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Yulia (Paramonova) Kuchumova

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# The Optimal Deterrence of Tax Evasion: The Trade-off Between Information Reporting and Audits

Yulia (Paramonova) Kuchumova
Department of Economics, National Research University Higher School of Economics in St. Petersburg

**Abstract**

Despite the widespread recognition of the effectiveness of information reporting to increase tax compliance, existing tax theory considers tax audits to be the only tool to prevent evasion. This paper extends tax theory by modeling information reporting as an additional enforcement instrument that allows a tax authority to acquire signals about taxpayers' income. The paper rigorously characterizes the optimal strategy to maximize tax revenue when enforcement resources are limited. It determines the optimal allocation of resources between audits and information reporting, which is governed by how effectively the signals facilitate audit targeting. The model demonstrates that the value of information reporting declines with audit coverage because of the corresponding decline in the value of audit targeting. The optimal level of information reporting is an inverse U-shaped function of the budget allocated to enforcement, while the optimal audit coverage always increases with the budget. This finding implies that at some point it may not be optimal to expand information reporting.

**Keywords**: information reporting; tax audit; optimal enforcement
**JEL Code**: H21, H26

## 1. Introduction

Information reporting is a highly valuable tool for improving tax compliance.[1] It serves this purpose by reducing the information asymmetry between the tax authority and taxpayers. It does so by allowing the tax authority to verify tax returns against reports about

[1] According to the existing empirical literature (Kleven et al. [16], Gordon and Li [10], Alm, Deskins and McKee [1], Klepper and Nagin [14]), income sources that are subject to information reporting are characterized by a higher tax compliance than income sources that are not. On the basis of the report of the IRS (IRS [12]), noncompliance is 56 percent for incomes without information reporting and withholding and 1 percent for incomes with both information reporting and withholding.