpha}}, L_{\bar{\alpha}}^*(\tilde{t}_{e,\bar{\alpha}})). \quad (20)$$

## 353 5.2 Some remarkable results

354 The optimization performed in the previous section allow us to emphasize some important  
 355 features of our model.

356 Let us start from the analysis of the  $T$ -maximizing State.

357 The function  $T$  is well-behaved so that we can explicitly describe how  $e$  and  $\underline{\alpha}$  affects  
 358 the optimal tax rate  $t^*$  in defining  $\tilde{t}_{e,\underline{\alpha}}$ . In fact, by applying the Implicit Function's Theorem  
 359 (IFT), there exists a function  $t^* = t^*(a)$  that is continuous and such that

$$360 \frac{\partial T(a, t^*(a))}{\partial t} = 0, \quad \forall a \in \mathbf{R}. \quad (21)$$

361 The IFT and Eq. (21) allow us to think of the Laffer optimal tax rate  $t^*$  as a function of the  
 362 institutional setting  $a$ . Following Friedman et al. (2000), we assume that  $t^*(a)$  is an increasing  
 363 function. Also, conditional on any given  $a$ , we define the Laffer-optimal (maximum) revenue  
 364 level  $T_a^* := T(a, t^*(a))$ . Since  $T$  is positively related to  $a$ , then  $T_a^*$  is increasing with respect  
 365 to  $a$  as well.

366 We now limit the analysis to the situation in which a country, with an institutional setting  $a$ ,  
 367 levies the optimal tax rate  $t^*(a)$  and reaches the maximum level of revenue  $T_a^*$ . Accordingly,  
 368 the following analysis will be restricted to the optimal tax rate,  $t = t^*$ . It is worth noticing  
 369 that we use this restriction only because in whichever point different from the lafferian top  
 370 tax rate our results are simply reinforced. This said, we ask: what are the features of this  
 371 peculiar "best case" fiscal framework?

- 372 •  $T^*$  decreases with respect to the undeclared level of income  $y^*$ , as it naturally should be.
- 373 • Since  $t^* = t^*(a)$  is continuous and increasing, then it is also invertible. Thus, there exists  
 374 a function  $k$  such that

$$375 t^* = t^*(a) \Leftrightarrow a = k(t^*). \quad (22)$$

376 A standard analytical argument gives that  $k$  is continuous and increasing.

377 From (22) and since  $t^*$  is increasing with respect to  $a$ , it turns out that only countries with  
 378 a high-quality institutional setting can afford to impose a large optimal tax rate threshold  
 379  $t^*(a)$ . This is in line with the analysis by Friedman et al. (2000). Notwithstanding the high  
 380 tax rate, this kind of Bureau enjoys a small optimal share of undeclared income because of  
 381 the high expected penalty facing its taxpayers.

382 A further mathematical implication of the connections between  $a$  and  $y^*$  is the invertibility  
 383 of  $y^*$  as a function of  $a$ . There exists a decreasing function  $m$  such that

$$384 \quad y^* = y^*(t^*(a), a) \Leftrightarrow a = m(y^*). \quad (23)$$

385 Condition (23) has a deep as well as logic significance: an increase in the share of undeclared  
 386 income,  $y^*$ , worsens the institutional setting of a country.

387 This outcome is in stark contrast with the positive correlation between  $t$  and  $y^*$  highlighted  
 388 by the standard approach to the tax evasion. In particular, as we will show, our theoretical  
 389 model points out that for the maximum level of institutional setting,  $\bar{a}$ , the share of undeclared  
 390 income is minimized. However, the institutional setting level  $\bar{a}$  cannot be attained. As a  
 391 consequence, the theoretical minimum level of undeclared income is outside the strategies  
 392 available to the government. As such, it is not a practicable equilibrium of the economic  
 393 system.

394 By the arguments explained above on the institutional setting parameter  $a$ , we are able  
 395 to show that self-consistent, feasible, triplets do not allow to obtain a situation with zero  
 396 tax evasion. We keep analyzing the “best case”, that is the optimal lafferian State:  $(t, \alpha) =$   
 397  $(t^*, \alpha^*)$ .

398 Fix  $e \in [0, 1]$  and define the function  $f_e$  of the variable  $\alpha$  such that

$$399 \quad f_e(\alpha^*) = T_{a(e, r(\alpha^*))}^* = T(a(e, r(\alpha^*)), t^*(a(e, r(\alpha^*))))). \quad (24)$$

400 As stated above, the optimal revenue  $T_a^*$  is continuous and increasing with respect to  $a$ ;  
 401 moreover,  $a = a(e, r(\alpha^*))$  is a continuous and increasing function with respect to  $\alpha^*$ . Thus,  
 402 the function  $f_e$  defined in (24) is continuous and increasing, and this implies the existence  
 403 of its inverse  $Q_e$ , that is continuous and increasing and works as follows:

$$404 \quad f_e(\alpha^*) = T_a^* \Leftrightarrow \alpha^* = q_e(T_a^*). \quad (25)$$

405 Consider now the optimal regulation threshold defined implicitly in (12).

406 Fix  $\alpha^* \in [0, 1]$  and define the function  $f_{1, \alpha^*}$  of the variable  $e$  such that

$$407 \quad f_{1, \alpha^*}(e) = T_{a(e, r(\alpha^*))}^* = T(a(e, r(\alpha^*)), t^*(a(e, r(\alpha^*))))), \quad \forall e \in [0, \bar{e}_{\alpha^*}]. \quad (26)$$

408  $T_a^*$  is continuous and increasing with respect to  $a$  and  $a = a(e, r(\alpha^*))$  is continuous and  
 409 increasing with respect to  $e$  in  $[0, \bar{e}]$ . Thus, there exists its inverse  $q_{1, \alpha^*}$  that is increasing and  
 410 such that

$$411 \quad f_{1, \alpha^*}(e) = T_a^* \Leftrightarrow e = q_{1, \alpha^*}(T_a^*), \quad \forall T_a^* \in [T_{a(0, r(\alpha^*))}^*, T_{a(\bar{e}_{\alpha^*}, r(\alpha^*))}^*]. \quad (27)$$

412 A very similar argument gives that, if we fix  $\alpha^* \in [0, 1]$  and define the function  $f_{2, \alpha^*}$  of the  
 413 variable  $e$  such that

$$414 \quad f_{2, \alpha^*}(e) = T_{a(e, r(\alpha^*))}^* = T(a(e, r(\alpha^*)), t^*(a(e, r(\alpha^*))))), \quad \forall e \in [\bar{e}_{\alpha^*}, 1], \quad (28)$$

415 then there exists a decreasing function  $q_{2, \alpha^*}$  such that

$$416 \quad f_{2, \alpha^*}(e) = T_a^* \Leftrightarrow e = q_{2, \alpha^*}(T_a^*), \quad \forall T_a^* \in [T_{a(1, r(\alpha^*))}^*, T_{a(\bar{e}_{\alpha^*}, r(\alpha^*))}^*]. \quad (29)$$

417 The true meaning of the formalized relations between Laffer-optimal revenues and regulations  
 418 can be stated as follows: a greater level of revenues implies that a country spending  $\alpha$  (to  
 419 increase  $r$ ) is improving its bureaucratic apparat so that  $e$  is approaching  $\bar{e}_\alpha$ , i.e. the “Laffer-  
 420 optimal” regulation level.

421 More importantly, the relationship between the couples  $(T^*, \alpha^*)$  and  $(T^*, e)$  formalized  
 422 in (25), (27) and (29), allows us to state the existence of a relationship between  $e$  and  $\alpha^*$ .  
 423 Specifically, there exists a function  $h$  such that  $\alpha^* = h(e)$  and

$$424 \quad \begin{cases} h'(e) > 0, & \text{for } e < \bar{e}_{\alpha^*}; \\ h'(e) < 0, & \text{for } e > \bar{e}_{\alpha^*}; \\ h'(e) = 0, & \text{for } e = \bar{e}_{\alpha^*}. \end{cases} \quad (30)$$

425 Our model has important implications.

426 Next Proposition proves that the  $T$ -maximizing State has some constraints in choosing  
 427 the share of public expenditure devoted to fight the tax evasion:

428 **Proposition 2** *The level  $\alpha^* = 1$  cannot be reached.*

429 Another intriguing result of our analysis deals with the persistence properties, and the  
 430 consequent ineluctability, of the tax evasion:

431 **Proposition 3** *Given  $e \in [0, 1]$ , then*

$$432 \quad y^*(t^*(a(e, r(\alpha^*))), e, r(\alpha^*)) > 0.$$

433 Let us now turn our attention to the output-maximizing State. In this case next Proposition  
 434 will show that, starting from (20), the underground economy cannot be avoided:

435 **Proposition 4** *Given  $e \in [0, 1]$ , then*

$$436 \quad y^*(\bar{t}_e, \bar{\alpha}, e, r(\bar{\alpha})) > 0.$$

437 Whichever the preferred target, then, another situation in which the tax evasion can be  
 438 reduced to zero is when the ruler sets the tax rate equal to zero. Although clearly this is too  
 439 extreme a case, our model allows to conceptualize it. If a country applies a tax rate  $t = 0$ , then  
 440 (22) gives that the institutional setting of the country is  $a = g(0)$ . Since  $g$  is an increasing  
 441 function, then  $g(0) = \bar{a} = 0$ . As expected,  $t = 0$  is incompatible with functional values of  
 442 the other variables of the model. Moreover,

443 *Remark 5* If the only aim of the State were to minimize the tax evasion, it should implement  
 444  $t^* = 0$  and/or  $\alpha^* = 1$ . The former is unrealistic and the latter is impossible (see Proposition  
 445 2). This is a supporting argument to the unavoidability of the underground economy.

446 All in all, the State is not able to erase totally the tax evasion.

447 Finally, by Remark 1, we have that the tax rate which maximizes the output cannot be  
 448 greater than the one maximizing the tax revenues. This fact implies that the fiscal policies  
 449 that a country should implement to maximize the output are lighter than the ones useful for  
 450 the maximization of the revenues.

451 *Remark 6* Our model is able to conceptualize bad and good equilibria. The former are char-  
 452 acterized by a low level of tax rate and institutional setting and a high level of tax evasion.  
 453 Good equilibria, instead, are identified by a high level of tax rate and institutional setting,  
 454 and a low level of tax evasion.

455 The arguments outlined in Remark 6 come out directly from the relationship between  
 456 the variables  $a$ ,  $y^*$  and  $t^*$ . Specifically, formula (22) explains that  $t^*$  and  $a$  are positively  
 457 correlated, while (23) states that  $y^*$  and  $a$  are negatively correlated.

## 458 6 The model and the reality

459 This section offers a simple attempt to see how our theoretical model is able to match the real  
 460 world. In doing that we focus on two rich countries, likely lying in good equilibria and that  
 461 differ with respect to their macroeconomic goals, namely revenues and output maximiza-  
 462 tion. As mentioned, these goals could be seen as representative of the policies implemented  
 463 in, respectively, social-democratic (say, Sweden, henceforth denoted with subscript 1) and  
 464 capitalistic (say, the USA, henceforth denoted with subscript 2) countries.

465 Before going through the data, it is worth recalling that ours is a static general equilibrium  
 466 model. Thus, what is important here is to see whether our theoretical suggestions match the  
 467 systematic tendencies of data with no consideration about dynamics.<sup>8</sup> The generality of our  
 468 model is also mirrored in the definitions of some of the variables we are dealing with. Just to  
 469 mention, in our economy there is just one tax rate, the institutional setting may be thought  
 470 of as including several (potentially strongly correlated) variables such as corruption, the rule  
 471 of law and so on. This means that, hopefully, further (empirical and theoretical) analyses  
 472 can stem from our model. Yet, there is an obvious trade off between the number of variables  
 473 and the analytical tractability of a model.<sup>9</sup> Also, as already underlined, our main aim is the  
 474 theoretical conceptualization, not the quantification, of the links between the variables. These  
 475 latter, then, are non linear and, accordingly, not easy to examine by standard econometric  
 476 tools.<sup>10</sup> On the positive side, we can afford to compare just two economic systems. Obviously,  
 477 it greatly simplifies the comparisons and reduces data problems. Finally, it should be clear  
 478 that the less reliable data are, the greater is the need for the empirical analysis to be supported  
 479 by sound theoretical indications. This said, we are eventually ready to see whether the real  
 480 life situation matches the analytical structural prescriptions of the model.

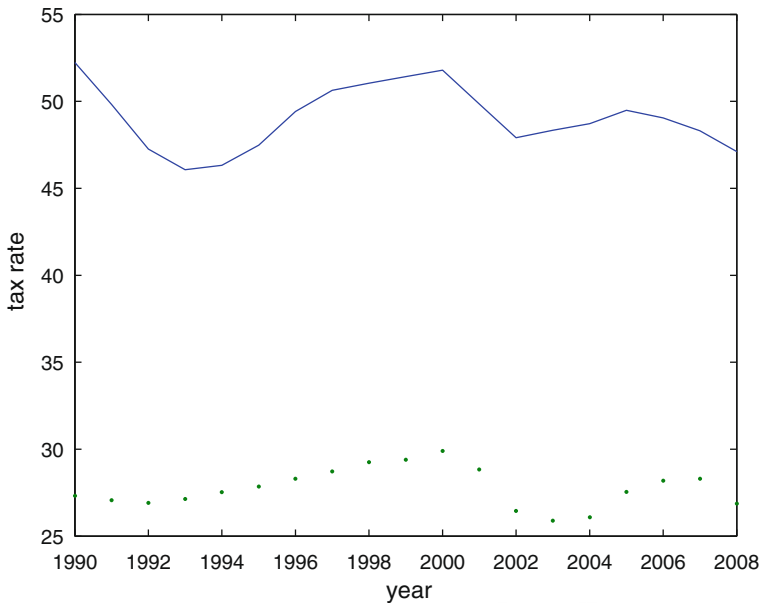
481 According to our model,  $t_1 > t_2$ . Indeed, the tax rates that a revenues-maximizing country  
 482 imposes on citizens is greater than the one imposed by an output-maximizing country, as  
 483 Remark 1 shows. This result fits the evidence of a structurally larger tax rate in Sweden than

<sup>8</sup> For a recent example of a dynamic analysis dealing with the tax evasion, see [Cerqueti and Coppier \(2011\)](#).

<sup>9</sup> For instance, an intriguing improvement of our model could be inserting income distribution and/or, more explicitly, corruption in our framework. [Hillman \(2004\)](#) describes how corruption, akin tax evasion in our model, reduces tax revenues and affects economic development.

<sup>10</sup> This may explain the different results obtained by splitting world-wide samples as, e.g., in [Friedman et al. \(2000\)](#) with respect to [Bovi and Dell'Anno \(2010\)](#).





**Fig. 1**  $t_1$  (continuous line) is constantly greater than  $t_2$  (dotted line)

484 in the USA. In Fig. 1 the time series of the annual tax rates<sup>11</sup> applied in Sweden and in the  
 485 USA in the period 1990:2009 are plotted.

486 Since  $t_1 > t_2$ , our model states also that  $a_1 > a_2$ . Indeed, relations (22) show that the  
 487 institutional parameter  $a$  increases with respect to  $t$ . This result is in line with both the common  
 488 wisdom that a mature social democracy is featured by a top-quality institutional setting  
 489 and qualitative data such as the World Bank's "Indicators of Governance and Institutional  
 490 Quality".<sup>12</sup>

491 Moreover, we also have that  $\alpha_1 > \alpha_2$ . This result is grounded on  $a_1 > a_2$ , by using the  
 492 relations in (11). It sounds palatable and somewhat in line with the study by Van der Weele on  
 493 tax evasion (2009)—a country with very high statutory tax rates needs to check tax evasion  
 494 more forcefully than a country where the taxpayers are not request to contribute so heavily.

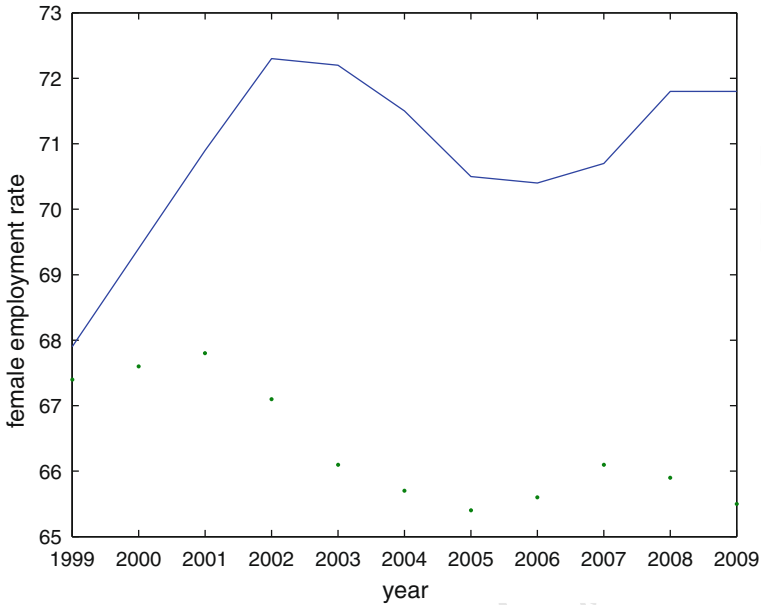
495 Lastly, we have  $L_1 > L_2$ . This finding is based on  $\alpha_1 > \alpha_2$ , since  $L$  increases with respect  
 496 to  $\alpha$ . In fact, data shows that the employment rates in well-established social democracies are  
 497 structurally larger than the ones recorded in capitalistic countries. Though ours is a theoretical  
 498 model, we are nevertheless strongly tempted to speculate that this may be so due to well-  
 499 functioning publicly-funded social infrastructures allowing, e.g., women to participate more  
 500 actively in the labor market. This result is in line with the employment rates of the females in  
 501 Sweden and in the USA. In Fig. 2 the time series of the annual female employment rates<sup>13</sup>  
 502 in Sweden and in the USA in the period 1999:2009 are plotted—once again the structural  
 503 indications of our model are mirrored in the trend of the data.

504 Despite the availability of reliable data referring to hidden activities is almost by definition  
 505 narrowed, some consideration based on the ranking appears reasonable. Specifically, figures  
 506 say that  $y_1 > y_2$  (see Table 1).

<sup>11</sup> Source: OECD.

<sup>12</sup> See <http://www1.worldbank.org/publicsector/indicators.htm>.

<sup>13</sup> Source: Eurostat.



**Fig. 2**  $L_1$  (continuous line) is constantly greater than  $L_2$  (dotted line)

**Table 1** The estimate of the shadow economy in Sweden and USA

Source Bovi and Dell'Anno (2010).

	1990	1993	1995	1998	2000	2003
$y_1$	18.8	20.5	24.2	24.8	23.8	22.4
$y_2$	7.2	8.9	9.6	9.8	9.5	9.2

On that, our model guarantees that the value of  $y$  increases with respect to  $t$  and decreases with  $a$ . Therefore, we argue that the legal tax rate in Sweden is so high that, in spite of the presence of very well functioning institutions, the Sweden's underground sector is tendentially larger than that of the USA. This finding is in line with both the classical theoretical prescriptions of Allingham and Sandmo (1972) and the empirical outcomes by Bovi and Dell'Anno (2010) that, like us, focus on rich economies.

Given the Laffer relations for  $T$  with respect to  $t$ , and  $Y$  with respect to  $\alpha$ , we are not able to theoretically conclude which is the greater between  $T_1/Y_1$  and  $T_2/Y_2$ . Nonetheless, evidence suggests that  $T_1/Y_1 > T_2/Y_2$ . This means that an increase in the legal tax rate has a greater negative impact on output than on the tax revenues when a country maximizes the tax revenues.

## 7 Concluding remarks

The existing literature on tax evasion typically deals with its measurement, causes, consequences and remedies. Less analysed, at least explicitly, is the reason why the tax evasion is so persistent and how it impacts, given its longevity, on the long run macroeconomic performances of different economic systems.

This paper has exploited both traditional and recent indications to conceptualize the relationships between taxation, institutional setting and tax evasion. In doing that, and since tax evasion is a fact of life even in rich countries, this paper has focussed on the comparison between the macroeconomic performances of two well-established Bureaus—a social-democracy and a capitalistic country—which aim to maximize, respectively, fiscal revenues and GDP. The theoretical model is general and, as a consequence, it is robust to several specifications. Furthermore, it reconciles two important strands of research and it allows to examine a number of usually overlooked non linear “Laffer-type” connections. As per the comparison between economic systems, the model leads to the following results. Governments cannot be revenues—and GDP-maximizers at the same time and the effects of the tax evasion are different according to the different policy targets pursued by the State. As compared to GDP-maximizing states, then, revenues maximizing ones are featured by higher tax rates, more pervasive regulations and, consequently, from larger tax evasion despite they spend relatively more to contrast tax dodgers. On the other hand, revenues maximizing governments can afford to have better institutional settings and greater participation rates. This said, in no case the Bureau is able to erase totally the tax evasion, which may explain why this latter is so pervasive and persistent even in affluent economies i.e., in the words of the institutional literature, even in good equilibria. As a consequence, differently politically-oriented mature countries may not share the same good equilibrium that, accordingly, is not unique.

## Appendix

*Proof of Proposition 2* Let us fix  $e \in [0, 1]$  and assume  $\alpha^* = 1$ . Formula (30) assures that  $e = \bar{e}_{\alpha^*} = \bar{e}_1$ . Hence we get  $a(e, r(\alpha^*)) = a(\bar{e}_1, r(1)) = \bar{a}$ . From (22) and since the tax rate is increasing with respect to the institutional setting parameter  $\alpha$ , we have that  $t^* = t^*(\bar{a})$  is the maximum level of lafferian tax rate. This means that the share of undeclared income  $y^*(t^*)$  reaches its maximum level, since  $y^*(t^*)$  is increasing. The analysis of the Laffer revenue  $T^*$  points out that two inconciliable situations should coexist:

- $T^*$  must reach its *maximum* level as function of  $t^*(\bar{a})$  (see formula (16)).
- $T^* = T^*(y^*)$  must reach its *minimum* level, since the level of the optimal Laffer revenue decreases with respect to  $y^*$ .

We have an evident contradiction. □

*Proof of Proposition 3* Let us fix  $e \in [0, 1]$  and assume  $y^* = 0$ .

By (23), we derive that  $a$  attains its maximum value  $\bar{a}$ , since it decreases with respect to  $y^*$ . Therefore,  $t^*(\bar{a})$  is maximum, by using relation (22). Since  $y^*$  increases with respect to the tax rate, we have an evident contradiction. □

*Proof of Proposition 4* Let us fix  $e \in [0, 1]$  and assume  $\alpha = \bar{\alpha}$  and  $t = \bar{t}_{e, \bar{\alpha}}$ .

Since  $y^*$  decreases with respect to  $\alpha$ , then

$$0 < y^*(\bar{t}_{e, \bar{\alpha}}, e, r(\alpha)) < y^*(\bar{t}_{e, \bar{\alpha}}, e, r(\bar{\alpha})), \quad \forall \alpha < \bar{\alpha},$$

and the result is proved. □

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