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Tax evasion and income source: A comparative experimental study

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Abstract

We compare tax evasive behavior in a country in transition from communism to that in a developed economy by running an experiment across distinct social groups in Albania and the Netherlands. Aside from the tax compliance decision, subjects choose a source of income, where one type enables subsequent tax evasion. We show that they take the possibility of evasion into account when deciding on the income source. This yields potential allocative inefficiency in the labor market. In addition, Dutch subjects evade more than the Albanians. We argue that the different levels of tax evasion outside of the laboratory in the two types of countries can be attributed to distinct formal tax institutions.

JEL classification: C91; H26; O17; O57

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1. Introduction

Over the years, numerous studies have emerged, analyzing the underground economy in developing and developed countries, as well as in countries in transition from socialist to

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market oriented economies.[1] In this study, we focus on one of the phenomena related to the underground economy: tax evasion. There are two main reasons. First, it is directly linked to large budget deficits and hence to lower investments in public goods. Aside from being of general interest from an economic point of view, this means that the effects may differ significantly depending on a country's level of development. Second, studying tax evasion creates the opportunity to investigate the decision-making process related to the underground economy at the individual level. Though tax evasion has been studied extensively (Allingham & Sandmo, 1972; Andreoni, Erard, & Feinstein, 1998; Cowell, 1990; Cowell & Gordon, 1988; Feige, 1989; Frey & Weck, 1981; Johnson, Kaufmann, & Zoido-Lobaton, 1998; Kolm, 1973; Pommerehne, Hart, & Frey, 1994; Schneider & Enste, 2000, 2003; Tanzi, 1982; Yitzhaki, 1974 and many others), only part of this research has been undertaken to get a better understanding of the individual decision whether or not to evade taxes in a behavioral perspective (Alm, 1991; Alm, Jackson, & McKee, 1992; Alm, McClelland, & Schulze, 1992, 1999; Becker, Buchner, & Sleeking, 1987; Feld & Frey, 2002; Feld & Tyran, 2002; Friedland, Maital, & Rutenberg, 1978; Güth, Levati, & Sausgruber, in press; Kim, 2002; Robben, Webley, Elffers, & Hessing, 1990; Robben, 1991; Torgler, 2004).

When studying tax evasion, it is important to distinguish between different types of income. In almost every country, one can make a distinction between income that is officially registered and unregistered income. Typically, taxes are withheld from the regular wage payments when income is registered (e.g., in the public sector). Unregistered income can occur where there is no job contract and in case of self-employment. Income of this type must be self-reported to the tax authorities in order to determine the income tax owed. Because it is easier to evade taxes in case of unregistered income, there may be individual incentives to choose a job with this type of income.[2] This may distort the allocation of labor and cause inefficiencies in the distribution across types of jobs.[3] The experimental environment we will discuss below distinguishes between these two types of income. This allows us to study the choice of income type (i.e., labor supply) simultaneously with the decision whether or not to evade taxes. Hence, we can study the extent to which the evasion possibilities affect the choice of income type.[4]

The extent of tax evasion may be related to a country's economic and institutional development (Feige, 1997; Gërxhani, 2004b). To test this, we study tax evasive behavior in two countries, Albania (an underdeveloped country in transition) and the Netherlands (a developed country). The reason to focus on these two countries is as follows.

Our starting point is that we wish to conduct the study in a country where institutions are in a transitional phase and in one where institutions are stable and well developed. Given that: "one of the more vexing problems for policy makers in developing and transition economies is encouraging high levels of tax compliance" (Cummings, Martinez-Vazquez,

[1] For recent surveys, see Schneider and Enste (2000, 2003) and Gërxhani (2004b).

[2] As pointed out by a referee, there are other reasons why individuals might choose self-employment or other types of unregistered income. For example, the complexity of the tax system might play a role (Schneider & Neck, 1993).

[3] Of course, there may be inefficiencies as a consequence of other factors, for example the income tax itself or the resources wasted in reporting and auditing taxes (Bayer & Sutter, 2003). Moreover, the possibility of tax evasion may also enhance efficiency by encouraging entrepreneurial risks (Pestieau & Possen, 1991).

[4] Collins and Plumlee (1991) analyze a related experiment where subjects' income (to be reported to the tax authorities) depends on an effort made. They observe more effort when tax evasion is possible.