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REFEREE-REPORT of the paper

Hidden Economies and the Socially Optimal Fiscal-Tax to Liquidity-Tax Ratio

written by Marco Ercolani (University of Birmingham)

As wished by the editor, I concentrate in this referee-report on the following two questions:

(1) Is a contribution of the paper potentially significant?
After a major revision of this paper, I think, the contribution will be potentially significant, but the author has to clarify the theoretical approach and he has to work a lot on his empirical estimations.

(2) Is the analysis correct?
See the referee-report below. From a methodological standpoint, I think, there are two problems, which I have with the paper.

(3) Referee-Report
The author wants to show by using differential tax analysis how the socially optimal fiscal tax to liquid tax ratio changes with the relative size of the tax avoiding hidden economy. He reaches the results, the smaller the relative size of the hidden economy, the larger the optimal fiscal-tax to liquidity-tax ratio. The author argues that these results are additionally supported by an empirical gross section and panel analysis. I have the following four points of criticism:

1. Theoretical approach
Considering the theoretical approach, I have one big problem: Does the author assumes his model is in a “first best” world where we have a government acting like a benevolent dictator maximizing a social welfare function? I think the author assumes this. If this is really the case then in such a economy there should be no shadow economy, because we live in a first best world and “tax rates” are only evaluated under the aspect that they minimize distortions so that the shadow economy should not exist. If we live in a second or third best world, where a shadow economy exist, then I do not see what the socially optimal behaviour of

thegovernment really should be. The authors write on page 7 "…the government's preferences are simply to minimize fiscal and liquidity tax distortion subject to maintaining its predetermined expenditure policy…". On page 5 the author writes "…the government seeks to maximize social welfare by coordinating the actions of its three administrative branches: the expenditure branch, the treasury and the central bank. As in Phelps the total tax burden is predetermined by the government's exogenous expenditure policy which can include some deadweight loss…". If the author assumes this, then for me it is really not clear how a shadow economy can exists and this is not convincingly shown in the paper. The author should really solve this problem and model government behaviour in a second best or third best world.

2. Empirical analysis

From the econometric standpoint the empirical analysis is well done. However I have several problems interpreting the empirical regressions in tables 2-5. First, what is really missing is, is that the author writes down the test equation and derives the signs of the independent variables in his test equation. Third, what is much more problematic in the test equation is that in all test equations the only "valid" independent variable is the size of the shadow economy. To this the author adds a transition dummy variable and a time trend which are all artificial variables. Why did the author not include other independent variables like wage pressure, like GDP per capita or growth rate of GDP or the export/importratio or the openness of a country? There are number of variables which should play a role in explaining either the liquidity-tax to fiscal-tax ratio or the tax to inflation ratio. I think the author really heavily violates the ceteris paribus conditions just including only the shadow economy as the only "valid" independent variable. The author should explain this and should at least show some results, if other important variable are included here, too.

3. Time trend variable

The time trend variable is always highly statistically significant and has a sizeable positive coefficient. Why did the author not use lagged endogenous variables avoiding the problem that he regresses on the dependant variables (a ratio) a time trend, which does not make so much sense. The authors should here try the lagged dependent variable or a more advanced autoregressive structure.

4. Missing interpretation of the regression results

What is totally missing is a good interpretation of the regression results, especially how quantitatively important the size and development of the shadow economy is.

5. Overall evaluation

To formulate a final and last recommendation, I think, this paper has to undergo a major revision, but then it might be an interesting piece for publishing in the journal e-conomics.