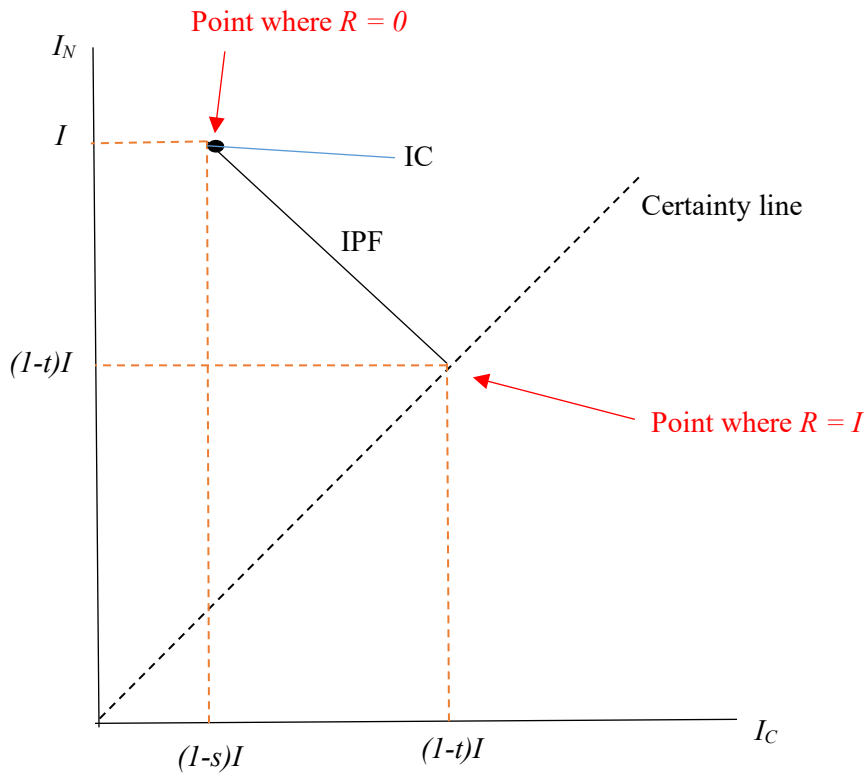


Quiz #5 (Answer Key)  
 ECNS 316  
 Spring 2021

Name \_\_\_\_\_

1.) Consider the tax evasion model we covered in class where  $p_c$  is the probability of conviction,  $s$  is the sanction (i.e., penalty tax rate),  $I$  is actual income,  $R$  is reported income, and  $t$  is the income tax rate. Assuming that  $t/(s-t) > p_c/(1-p_c)$ , how much income will a risk-neutral taxpayer choose to report?



If  $t/(s-t) > p_c/(1-p_c)$ , the taxpayer will choose full evasion and report  $R = 0$ . On the other hand, if  $t/(s-t) < p_c/(1-p_c)$ , then the taxpayer would choose to report full income (i.e.,  $R=I$ ).

2.) What happens to the IPF when the tax rate,  $t$ , goes up?

Your IPF becomes steeper as it rotates clockwise around the point where  $R = 0$ .

3.) What happens to the IPF when income increases?

This is simply a shift out in the IPF.