

Tax avoidance and fiscal limits: Laffer curves in an economy with informal sector

By Lukas Vogel

The paper augments the QUEST III model by home production to discuss fiscal limits in an economy with tax avoidance. The analysis offers a general-equilibrium assessment of the economic limits to distortionary taxation. The general-equilibrium approach captures direct and indirect effects of tax policy, i.e. the first-round mechanical impact of the tax rate on tax revenue at a given tax base and the second-round effects of tax rates on tax bases. The model is calibrated to an average EU member country.

The paper adds an informal sector in the form of home production to the open-economy framework. Home production is modelled as informal alternative to activity in the official sector. The inclusion of home production in the model gives rise to tax avoidance by relocating activity from the official to the informal sector, which increases the elasticity of tax bases with respect to distortionary taxes. In addition, the open-economy framework addresses some aspects of international tax competition.

The analysis builds on the concept of Laffer curves that display tax revenues as a function of tax rates. The peak of the Laffer curve shows the revenue-maximising tax rate. It is the point beyond which tax base contraction more than offsets the positive impact of tax increases on the total tax revenue.

The paper finds that revenue-maximising labour and corporate tax rates in the benchmark model are relatively high (54% and 72%) compared to current EU-average implicit tax rates (37% and 32%). No revenue limit is found for the consumption tax. Higher substitutability between market and home production flattens the Laffer curves for labour and corporate taxation and introduces one for the consumption tax, however. In the case of high substitutability between market and home goods in demand and supply, the revenue-maximising labour tax rate is only slightly above the current EU-average implicit labour tax rate. In this case, there is also a Laffer curve for the tax on consumption, with tax revenues practically flat for tax rates of 40% and above.

Although tax increases raise additional tax revenue, the economic costs of higher distortionary taxation are substantial. Increasing total tax revenue by 12%, which is the maximum fiscal space for labour and corporate taxation in the benchmark model, reduces total output by 12% in the case of the labour tax increase, 9% in the case of the corporate tax increase, and 1% in the case of an equivalent increase in the consumption tax.