



Referendums, trust, and tax evasion

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ABSTRACT

Countries engaged in transitions from Communist rule to democracy and market economies face a considerable challenge to foster tax morale and to reduce tax evasion. Tax evasion, however, severely limits the capacities of these reformed states, which reduces in a vicious circle the citizens' incentives to pay taxes. The question then arises how this vicious circle may be broken. Several authors suggest that political institutions may do the trick. Based on insights that institutions allowing a direct say on policy issues (especially tax questions) may increase tax morale, we propose to study comparatively how the link between trust and tax morale is affected by these institutions. We find that allowing for referendums strengthens the link between trust and tax morale, but that this effect depends on the nature of the institutions.

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1. Introduction

For countries engaged in transition processes from Communist rule to democracy and market economies tax evasion forms a major problem (see for instance [Martinez-Vazquez and McNab, 1999](#); [Easter, 2002](#); [Martinez-Vazquez and Alm, 2002](#); [Torgler, 2003a](#); [Hayoz and Hug, 2006](#)). While loosely speaking taxes needed not to be levied by communist states, the newly democratized states had to find resources to offer the basic public services of states. Obviously, various privatization strategies (e.g., [Brada, 1996](#)) allowed at least initially to contribute to the budget of the new democracies. In the longer term, however, tax receipts have to be the major component to finance state activities.¹

In the absence of sufficient resources a state's capacities are severely diminished, and it faces considerable difficulties to offer the basic public goods. These lacking state capacities and the ensuing underprovision of public goods, however, also affect the tax morale of citizens. Why should a citizen pay taxes, if the state fails to offer basic services? Hence, several authors consider this interaction between state capacities and tax evasion as a vicious circle (see for instance [Easter, 2002](#); [Easter, 2006](#); [Uslaner, 2006](#)). The question then becomes how this vicious circle can be broken or even turned into a virtuous circle.

Some authors, either directly or indirectly, argue that trust may be a crucial element in breaking this vicious circle. More precisely, several scholars have emphasized the important role that trust plays in explaining tax morale and tax evasion (e.g., [Feld and Frey, 2002a](#); [Torgler, 2003c, 2006](#); [Dalton, 2008](#)). For the policy question how tax morale may be improved this explanation, however, only pushes the question up one level, since now a state needs to know how trust may be fostered among its citizens. In the literature on

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¹ Obviously this does not necessarily hold for states, like Russia [Easter \(2006\)](#), with considerable natural resources, able to profit, for instance, from increasing oil prices.

trust (for an overview see [Hardin, 2006](#)) an animated debate turns around the question whether political institutions may foster such trust, or whether this is not possible (see for instance [Uslaner, 2006](#); [Rothstein and Stolle, 2008](#); [Voigt and Blume, 2009](#)). When it comes to tax evasion and tax morale, however, there seems to be some theoretical and empirical evidence that institutional elements play a role. More precisely, institutions used to determine taxes seem to matter. [Pommerehne et al. \(1994\)](#), [Pommerehne and Weck-Hannemann \(1996\)](#), and [Feld and Frey \(2002b, 2006\)](#) suggest that at least in Switzerland, direct involvement in decisions on taxes and the rules of the “tax-man” significantly affect tax evasion, while [Dalton \(2008\)](#) offers a more pessimistic view for the states in the US.

Given these results the question arises whether this impact of institutional arrangements also holds comparatively when looking at the differences in terms of tax morale across countries. More precisely, do institutions allowing citizens to directly affect policies influence tax morale? This question is all the more relevant, since many of the newly democratized and formerly communist countries have introduced in part wide-ranging institutions for referendums² in their constitution ([Brady and Kaplan, 1994](#); [White and Hill, 1996](#); [Auer and Bützer, 2001](#); [Hug and Tsebelis, 2002](#); [Hug, 2005](#)).

Consequently we wish to address in this paper the question how institutions, more specifically institutions allowing citizens a direct say on policy decisions, affect tax morale. Building up on the existing comparative work on tax morale we wish to assess how the important link between trust and tax morale is affected by institutions allowing for referendums. To do so we rely on combining survey data from the World Values Survey and the European Values Survey ([European Values Study Group and Association, 2006](#)) with detailed information on the institutional setup of the countries considered. We find, that the possibility of holding referendums mostly strengthens the link between trust and tax morale, while having almost no direct effect on tax morale.

In the next section we briefly review the literature on tax evasion as it is linked to the question of trust and referendums might affect this link. In Section 3, based on the literature review, we offer our theoretical argument why institutions allowing for referendums should affect tax morale directly and through their mediating effect on trust. In Section 4 we present our empirical results which rely on two-step estimations of a simple multilevel model (e.g., [Achen, 2005](#); [Franzese, 2005](#); [Lewis and Linzer, 2005](#)). Section 5 concludes.

2. Tax evasion, trust, and institutions

The relationship among tax evasion, trust and institutions is dealt with in different literatures. As a consequence we will only briefly discuss work that is most directly relevant to our research question, namely how institutions might help strengthen the link between trust and tax morale.

For this latter link the work by [Easter \(2002, 2006\)](#) and [Uslaner \(2006\)](#) is the most relevant. [Easter \(2002, 2006\)](#) highlights in his work the importance of taxation and how it is linked to the perception of the public of getting sufficient public services in return. In close parallel, the evidence of [Uslaner's \(2006\)](#) analysis suggests that people do not see taxes as an obligation to their fellow citizens as much as a contract with the state. Citizens are more likely to justify tax evasion by judging the leaders than fellow citizens. Therefore, people look to public officials to determine whether the elites are behaving honestly.

[Uslaner \(2006\)](#) also shows that having a strong legal system matters, too, while confidence in the legal system only seems to matter when there is an effective and fair judiciary (e.g., in Romania, where the legal system is weaker, perceptions that the courts and police are fair seem not to matter). Generally speaking, the political institutions shape the perception of procedural fairness. Therefore, the fairness of the legal system is more strongly related to tax compliance than is simple confidence in the legal system. People's tax compliance seems to depend on how well the entire government works, not just the judiciary. [Uslaner \(2006\)](#) finds very modest correlations between tax compliance and generalized trust. As a consequence he stresses the problem that it might be possible to construct better institutions, but it is extremely difficult to construct better functioning institutions. Not finding any correlation between democratization measures and corruption [Uslaner \(2006\)](#) concludes that “[i]nstitutions are not nearly as sticky as corruption—and structural change does not track the level of transparency.”

Relatedly, [Torgler \(2003a,b,c\)](#), [Torgler \(2005\)](#) (see also [Torgler, 2007](#)) has explored in a series of studies the determinants of tax morale. Based on survey evidence from the World Values Survey and the European Values Survey ([European Values Study Group and Association, 2006](#)) he finds that tax morale in the Central/Eastern European Countries (CEE) is significantly higher than in countries of the Former Soviet Union (FSU) ([Torgler, 2006](#)). In explaining both interpersonal and cross-country differences he finds that all trust variables are highly significant (trust in legal system, trust in government, satisfaction with national officers, and evaluation of the political system) and correlate positively with a higher tax moral, whereas corruption affects tax morale negatively.

Transition countries are faced with many problems that have an impact on people's trust in institutions. [Frey \(2003\)](#) argues that in times of uncertainty as during the transition process from Communist rule to democracy and market economies, social capital in terms of mutual trust and honesty is an important factor to conclude deregulations and privatization successfully. According to [Alm and Torgler \(2006\)](#) a large shadow economy reflects weak and inefficient external institutions and has a negative impact on the degree of tax morale. This leads [Torgler \(2003a,b,c\)](#), [Torgler \(2005\)](#) to conclude that differences in the reform procedures may influence the higher tax morale in the CEE countries compared to the FSU countries: The smaller size of the shadow economy, the better established property rights as well as more stable institutions in general have reduced uncertainty and fostered trust in the political institutions in the CEE countries. Countries in negotiation with the EU had an additional motivation and pressure for rapid reforms ([Schneider, 2002](#)). Stable and transparent institutions create reliability, reduce uncertainty and therefore help the government to produce trust. Taxes might be seen as a price for government's positive actions. If citizens perceive institutions as fair and trust the public officials and the political institutions, their tax morale might increase.

² We employ the term referendum in this paper to designate all institutions that give citizens a direct say about policy decisions ([Butler and Ranney, 1994, 1](#)). To distinguish among the various direct democratic institutions we will rely later on work by [Hug and Tsebelis \(2002\)](#) and [Hug \(2004\)](#).

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