

Optimal Audits with Search and Tax Evasion*

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Abstract

This paper studies the trade-off between the formal sector tax rate and output seizures in the underground economy (the audit rate). Audits are assumed costless to implement and that formal and underground goods are of equal quality. If an auctioneer sets the price in each market, the optimal policy equates the tax rate to the audit rate. Next, we remove the auctioneer from the underground market by assuming that underground traders must search in order to trade. An increase in the tax rate reduces formal sector output, but the same percentage increase in the audit rate reduces underground output by an even larger margin. An increase in the audit rate does not only reduce output within each trade encounter; it also reduces the aggregate number of trade encounters as agents search less. The optimal audit rate is low, as consistent with data. If underground goods are inferior to formal sector goods, the optimal audit rate rises, but this is promptly reversed if we allow for costly audits.

Keywords: Search Intensity, Audits, Taxation, Underground Economy

JEL classification: E26, H26, L51, O23

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