

# Tax Evasion and Financial Development under Asymmetric Information in Credit Markets

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## 1 What is the question?

We find that there is a negative correlation between financial development and tax evasion from previous studies. The author tries to build up a model to explain this phenomenon. This model is mainly involved in three parts. First, the author tries to solve the optimal tax evasion problem for firms. Second, the paper analyze how the optimal financial contract was determined between financial intermediaries and firms. In the end, the paper discuss how government set up the optimal tax enforcement to maximize social welfare.

## 2 Why should we care about it?

For firms, their ultimate goal is to maximize profit. Given the tax auditing probability set up by the government, firms need to find out how much tax they need to evade to maximize their expected after-tax profit. However, from the standpoint of a benevolent government, its goal is maximizing social welfare, so it needs to find out the best tax auditing policy according to different financial development. No matter which role we are playing, we all need a model to help us figure out the best strategy.

## 3 What is the author's answer?

(1) A tighter tax auditing policy will lead to an increase in the expected after-tax rate of returns and more tax compliance by firms.

(2) There are some efficient firms can borrow money without any informational imperfection and some extremely inefficient firms cannot receive bank loans, others need to borrow with costly monitoring. The equilibria of the thresholds were solved.

(3) A lower agency cost (better financial development) will increase the socially optimal tax auditing probability.

## 4 What's the implications of the answer? What do we learn from the paper?

Given the country's financial development, we can evaluate a government's tax auditing policy, testing whether it is good for a country. Or we can use a government's tax auditing policy to estimate the degree of financial development of a country.