



## Perceived tax evasion and the importance of trust<sup>☆,☆☆</sup>

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### ABSTRACT

Using Swedish individual survey data, we analyze the perception of tax evasion in terms of ten different taxes. We find large variation across taxes, highlighting the importance of studying different taxes separately rather than treating tax evasion as one common phenomenon. We focus on the importance of trust in taxpayers and in politicians. Those who do not trust their fellow citizens are more likely to believe that they are evading taxes, but distrust in politicians has an even greater effect, especially for redistributive and fiscally motivated taxes. Hence, it is important for politicians to be perceived as trustworthy in order to be able to collect taxes for maintaining the welfare state.

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### 1. Introduction

Maintaining a general welfare state requires quite large tax revenues. In a non-totalitarian society, tax payment must, at least to some extent, be voluntary and it is therefore important to make people willing to pay the taxes they are obliged to pay. There is a large body of literature on tax compliance that gives explanations to what actually makes people willing to pay taxes.<sup>4</sup> One important determinant has shown to be the *perception* of what others

do: If people are convinced that their co-citizens are doing their fair share, they are themselves more willing to contribute, while perceived tax evasion (true or not) among others affects tax compliance negatively.<sup>5</sup> Hence, understanding *perceived* tax evasion is important in order to prevent *true* tax evasion. This paper attempts to do just that; we analyze factors that make people believe that others evade various kinds of taxes. We use individual survey data from Sweden – a country with a high general tax-level and with a large public sector – and we specifically analyze the respondents' perceived evasion of ten different taxes.<sup>6</sup> An obvious advantage of studying perceived rather than actual tax evasion by means of a survey is of course that we can expect respondents to answer more truthfully when they are not asked to reveal their own behavior in this rather sensitive matter. We find trust both in taxpayers and in politicians to be very important for perceived tax evasion in the sense that (1) the more the respondents claim to trust other people (i.e. taxpayers), the less they suspect them to cheat. However, for

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<sup>4</sup> See Andreoni et al. (1998) for a thorough survey.

<sup>5</sup> Torgler and Schneider (2005) who study Austria find a strong negative impact of perceived tax evasion on tax morale as do Frey and Torgler (2006) using data from 30 European countries.

<sup>6</sup> The taxes are municipal and state income taxes, payroll tax, corporate tax, real estate tax, gift tax, wealth tax, alcohol tax, vehicle tax, and carbon dioxide tax on fossil fuels.

most taxes the effect of political distrust is even greater: (2) respondents who distrust the politicians in the Swedish parliament are about twice as likely to perceive evasion of payroll, corporate, real estate, gift, and wealth taxes to be common compared to those who do not distrust the politicians.

Trust is commonly considered to be important for the maintenance of social capital (Putnam, 1993, 2000) and for the general social and economic development in societies (Rothstein and Uslaner, 2005). For instance, generalized trust as defined by Yamagishi and Yamagishi (1994) roughly deals with to what degree one trusts that others do their share. Empirical findings also show that trust in the government, public officials, and in the legal system has a significant positive effect on tax morale (see e.g. Tyler, 1990; Scholz and Pinney, 1995; Scholz and Lubell, 1998; Torgler, 2003a,b, 2004), and a study by the Swedish Tax Agency (STA) (2005b) – STA is an autonomous public authority accountable to the Swedish Government – shows that the most common argument legitimizing tax evasion among Swedes is that those in leading positions in society violate the social norms. Moreover, generalized trust is important for people's willingness to pay taxes (see e.g. Scholz and Lubell, 1998; Frey and Torgler, 2006), and as stated by Bordignon (1993), one can even regard it as unfair to comply if others do not. Hence, trust is likely to be an important determinant for actual as well as for perceived tax evasion. A key finding in this paper is that political and generalized trust appear to play different roles for the perceived evasion of different types of taxes.

Previous research on tax evasion and compliance has mainly dealt with income taxes and to some extent with VAT.<sup>7</sup> This, we argue, is probably a too simplified view. Taxes differ for example with respect to how technically easy they are to evade and how popular they are, and these factors can also be expected to affect the perceived evasion of different taxes. This is also what we find; both the perceived occurrence of tax evasion and its determinants differ among taxes. To our knowledge, this is the first tax-evasion study that looks at several kinds of taxes.

The Swedish taxes that we investigate in this paper differ in popularity, with the real estate and gift taxes being the most unpopular. Also, the tax base (e.g. carbon dioxide, alcohol, income, gifts) and motives (steering, fiscal, distributional) differ among these taxes, which may affect the perception of tax evasion. It turns out that more than 70% of the respondents think that gift and wealth tax evasion is common, while only 17% think that evasion of the vehicle tax and the carbon dioxide tax on gasoline and diesel is common.

The paper is organized as follows. In Section 2 we present some suggested determinants of tax evasion in general. Thereafter we present a formal model of tax evasion and our formulation of the hypotheses. Section 4 contains a presentation of the data including a description of the studied taxes, followed by a regression analysis in Section 5. Some concluding remarks in Section 6 end the paper.

## 2. Suggested determinants of tax evasion in general

There are a number of explanations to why people evade taxes (or do not evade them), and we will here focus on three that have shown to be very important: self-interest, social norms concerning tax evasion, and trust.<sup>8</sup>

Perhaps the most obvious reason for someone to try to earn money “off the record” is to keep his or her wallet in good shape; in other words, people want to maximize their expected net income

(see e.g. Allingham and Sandmo, 1972; Clotfelter, 1983; Andreoni et al., 1998; several contributions in Mansbridge, 1990). Two evasion factors that can be included in this self-interest motive are marginal tax rates and the detection probability. The higher the marginal tax rate, the higher the gain from withholding income from tax authorities, but the higher the detection probability, the lower the expected utility of evasion. Some taxes are technically easier to evade than others. For instance, if taxable income is reported by employers directly to the tax authorities, then the technical evasion possibilities for an employee are smaller than if it were the employee's duty to report.

The second factor concerns the fact that taxes differ with respect to how popular they are, or to how fair they are perceived to be, which can be expected to affect the social norms towards tax evasion. A tax that is generally considered to be unfair may, socially, be relatively acceptable to evade. It could also be the case that popularity and perceived fairness vary across motives for taxation. Whether redistributive taxes are perceived as fair depends on the taste for redistribution. Similarly, the attitude towards mainly fiscal taxes depends on the opinion about the optimal size of the public sector.

Our third fundamental factor for the understanding of tax evasion is, as already mentioned, *trust*. Generalized trust is one important factor determining the probability that people will pay their taxes (see e.g. Scholz and Lubell, 1998; Frey and Torgler, 2006). The reason is found in the rational choice theory and the social dilemma literature (Komorita and Parks, 1994) and is rather self-explaining: If I trust that most other citizens pay their taxes, then I am more inclined to pay mine. Political trust is also found to have a positive effect on tax morale (see e.g. Scholz and Lubell, 1998; Torgler, 2003a,b, 2004). Simply put: If I do not trust that politicians are doing what they are supposed to do, then I become more tempted to evade taxes.

## 3. Model and hypotheses

In a theoretical model, we try to incorporate the previously mentioned explanations of tax compliance. When modeling the agent's problem in an Allingham-Sandmo fashion, we add a “social-taxpayer factor” to the utility function. We also include utility from the public sector itself, i.e. an explicit modeling of the perceived benefits of public expenditures (financed by taxes and administered by politicians and public officials). We assume that utility is strictly concave in consumption, implying that the individual is risk averse. We also assume that the individual receives two kinds of income,  $Y_A$  and  $Y_B$ , both subject to taxation but possibly at different rates. The expected utility,  $E[U]$ , is

$$E[U] = (1 - p)U[Y_A - t_A DY_A + Y_B - t_B DY_B] + pU[Y_A - t_A DY_A + Y_B - t_B DY_B - f_A(Y_A - DY_A) - f_B(Y_B - DY_B)] - d_A(Y_A - DY_A) - d_B(Y_B - DY_B) + E[\theta], \quad (1)$$

where  $Y_i$  is total gross income of type  $i$  and  $DY_i$  is declared income, which is taxed at the tax rate  $t_i$ ,  $i=A, B$ .<sup>9</sup> Income evaded is therefore  $Y_i - DY_i \geq 0$ . The subjective probability of auditing is  $p$ , and in that case both kinds of income are audited.<sup>10</sup> If the individual is caught, a fine proportional to the evaded amount has to be paid,  $f_i(Y_i - DY_i)$ .

<sup>7</sup> Related to value added tax there has been considerable work undertaken (Adams and Webley, 2001; Bergman and Nevares, 2006; Cnossen, 1994; Webley et al., 2006).

<sup>8</sup> See e.g. Scholz and Lubell (1998), Torgler (2003a,b), Davis et al. (2003), and Fortin et al. (2007).

<sup>9</sup> Naturally, the model can be extended to a “many-tax” model. For reasons of presentation we choose to model only two taxes.

<sup>10</sup> Allingham and Sandmo (1972) discuss what affects  $p$ , and Sandmo (2005) extends this discussion. In this paper we do not analyze this probability *per se*.

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