

## **Introduction to the Symposium on the Shadow Economy, Tax Behaviour, and Institutions**

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### **Abstract:**

This JOIE Symposium features some of the most influential papers presented in the 7<sup>th</sup> version of the conference on *The Shadow Economy, Tax Behaviour and Institutions*. Accordingly, it brings together contributions from several disciplines and schools of thought in the social sciences and the humanities exploring such issues as the role of formal and informal institutions in understanding the shadow economy, the importance of social aversion in the motivations for tax compliance, and the dual nature of corruption. This introduction lays out the scope of the symposium, summarises the preceding literature on the topic, and provides a brief outline of each contributing article, noting that, although each paper focuses on a different economic and cultural context, they share several elements in common with alternative theories addressing the institutional, psychological, and sociological aspects of tax law compliance and other appropriate behaviours.

**Keywords:** shadow economy; tax behaviour; informal institutions; regional and country studies

**JEL Classification:** D73, H30, K42, O17, O50

## **1. Background**

This Symposium features some of the most outstanding papers presented in the 7<sup>th</sup> version of the international conference on *The Shadow Economy, Tax Behaviour and Institutions*, which took place virtually during September 23-25, 2021, at Brunel University London. This conference brought together researchers from several disciplines and schools of thought in the social sciences and the humanities to explore and discuss about the nature, role and evolution of institutions pertaining to the shadow and/or informal economy, tax compliance and tax administration; historical, sociological, and psychological aspects of tax behaviour; and taxpayers' social and cultural norms and practices.

## **2. Overview of the literature**

Tax behaviour – compliance, avoidance, and evasion – has been heavily investigated in economics and the social sciences, indicated by a remarkable increase in scientific publications in recent years. Despite important earlier works in the field (Schmölders, 1960), the most influential economic theory of tax compliance was introduced in the early 1970s. Accordingly, Allingham and Sandmo (1972) framed the decision whether to comply with tax laws or to evade taxes as a decision under uncertainty. Rooted in the economics-of-crime paradigm (Becker, 1968), the central assumption of their theory was that tax compliance increases with stronger deterrence, mainly via higher audit probability and tougher fines. The underlying rationale is that taxpayers are motivated exclusively by utility maximization, choosing evasion over compliance when it yields a higher expected utility than complying with the regulations. Yet, in empirical studies the effects of audits and fines are not always observable while the effects of other crucial factors such as income and tax rates are

not completely clear (Andreoni *et al.*, 1998; Fischer *et al.*, 1992; Kirchler *et al.*, 2010). Considering the relatively low probability of being audited in combination with the rather mild fines for detected tax evasion in most countries, taxes on earned income should be evaded almost completely according to Allingham and Sandmo's (1972) model. Importantly, their assumption is inconsistent with reality, where observed tax compliance is remarkably higher (Alm *et al.*, 1992).

In contrast to this classical economic approach, alternative theories highlight the importance of social, institutional,<sup>1</sup> and psychological factors. According to these approaches, tax behaviour is influenced by trust in government authorities (i.e., institutional trust) as well as trust in other citizens (i.e., interpersonal trust), social norms and fairness considerations, and individual characteristics like attitudes, motivational postures, and tax morale (see, e.g., Braithwaite, 2009; Kirchler and Braithwaite, 2007; Torgler, 2002; Tyler, 2006; Wenzel, 2004). In recent years, these factors have gained increased attention in the field of tax research as determinants of compliance and evasion. In particular, the concept of tax morale, which is commonly referred to as the intrinsic motivation for paying taxes independent of deterrence and enforcement mechanisms (Frey, 1997), offers a promising avenue for investigating and explaining the cross-cultural differences that have been identified in tax compliance levels (Alm and Torgler, 2006; Andriani *et al.*, 2022). In addition, many studies on tax compliance behaviour and tax morale identify relevant gender differences, with women being more compliant than men (Alm *et al.*, 2009; Baldry, 1987; Lewis, 1982; Torgler and Valev, 2010; Webley *et al.*, 1991).

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<sup>1</sup> According to Hodgson (2006), institutions represent formal and informal norms and rules that determine human interaction and social exchange. Like culture, institutions influence individual and collective preferences and attitudes (Hodgson, 2006; Hodgson and Jiang, 2007; Hofstede, 1980).

More recently, the so-called slippery slope framework (Kirchler *et al.*, 2008) was introduced in an attempt to integrate various influencing factors of tax behaviour. Based on two overarching dimensions, trust in authorities and power of authorities, this approach offers a possibility to integrate classical economic and socio-psychological determinants of tax compliance (Alm and McClellan, 2012; Bazart and Pickhardt, 2011; Durham *et al.*, 2014). While power is manifested by the economic factors of the Allingham and Sandmo (1972) model, trust is assumed to be propelled by factors such as attitudes, social norms, and fairness perceptions. In addition, recent research has investigated the role of public shaming (Coricelli *et al.*, 2010, 2014), emotions (Enachescu *et al.*, 2019), cultural values (Andriani *et al.*, 2022), and new experimental methods have been applied to gain insight into the underlying cognitive processes influencing tax compliance decisions (see, e.g., Kogler *et al.*, 2022).

### **3. Summary of the contributions of this symposium**

This JOIE Symposium includes some of the most valuable contributions to the seventh Shadow conference along the lines mentioned above. It consists of three articles addressing such issues as the role of formal and informal institutions in understanding the shadow economy, the importance of social aversion in the motivations for tax law compliance, and the nature of corruption. Although each article focuses on a different economic and cultural context, the three papers share some elements in common with the alternative theories summarized above. First, they challenge the classical economic approach to tax compliance by arguing that the probability of audits and the degree of punishment do not fully explain tax evasion. Second, their findings suggest that a trust-based relationship with the government and other individuals makes people more inclined to comply with tax laws and other appropriate behaviours.

To begin, Gërxhani and Cichocki (2023) present an overview of the empirical research on drivers of the shadow economy in transition countries.<sup>2</sup> After the fall of communism, many former communist countries entered a transition stage from a planned to a free-market economy that entailed a complete overhaul of the previous formal governing institutions. This transition stage led to a paradoxical situation of formal institutions changing fast and drastically, while informal institutions – the norms and traditions established during 45 years of communism – have changed less so. This review article focuses on two aspects: First, whether and how both formal and informal institutions, their interaction and their enforcement affect individuals' participation in the shadow economy; and second, how involvement in shadow economies affects individuals' wellbeing. The authors find that intensified immersion in the shadow economy is observed when there is a conflicting relationship between perceptions of formal institutions and individuals' informal institutions. Further, joining the underground economy in transition countries may not be a voluntary choice, but more of a survival tactic because of people being 'excluded' from formalised employment opportunities and their benefits, with generally negative implications on individuals' wellbeing. These findings confirm the importance of simultaneously considering both formal and informal institutions when studying individual engagement in the shadow economy, which acquires more relevance for transition countries that have experienced radical institutional reforms.

Then, Malka Tiv (2023) examines the factors affecting the motivations for tax law compliance in Israel, mainly focusing on the effect that social stigma exerts on an individual's willingness to comply with tax laws. The basic assumption of any tax system is that most of the population pays

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<sup>2</sup> This review article is mostly based on Gërxhani's keynote address at the 7<sup>th</sup> International Conference *on The Shadow Economy, Tax Behaviour and Institutions* (Brunel University London, 2021).

their due taxes voluntarily. For this reason, a better understanding of taxpayer behaviour and individuals' motivations for paying taxes would be of help for tax authorities in designing better compliance strategies. However, this issue has been relatively neglected since revenue agencies' main emphasis, consistent with the classical economic approach to tax behaviour, has been placed on effective enforcement. This article presents the first quantitative study exploring the actual motives for tax law compliance in Israel, and particularly the impact of social aversion towards tax offenders on a taxpayers' choice of paying taxes. Framed in the recent research on public shaming, this study shows that the social response to tax evaders and personal values regarding the obligation to pay taxes are the most influential variables on the intention to comply with tax laws, while the fear of punishment does not play any role on tax law compliance. These results highlight the importance of education aimed at internalising the meaning of paying taxes and the consequences of non-payment as a means for increasing tax law compliance among a country's citizens.

Finally, Hugo *et al.* (2023) employs causal and indicative variables to analyse the dual nature of corruption in Latin America during 1980–2018. The authors conceptualise corruption as comprised of two distinct behaviours, namely, rent seeking and systemic corruption. In fact, these two forms of corruption coexist and may work in opposite directions in terms of helping or hindering economic growth. Thus, while rent seeking is driven by greed and private gain, systemic corruption arises as a way of dealing with inefficient bureaucracies and speeding up economic activity. Using structural equation modelling, this article explores the existence of both rent seeking and systemic corruption empirically, thus providing evidence for these two types of corruption. The findings in this study support the view that corruption is not a homogeneous

phenomenon, but one that encompasses a complex set of social behaviours, and thereby suggest the need to consider the duality of corruption when designing policies aimed at countering it.

#### **4. Concluding note**

Without a doubt, the articles in this Symposium will exert a meaningful contribution to the literature on the shadow economy and tax compliance and, more generally, on how institutions affect individuals' attitudes towards rent-seeking behaviour and compliance with the law.

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