

Tax Evasion and Macroeconomic (In)stability

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Abstract : This paper incorporate tax evasion into a one-sector real business cycle (RBC) model to explores the quantitative interrelations between income tax rate and equilibrium (in)determinacy, and income tax rate is endogenously determined in order to balance the government budget. We find that the level of the effective income tax rate is key factor for equilibrium (in)determinacy, instead of the level of income tax rate in a tax evasion economy. Under an economy with tax evasion, the higher income tax rate is not sufficiently to lead to equilibrium indeterminate, it must combine with a necessary condition which is the lower fraction of tax evasion and that can result in agents' optimistic expectations to become self-fulfilling and sunspot fluctuation more likely to occur. On the other hand, an economy with tax evasion can see its macroeconomy become more stabilize, and a higher fraction of income tax evasion may has a stronger stabilizing effect.

Keywords : tax evasion, balanced-budget rule, equilibrium (in)determinacy, effective income tax rate

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