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Entrepreneurship, Tax Evasion and Corruption in Europe

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Abstract

This paper investigates the long-run relationship between the entrepreneurial activity, tax evasion and corruption in 15 European countries. We posit that tax evasion and corruption have a negative influence on entrepreneurship, but some endogeneity issues appear when investigating this relationship. Therefore, we use a panel cointegration analysis and we find that there is a long-run link between our variables, and that tax evasion and corruption negatively affect the total entrepreneurial activity. In addition, this paper shows that the impact is smaller if we consider the necessity-driven entrepreneurs only, due to the fact that this category of entrepreneurs is forced to start a business having no other revenue sources and is less sensitive to institutional weaknesses. More precisely, while corruption still influences the activity of necessity-driven entrepreneurs, no effect is documented in the case of tax evasion. This result proves that necessity-driven entrepreneurs do not carefully take into account the external traits when they start a business. Consequently, if the entrepreneurship is associated with one of the main drivers of economic growth, the authorities shall handle the institutional weaknesses in order to favor the entrepreneurial activity.

1. Introduction

Entrepreneurship is considered one of the main ingredients of economic growth, fostering the productivity level, enhancing the employment and leading to other potential efficiency gains through the tax system (Cullen & Gordon, 2007). In this context, the impact of taxation on the entrepreneurial activity is heavily investigated. However, less

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attention is paid to the long-run impact of tax evasion and corruption level on the entrepreneurial activity. Several scholars indicate that corruption has a significant negative impact on the levels of tax revenues collected in a country (Nawaz, 2010), and that it is inter-linked with the tax evasion, but, as far as we know, there is no research investigating their joint impact on entrepreneurship.

This paper fills in this gap and analyzes the complexity of the relationship between corruption, tax evasion and the entrepreneurial activity in Europe. The fact that countries with higher levels of corruption also tend to have larger shadow economies, which generate tax evasion, is commonly accepted. At the same time, the presence of tax evasion nourishes the corruption environment, especially in the case of tax administrators. Both phenomena have a negative impact on entrepreneurship and economic growth, discouraging the initiative of the private sector and enhancing the uncertainty on the market.

Although a large body of works have addressed how different institutional weaknesses influence the entrepreneurial activity, less attention was paid to tax evasion and corruption, with few exceptions. For example, Estrin & Mickiewicz (2012) consider that in countries with larger shadow economies individuals are more or less likely to initiate entrepreneurial activities. Similarly, Parker (2003) shows that tax evasion influences the occupational choice and the entrepreneurial activity. Anokhin & Schulze (2009) posit in their turn that better control of corruption might be associated with rising levels of entrepreneurship.

However, neither of these papers considers the endogeneity problems associated with the fact that entrepreneurs can also influence the level of tax evasion and corruption. On the one hand, entrepreneurs can obtain advantages from illegal trading, generating then tax evasion (Fadahunsi & Rosa, 2002). So, several papers show that entrepreneurs pay taxes only when the tax morale is high, when the tax evasion is costly, and when the risks of being caught and the severity of punishment are also high (Allingham & Sandmo, 1972; Lisi &Pugno, 2011; Mickiewicz, Rebmann & Sauka, 2012). But this conclusion is too simplistic, because the mechanism of entrepreneurs generating tax evasion is complex. On the other hand, if we assume that entrepreneurs can play a role in tax evasion, they also might be engaged in small corruption practices. Therefore, the current study attempts to fill in the void existing in the literature by exploiting the long-run interdependencies which exists between these phenomena.

Our study brings forward three contributions to the canon of work on the subject. First, the study here analyzes the long-term relationship between institutional weaknesses, associated with tax evasion and corruption, and the entrepreneurial activity in 15 European countries, over the time-span 2002-1010, using Global Entrepreneurship Monitor (GEM) data for entrepreneurship, Transparency International data for corruption and the statistics proposed by Schneider & Buehn (2012) for measuring tax evasion.

Second, it addresses the long-run relationship within a cointegration framework and takes into account the potential endogeneity of the involved variables by using adequate models as the fully modified OLS estimator (FMOLS) and the dynamic OLS (DOLS) estimator. In particular, we use the cointegration analysis for heterogeneous panels, as proposed by Pedroni (1999, 2001), and we compare the results with the cointegration techniques conceived for homogenous panels, advanced by Kao (1999). However, given the structure of our sample the probability to have homogenous panels is reduced. Therefore, the results' interpretation is largely based on the Pedroni's technique. The long-term regression is carried out using the FMOLS and DOLS estimators.

Another important consideration is the distinction between different types of entrepreneurs. The GEM statistics allows to differentiate between necessity-driven entrepreneurs (NDE) and innovation-driven entrepreneurs (IDE). Consequently, because the NDE are forced to engage themselves in entrepreneurial activities having no other source of revenues, the impact of corruption and tax evasion on NDE is expected to be smaller than the impact on the total entrepreneurial activity (TEA), which includes both the NDE and IDE.

To anticipate the primary results, we find that entrepreneurship, tax evasion and corruption are cointegrated. Furthermore, we discover that the level of corruption and tax evasion negatively impact the total entrepreneurial activity in Europe, in the long-run. In addition, tax evasion has no impact on NDE while the corruption level negatively affects the activity of this category of entrepreneurs.

This paper continues as follows. The second section shortly reviews the literature and presents the research hypotheses. The third section describes the methodology. Section 4 describes the data and presents the results. The last section concludes.