Referee report on MS 474 ”Optimal capital income taxation with tax evasion”

The paper examines the appropriateness of differentiated tax rates on capital income in the presence of tax evasion, motivated by an apparent disagreement with the results in a previous paper on optimal taxation in open economies under capital mobility (Sørensen, 2007).

The paper points out that tax evasion complicates optimal taxation analysis since “it brings an additional layer of choice along which taxpayers may move” (p.2) and concludes that “(…) under imperfect capital mobility where domestic sectors with a particularly high or low capital mobility are subject to limited tax evasion, or in absence of significant inter-sectoral differences in tax evasion, it is possible to risk the leaving of direct neutral taxation, because in such cases the benefits obtained in terms of lower distortions will probably surpass second-order effects due to tax evasion. But, in cases when significant differences are observed between reported income elasticities to tax rates in domestic sectors, without certainty about a number of variables and descriptive functions required to truly calculate optimal tax rates, it seems advisable to stick to traditional wisdom suggesting to pursue neutral capital taxation.” (p. 20)

In my opinion, the paper builds on a misreading of Sørensen (2007): Contrary to the impression that a reader might get from the present paper, Sørensen himself points out that the possibility of tax evasion is an important argument against non-uniform tax rates. More specifically, Sørensen list five arguments against differential capital income taxation, of which two are related to tax evasion (transfer pricing and industry reclassification) and he concludes: “In summary, the practitioners’ case against selective direct and indirect taxation remains strong” and “deviations (from uniform taxation) should be accepted only in those few cases where theory and evidence clearly indicate a high welfare cost of uniform taxation” (p. 403).

Thus, regarding its main subject the paper appears to kick in unlocked doors. Also (and similar to Sørensen), the author gives no clear conclusion on the matter. In addition, with respect to the analysis itself and the calculus, I cannot see that it provides convincing arguments against the intuitive argument of Sørensen (2007), that *if* (under special circumstances) one nevertheless should accept differential capital income taxation, then one should tax more heavily sectors (firms) with a high degree of rent.

Based on this I am sorry to say that I do not recommend publication of the paper, as it in my opinion provides little new insight.

If the author still wants to adapt the paper, I recommend a language vetting, as the current text suffer from really long sentences with embedded clauses and parentheses, providing the reader with perhaps to much information at once. This makes the paper a bit hard to read. The lack of conciseness also occur on a higher level; for example, the author appears to discuss with himself on page 11, in argument 1 through 3, directed against his own results (2) and (3). Indeed, these arguments (in particular number 3) are relevant and question the relevance of the entire section 4.1.