Taxation and Revenue Extraction: A Snapshot
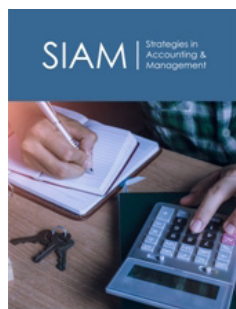
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Opinion

My recent research interest lies in the sphere of government efficiency, and in particular in the sphere of public finance and revenue extraction. In Bulgaria, the poorest EU member state, consumption (VAT) taxation makes almost 45 percent of total tax revenue, and evasion in this category is the largest. I think that it would be interesting to pursue the political economy issue of why the government cannot collect all the VAT. Intimately tied to the question of tax compliance is the issue of the size of the informal sector. One way to approach the issue is to connect the problem to the "fiscal capacity" category introduced in Tabellini, which is also ties to the overall notion of "state capacity" and the quality of institutions. In my earlier work, Vasilev [1], I introduce a rent-seeking technology, where the degree of VAT evasion is determined endogenously, and is captured by a single parameter. In a policy exercise, I tie this parameter to spending on law and order to measure how the decrease in evasion can be beneficial for the population, in the sense that higher revenue can be then spent on public goods. There is need in my view to go deeper and understand better why the evasion exists. Is it an information problem, i.e., tax authorities using risk-based analysis to determine the auditing probability, and some people fall under the radar, as the cost of checking everyone is too high. Is it a principal-agent problem e.g., Minister vs Prime Minister, or Minister vs administration, or government vs population, the latter becoming a re-election issue? Is it the fact the people are using more tax consultants to avoid taxes legally? Incorporating those mechanisms in a dynamic general equilibrium model, would potentially allow us to get a quantitative measure of the degree of evasion. Later, in Vasilev [2], I delve deeper and model the degree of evasion as a quadratic function of the consumption tax rate itself-the higher the rate, the higher the incentive to evade taxes. Bulgaria is a good testing case for the theory, as it features a non-differentiated VAT rate-20 percent (with the exception of the tourism tax-8 percent- which is a tax on exports anyway). This modeling choice is able to generate a hump-shaped consumption-Laffer curve. To my knowledge, this is the only mechanism that can generate a peak in the consumption tax revenue as a function of the VAT rate in a plausible range of 0-100 percent. My follow-up work in Review of Economics deals with the optimal fiscal policy and the tax mix of consumption tax revenue vs income taxation, while Vasilev [3] performs the optimal policy exercise in the context of VAT evasion. In addition, for countries depending on indirect taxation, it might be interesting to measure the relative elasticity of demand and supply with respect to the VAT rate, in order to see change in the relative tax burden of VAT changes. This could be established through the use of a carefully designed experiment. An experiment could also try to track the "empirical consumption-VAT Laffer curve", which would be of interest to fiscal authorities. Together with the evasion channel this could advise the government of the trust in the fiscal branch, and its perceived ability to enforce the tax laws.

People's willingness to pay taxes (versus the choice of conducting transaction in the informal economy) is certainly a behavioral issue worth studying on its own, and a function of the audit probability, the penalty rate, and the reputation factor, among many others. That is why this aspect of people's behavior could be studied with experimental methods. What

we learn from those surveys/experiments, could be then used to inform authorities on the expected effects of certain tax reforms. For example, if high VAT drives evasion, one might suggest simply lowering the VAT on certain necessities, such as food and books. However, tax revenue might drop even further, as one unexpected effect might be that this policy would trigger an optimal response among merchants and lead to the re-labeling all magazines to "books," or a case where suddenly pastries become essential food items.

References

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2. Aleksandar V (2018a) Is consumption-laffer curve hump-shaped? The VAT evasion channel. Journal of Economic Studies 45 (3): 598-609.

3. Aleksandar V (2018b) Optimal fiscal policy in the presence of VAT evasion: The case of Bulgaria. Czech Journal of Finance and Economics 68 (4): 399-414.

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