

Taxation, Underground Economy and Economic Performance*

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Abstract

In this paper, we develop and estimate a dynamic stochastic general equilibrium model with limited tax enforcement for the Sri Lankan economy by means of Bayesian techniques. Our objective is to estimate the size and trend of the underground economy and investigate possible reforms of the income tax policy in Sri Lanka. Our findings reveal that the underground economy in Sri Lanka accounts for an average of 42 per cent of GDP and has been on a growing trajectory since 2012. Counterfactual experiments based on the estimated model suggest that policy reforms to fight against tax evasion are more effective alternatives to stimulating fiscal revenue generation than merely imposing higher income tax rates. Finally, we propose several policy adjustments that not only hold the potential to foster tax compliance but also contribute to augment overall economic performance in Sri Lanka.

JEL Classification: C11, E26, E62, H26

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