The impact of tax morale and institutional quality on the shadow economy

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\textbf{ABSTRACT}

This paper uses a multivariate analysis to examine how countries’ tax morale and institutional quality affect the shadow economy. The literature strongly emphasizes the quantitative importance of these factors in understanding the level of and changes in the shadow economy. Newly available data sources offer the unique opportunity to further illuminate a topic that has received increased attention. After controlling for a variety of potential factors, we find strong support that a higher tax morale and a higher institutional quality lead to a smaller shadow economy.

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1. Introduction

In the last two decades the number of studies investigating the underground economy has increased markedly. But knowing the unknown and therefore estimating the activities of the shadow economy is still a difficult task. Unfortunately, it is very difficult to get accurate information about shadow economy activities on the goods and labor market, because the indi-
viduals involved in these activities do not wish to be identified. Hence, trying to estimate the extent and value of the shadow economy activities can be considered as a scientific passion for knowing the unknown. Tanzi (2002) states, “it seems that the economic profession, immersed as it was in its theories, could not cope or was unwilling to cope with the messy world of the underground economy” (p. xiii). In more recent years, economists have stopped ignoring the topic as the interest in this phenomenon has strongly increased. Generating statistics is important insofar as it allows making effective and efficient resource allocation decisions. A similar tendency is observable in other areas that investigate illegal activities (Schneider, 2005b; Schneider & Enste, 2002). Studies on corruption in the 1980s were largely confined to other fields such as political science and sociology. Economic studies on the subject have started to emerge since the early 1990s. The transformation of the socialist economies was one of the main reasons for this surge in interest since institutional weaknesses and corruption surfaced as major obstacles to market reforms (Abed & Gupta, 2002). Moreover, the increased interest and new datasets contributed to a rapidly growing empirical literature on illegal activities such as shadow economy or corruption [see Schneider and Enste (2000, 2002), Treisman (2000), and Lambsdorff (1999) for reviews].

Our paper investigates the relation between shadow economy, tax morale and institutional quality. Although there are more and more studies that investigate the causes of shadow economic activities, societies often attempt to control these activities through measures such as punishment, prosecution, economic growth or education (Schneider & Enste, 2002). However, there are further instruments that merit more attention. It is highly relevant to investigate not only the importance of objective variables such as the tax burden, rate of public expenditure, or the density of regulation, but also the subjective perceptions, expectations, attitudes and motivations such as tax morale or the (perceived) institutional quality. Cross-country data sets such as the World Values Survey, the Latinobarómetro or the ISSP allows investigation of the impact of such factors on the macro level. This provides the fundament to test empirically the extent to which an integrated approach helps explain deviant behavior. Thaler (2000, p. 140) suggests that the Homo Oeconomicus will evolve into Homo Sapiens: “As economists become more sophisticated, their ability to incorporate the findings of other disciplines such as psychology improves”. Thus, data provide the basis to investigate the importance of more sophisticated theories at the micro and the macro level. In many experiments subjects have been shown to care about aspects as fairness, reciprocity, and distribution. According to Ochs and Roth (1989) and Roth (1995), many ultimatum experiments have shown that the modal offer is (50, 50), that the mean offer is somewhere around (40, 60), and that the smaller the offer, the higher the probability that the offer will be rejected. Moreover, according to Ledyard (1995) and Davis and Holt (1993), public good experiments indicate that, on average, subjects contribute between 40% and 60% of their endowment to a public good.

We do not argue a case that the main economic factors are irrelevant, but rather stress the importance of extending the focus including, for example, a moral dimension. The violation of social norms is connected with higher costs of being active in the informal sector. Similarly, better institutions provide stronger incentives to behave legally and increase the costs of illegal activities as a consequence of greater institutional accountability. Behaving illegally is associated with higher moral costs. Hence, our basic working hypothesis is that the factors previously investigated matter, but that in order to explain international differences in the size of shadow economies we also need to take into account social norms and institutional factors which we define together as societal institutions. In econometric terms, our hypothesis implies that the group of variables representing the role of societal institutions is statistically different from zero. That is, the size of shadow economy in any country does not depend only on external factors. If taxpayers perceive that their interests (preferences) are properly represented in political institutions and consider government to be helpful rather than wasteful, their willingness to opt for staying in the official sector and complying with their tax obligations will increase. In general, the better the societal institutions, other things equal, the lower we would expect the shadow economy to be. An important contribution of this paper is thus to extend the previous models by establishing the extent to which informal and formal institutions matter. In Section 2, we present our theoretical approach and develop our hypotheses. Section 3 describes the data set and Section 4 contains the empirical results. Finally, Section 5 concludes with a summary and discussion of the main results.

2. Theoretical considerations

Most economists have the tendency to base their analysis on neoclassic theory yet the complexity of the phenomenon may justify an integrative approach bringing together insights from different social sciences. An integrated human concept such as the RREEMM model may provide a solid foundation to investigate the phenomenon of behaving or not behaving illegally (Schneider & Enste, 2002). Such an approach not only considers the basic assumption of self-interest but also takes into account the relevance of social norms and standards (see, e.g., Alm, 1996). Researchers such as Frey (1997) stress the relevance of integrating a broader motivation structure and indicate that not only extrinsic, but also intrinsic motivation must be taken into account. Ignoring the importance of intrinsic motivation may lead to wrongly orientated policies and an underestimation of the crowding-out effects a reduction of volunteering may have. However, Frey (1997) points out that the attempt to combine economic, sociological, psychological, political, and biological man fails as long as the relative importance of each aspect is unknown and thus the interaction between them and the conditions under which one becomes dominant are open. Rothchild (2001) stresses that the complexity of the subject prevents the development of a “general” theory of human behavior but hints at the possibility that several theories may coexist to live up to the complexity of human behavior.
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