Economic Systems 37 (2013) 141–154

Contents lists available at SciVerse ScienceDirect

Economic Systems

journal homepage: www.elsevier.com/locate/ecosys

Exploring tax evasion in the context of political uncertainty

Barbara G. Katz *, Joel Owen [1]

Stern School of Business, New York University, 44 W. 4th Street, New York, NY 10012, United States

ARTICLE INFO

Article history:
Received 24 May 2012
Received in revised form 16 November 2012
Accepted 19 December 2012

JEL classification:
P37
P26
P27
K42

Keywords:
Tax evasion
Political uncertainty
Economic uncertainty
Policy uncertainty
Economies in transition

ABSTRACT

We present a model of agents facing the uncertainty of two future forms of government who are able to insure against this uncertainty by hiding funds from taxation. In order to choose whether or not to hide funds from taxation, agents need to know policy choices that each government would make should it come to power. But each government, before it could make its decision, would need to know the choices of the agents who would, for example, produce tax revenues. This informational tension is resolved endogenously. We derive the resulting level of tax evasion in society and the optimal choices made by the potential governments. We examine how changes in governmental structure would affect the level of tax evasion, and how that, in turn, would affect a particular form of capital flight.

1. Introduction

Between 1990 and winter 2011, thirty-nine incumbents were replaced in a total of fifty-two elections in the eight Central Eastern European countries that joined the European Union in 2004.[2]

* Corresponding author. Tel.: +1 212 998 0865; fax: +1 212 995 4218.
E-mail addresses: bkatz@stern.nyu.edu (B.G. Katz), jowen@stern.nyu.edu (J. Owen).
[1] Tel.: +1 212 998 0446; fax: +1 212 995 4003.

[2] See Kornai (2006, Table 4) for the list of the thirty governmental turnovers in these countries between 1990 and 2004. These eight economies in transition were the Czech Republic, Estonia, Poland, Latvia, Lithuania, Hungary, Slovakia and Slovenia. Using the same methodology and countries, and extending the time period to March 2011, we find thirty-nine instances in which incumbents were replaced in a total of fifty-two elections.

0939-3625/$ – see front matter
http://dx.doi.org/10.1016/j.ecosys.2012.12.005

These frequent electoral changes, often bringing reversals in ideological orientations, created a climate of political instability, as they often resulted in governments pursuing different social and economic policies than their predecessors.[3] Evidence that economic policy changes have an impact on business decision makers can be found, for example, in the BEEPS II data base. Turning to the broader group of twenty-six economies in transition covered in this study, hundreds of respondents from each of these countries were asked many questions, including the following: How great an obstacle to the operation and growth of your business is economic policy uncertainty? In twenty-two of those countries, more than fifty percent of the respondents stated that economic policy uncertainty was either a moderate or a major obstacle to the operation and growth of their business.[4]

Of course, the post-Soviet-type economies in transition do not have a monopoly on political uncertainty. In Western Europe, for example, incumbents in Portugal, Spain, France and Greece, to note only four, were even more recently replaced. Indeed, according to a recent paper by Baker et al. (2012), who construct several novel indices of policy uncertainty, policy uncertainty is responsible for a growing proportion of the more general category of economic uncertainty.[5] Their paper also documents that U.S. policy uncertainty increases at moments of federal elections. Clearly, at most election moments in most countries, there is uncertainty about the policies of the government that will emerge as the victor. In the post-communist period, however, both political instability and divergent ideologies were pervasive features of the economies in transition, and it is for this reason that we set our problem in their context, although the implications of our analysis are applicable more generally.

All the economies in transition suffered immediate drops in output, with real GDP falling for all of them until 1994. Furthermore, only three countries (Poland, Slovenia and Slovakia) had equal or higher real GDP in 1999 than they did in 1989.[6] The recognition that the economies in transition had outdated capital stocks and production methods, and needed thorough redesign in every area, e.g. economic, legal, political, suggests the scope of the problem that any government in that group of countries had to confront. With no recent tradition of democratic government, and in some cases no tradition of democratic government at all, and with the opportunism that the turmoil and early privatization efforts created, it is not surprising that some of the new governments were more benevolent and focused on improving their countries and others were not. It is in this context that the role of uncertainty becomes especially important to agents in the economies in transition. The uncertainty concerning the various possible future policy choices of the government not only affected the economic decisions of the agents, but also created political pressures in support of different governments. Also during this time, and as a consequence of agents' economic decisions, the economies in transition exhibited generally heightened, albeit varying, levels of tax evasion as well as capital flight. Because of the policy uncertainty during this period, agents were forced to make decisions in the absence of knowing whether the next government would be more or less benevolent, more or less democratic, more or less corrupt, or more or less able and willing to pursue economic growth and infrastructure development.

How would economic agents in an economy in transition have dealt with the significant economic policy uncertainty that they faced? Would this policy uncertainty have induced acts by these agents that would have undermined or impeded the development of stable market-oriented democracies? In this paper, we attempt to answer these questions by investigating the degree to which uncertainty concerning future governmental policy induces tax evasion on the part of agents and how this, in turn, has an impact on economic development.

In our model we imagine agents in a country in an early stage of transition from a planned to a market economy and suppose the transfer of property rights, once held by the state, has already

[3] We offer another comment on political instability, this time relating to Ukraine, a post-Soviet economy in transition. In Ukraine, ahead of the presidential election in January 2010, policy differences among the top contenders included whether or not to change the constitution to return to presidential rule, whether or not to pursue NATO membership, and whether or not to attempt to renegotiate gas prices with Russia.

[4] See BEEPS II Interactive Dataset (EBRD and World Bank, 2002). The question can be found under the heading Governance and Anti-Corruption. We excluded Turkey from the panel of countries, leaving the twenty-six economies in transition.

[5] See the references in this paper for background reading on policy uncertainty and economic outcomes.

[6] See EBRD Transition Reports (various years) and Campos and Coricelli (2002).