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Business culture and tax evasion: Why corruption and the unofficial economy can persist

Monika Çule[a,*], Murray Fulton[b]

[a] University of Regina, Department of Economics, 3737 Wascana Parkway, Regina, Saskatchewan, Canada S4S 0A2
[b] University of Saskatchewan, Johnson-Shoyama Graduate School of Public Policy, 101 Diefenbaker Place, Saskatoon, Saskatchewan, Canada S7N 5B8

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ABSTRACT

This paper shows that business and tax inspection culture can create multiple equilibria. In bad equilibria (high cheating and corruption), increases in penalties or auditing can have perverse impacts and increase cheating. The source of the multiple equilibria is the externalities created by business and tax inspection cultures. As tax evasion and corruption become more common, they become more acceptable and their cost is lowered. A third externality – that between firms and inspectors – is the source of the perverse effect; more cheating by firms is good for bribe-taking inspectors and more bribe-taking inspectors are good for cheating firms.

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1. Introduction

The unofficial economy is an important phenomenon in the economic activity of countries around the world. Although accurate measures of the underground economy (also referred to as the shadow, informal, hidden or parallel economy) are difficult to obtain due to the economy's clandestine nature, a number of measures of this activity have been developed. The most recent estimates of the size of the underground economy for developing, transition and developed countries are found in Schneider (2007). As Table 1 shows, while transition and developing countries typically have a large unofficial economy (averaging at approximately 40 percent of official GDP over the 1999–2000 to 2004–2005 period), the underground economy is also considerable in some developed countries where the rate can be as high as nearly 30 percent (Schneider, 2007).[1]

* Corresponding author. Tel.: +1 306 585 4708; fax: +1 306 585 4815.
E-mail address: monika.cule@uregina.ca (M. Çule).

[1] Earlier studies show that the size of the U.S. unofficial economy increased over the period 1965–1980 (Tanzi, 1999; Molefsky, 1982); by the end of this period, unrecorded income accounted for between 20 and 30 percent of recorded income (Feige, 1989). From 1980–1994, unreported income as a percentage of Adjusted Gross Income (AGI) fluctuated considerably. Depending on the method used, AGI gap estimates for 1994 are in the 12–27 percent range (Feige, 1994, 1996; Ledbetter, 2004a,b, 2007 provides more recent estimates). In the United Kingdom, estimates of unrecorded income are in the range of 2.5–15 percent of GDP, with an upward trend in the early 1970s and a flattening out in the late 1970s (O'Higgins, 1989). In West Germany, unobserved income was estimated to be about 27 percent of GNP in 1980, with estimates showing an increasing trend from 1956–1970 and 1975–1980 (Langfeldt, 1989). In France, unreported income was estimated to be at least 6.7 percent of GDP in 1979 (Barthelemy, 1989).

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Table 1
Size of the shadow economy in selected countries (percent of GDP).

Region		1999–2000		2004–2005	
	Average	16.8		14.8	
21 OECD countries	Overall pattern	Decline			
	Smallest	Switzerland	8.6	USA	7.9
	Largest	Greece	28.7	Greece	26.3
	Average	41.3		42.8	
African countries	Overall pattern	Fluctuations with a peak in 2003/2004			
	Smallest	South Africa	28.4	South Africa	28.2
	Largest	Zimbabwe	59.4	Zimbabwe	64.6
	Average	28.5		29.8	
Asian Countries	Overall pattern	Increase and then decrease with a peak in 2002/2003			
	Smallest	Singapore	13.1	Singapore	12.1
	Largest	Thailand	52.6	Thailand	53.6
	Average	41.1		42.2	
Central and South American	Overall pattern	Increase and then decrease with a peak in 2002/2003			
	Smallest	Chile	19.8	Chile	19.4
	Largest	Bolivia	67.1	Bolivia	67.2
	Average	38.1		38.8	
Transition economies	Overall pattern	Increase and then decrease with a peak in 2002/2003			
	Smallest	Slovak Rep.	18.9	Slovak Rep.	18.2
	Largest	Georgia	67.3	Georgia	66.4

Source: Schneider (2007).

The underground economy has important implications for public finance, growth and policy making. The unofficial economy affects a country's ability to efficiently allocate resources and sustain economic growth (Tanzi, 1983; Slemrod, 2007), to create and maintain market supporting institutions such as an impartial judicial system (Johnson et al., 2000; Shleifer and Vishny, 1993; de Soto, 1989), and to raise funds to provide public goods (Johnson et al., 1997). Equity problems are created since the firms that operate underground benefit from public goods provision without bearing the cost (Tanzi, 1983; Andreoni et al., 1998; Slemrod, 2007). Government is also less able to achieve a fair income distribution in the presence of a sizeable underground economy (Tanzi, 1983).[2] Finally, a sizeable underground economy distorts information on economic indicators (e.g., GDP, inflation) used in setting policy, resulting in ineffective policies or unintended outcomes (Tanzi, 1983; Feige, 1989, 1990, 1996; Alford and Feige, 1989; Slemrod, 2007).

There are numerous factors that drive firms to the underground economy: direct or indirect tax burden; regulation complexity and intensity; bureaucratic corruption; quality of public services and trust in government (Tanzi, 1982, 1983; Feige, 1996; Schneider and Enste, 2000; Schneider, 2002, 2007). Johnson et al. (1997, 2000) provide empirical evidence that large unofficial economies in transition countries are related to excessive regulation, a high tax burden and a high level of corruption; Johnson et al. (1998a,b) find similar evidence in a number of developing and developed countries. Feige (1996) shows that increases in unreported income in the United States during the period 1973–1994 were associated with increases in tax rates. Schneider (2007) provides empirical evidence that an increase in the tax burden, social security contributions and labour regulations are major motivators for firms to operate underground. Rosser et al. (2003) and Ahmed et al. (2007) argue that income inequality causes social alienation and, as a result of low social capital and weak social cohesion, participation in the informal economy increases.

While the unofficial economy takes many forms—e.g., illegal activities, unreported income (tax evasion) and the informal sector (see Feige, 1990, 1996 for a detailed explanation of these various forms), the focus of this paper is tax evasion.[3] Although tax evasion is present in developed countries (see Slemrod, 2007 for a sense of the extent of tax evasion in the United States and other OECD countries), the practice is widespread and persistent in most transition and developing countries (Andreoni et al., 1998). Of particular interest in this paper are transition economies, where tax evasion is prevalent (Schneider, 2002).

Tax evasion is influenced by a number of factors. Empirical work and experimental evidence has generally shown a positive relationship between the (marginal) tax rate and tax non-compliance (Clotfelter, 1983; Jaulfaian and Rider, 1996; Baldry, 1987; Christian and Gupta, 1993); exceptions include Feinstein (1991) and Alm et al. (1993) who find a negative relationship between marginal tax rates and tax evasion. Considerable empirical work has validated the deterrence effect of the probability of being caught (auditing) and of penalty severity, although studies vary on the magnitude at which these deterrents affect tax compliance (Witte and Woodbury, 1985; Dubin and Wilde, 1988; Dubin et al., 1990; Beron et al., 1992;

[2] Rosser et al. (2000, 2003) provide empirical support for a positive relationship between income inequality and the size of the informal sector in transition countries.

[3] Tax avoidance, which is not illegal and thus not punishable by law, is not considered. Although tax avoidance and evasion are similar in terms of intent, tax avoidance involves using loopholes in the tax system to avoid paying taxes. See Sandmo (2005) and Slemrod and Yitzhaki (2002) for a discussion of the difference between tax avoidance and evasion; Cebula (2004) provides empirical support for a substitution relationship between the two activities.

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