Product Number WP2004-7
Released July 31, 2004

Corporate Tax Evasion with Agency Costs

by

Keith J. Crocker

PENNSYLVANIA STATE UNIVERSITY

Joel Slemrod

UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

Corporate Tax Evasion with Agency Costs

Keith J. Crocker
Pennsylvania State University

and

Joel Slemrod
University of Michigan Business School

July, 2004

Corporate Tax Evasion with Agency Costs

Keith J. Crocker and Joel Slemrod

ABSTRACT

This paper examines corporate tax evasion in the context of the contractual relationship between the shareholders of a firm and a tax manager who possesses private information regarding the extent of legally permissible reductions in taxable income, and who may also undertake illegal tax evasion. Using a costly state falsification framework, we characterize formally the optimal incentive compensation contract for the tax manager and, in particular, how the form of that contract changes in response to alternative enforcement policies imposed by the taxing authority. The optimal contract may adjust to offset, at least partially, the effect of sanctions against illegal evasion, and we find a new and policy-relevant non-equivalence result: penalties imposed on the tax manager are more effective in reducing evasion than are those imposed on shareholders.