Journal of Economic Behavior & Organization xxx (2015) xxx–xxx

Contents lists available at ScienceDirect

Journal of Economic Behavior & Organization

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

Corruption, tax evasion and social values

Anastasia Litina[a,1], Theodore Palivos[b,*]

[a] University of Luxembourg, Faculty of Law, Economics and Finance, 148, Avenue de la Faiencerie, L-1511, Luxembourg
[b] Department of Economics, Athens University of Economics and Business, 76, Patission Str., GR104 34 Athens, Greece

ARTICLE INFO

Article history:
Received 11 June 2014
Received in revised form
18 September 2015
Accepted 22 September 2015
Available online xxx

Keywords:
Corruption
Tax evasion
Multiple equilibria
Social stigma

ABSTRACT

We provide a theoretical explanation for the vicious circle of political corruption and tax evasion in which countries often fall into. We address this issue in the context of a model with two distinct groups of agents: citizens and politicians. Citizens decide the fraction of their income for which they evade taxes. Politicians decide the fraction of the public budget that they peculate. We show that multiple self-fulfilling equilibria with different levels of corruption can emerge based on the existence of strategic complementarities, indicating that "corruption may corrupt." Furthermore, we find that standard deterrence policies cannot eliminate the multiplicity of equilibria. Instead, policies that impose a strong moral cost on tax evaders and corrupt politicians can lead to a unique equilibrium.

1. Introduction

Corruption and the misuse of government revenue often provide the moral justification for tax evasion. Indeed, corruption and tax evasion are often highly persistent and correlated. For example, there seems to be little disagreement to the claim that the current Greek economic tragedy is a play that involves both of these issues. In fact, as two Greek economists have written in a recent article:

> We contend that a crucial factor in this respect, and one which has been steadily eroding the foundations of Greek society and will impact on the resolution of the current fiscal crisis, is the interdependence between the tax burden, public good provision, tax compliance...The rise of budget deficits during the last three decades reflects in addition to outright corruption, the increasing inability of the public sector to deliver on the public goods and services that the higher-taxed citizens... have every right to expect in return. This has created a further "legitimization" of tax evasion... (Moutos and Tsitsikas, 2010, p. 173)

Political corruption, evidenced by a series of scandals, together with massive tax evasion and low quality of public services have been the case in Greece for at least the last three decades. This extensive corruption has resulted in a decline in social capital, a mutual distrust between citizens and the government and a social legitimization of tax evasion and

* Corresponding author. Tel.: +30 210 8203 346.
E-mail addresses: anastasia.litina@uni.lu (A. Litina), tpalivos@aueb.gr (T. Palivos).
URLs: http://natlitina.webs.com (A. Litina), http://palivos.weebly.com/ (T. Palivos).
[1] Tel.: +352 661 981692.

http://dx.doi.org/10.1016/j.jebo.2015.09.017
0167-2681/

bribery.[2] We view the situation that existed in Greece prior to the onset of the current crisis as a typical example of what we analyze in the rest of the paper.

The aim of this paper is to focus on the role of norms in fostering corruption and tax evasion. We argue that various manifestations of corruption may coexist and reinforce each other. The corrupt behavior of one group may become a strategic complement for another. In such a context, whenever agents expect other agents to be corrupt, they always find it optimal to be corrupt as well. An example of such a vicious circle is that of widespread political corruption and high tax evasion, which will be the focus of this paper.

Analytically, we construct a model economy that comprises two distinct groups of agents: private citizens and politicians. Citizens decide how much of their income to report to the tax authorities, taking into account the exogenously given probability of inspection and the size of the delinquent tax penalty. A certain fraction of tax revenue is supposed to be spent for the provision of a public good. Politicians, on the other hand, have the opportunity to peculate a certain fraction of the public funds that are earmarked for the public good. Crucially, each agent cares not only about her own consumption, but also about the quantity/quality of the public good.

In such a context, strategic complementarities may arise, leading to multiple self-fulfilling equilibria: a "good" ("bad") equilibrium with low (high) corruption, low (high) percentage of tax evasion and a high (low) share of output spent on the public good. The existence of multiple equilibria can help us understand why countries with similar background are characterized by different levels of corruption and tax evasion. It can also provide some insights as to why these two phenomena are so difficult to eradicate.

We then examine the use of standard deterrence policies, not only as a means to fight corruption and tax evasion, but also as a policy device to select an equilibrium in general. We show that in the presence of multiple equilibria driven by strategic complementarities in corrupt activities, standard policies, such as fines, are not fully effective. The reason is that whereas standard deterrence policies may increase the cost of tax evasion and corruption, they are unsuccessful in eliminating the strategic complementarity between groups.

Next, we modify the model to study alternative compliance schemes. In particular, we assume a social stigma cost associated with being involved in corrupt activities, i.e., individuals who commit unlawful actions and get caught are stigmatized by society.[3] If this social cost is sufficiently high, then the multiplicity of equilibria is eliminated and the economy converges to a unique equilibrium. The intuition behind the success of social stigma in eliminating the multiplicity of equilibria lies in that it effectively addresses the strategic complementarity aspect of corruption.[4]

Our analysis contributes to different strands of the literature. First, it provides a theoretical framework that can account for the following empirical facts. Existing evidence suggests that there is a positive correlation between corruption and tax evasion. The two of them often coexist and reinforce each other (Amundsen, 1999; Barreto and Alm, 2003). Moreover, there seems to be a negative correlation between these two phenomena and spending on publicly provided goods, such as education and health (see, e.g., Mauro, 1995, 1998; Tanzi and Davoodi, 1997).[5]

Second, it contributes to the literature emphasizing the importance of policies that raise the social cost of participation in corrupt activities. Our analysis suggests that these policies are particularly useful in the presence of multiple equilibria as an equilibrium selection mechanism, since they can put an end to strategic complementarity in corrupt activities.

Examining the role of moral costs in the context of tax evasion and corruption is motivated by the following empirical findings. Graetz and Wilde (1985) and Skinner and Slemrod (1985), among others, have empirically estimated the compliance rates in various countries and have found them significantly higher than expected, taking into account the auditing probabilities and fines.[6] Most models cannot account for the estimated rates unless they introduce some form of moral considerations (e.g., Sandmo, 2005; Alm and Torgler, 2011). Moreover, a number of experimental studies have indicated that some people never evade taxes, or they evade taxes less than expected (Alm et al., 1992). Another strand of the related literature has highlighted the fact that countries with similar fiscal systems and deterrence policies often exhibit different levels of compliance. To explain such differences, researchers have introduced some form of moral costs related to tax evasion (see Lewis, 1979, for the United Kingdom; Alm et al., 1995, for the US and Spain; Alm and Torgler, 2006, for the US and Europe).[7]

[2] Currently Greece ranks 80th among 177 countries, with a Corruption Perception Index (CPI) in 2013 of 4.0. Moreover, according to the 4th wave of the World Values Survey: (a) 37.1% of the respondents agree with the statement "It is never justifiable to cheat on taxes"; (b) 64.4% agree with the statement "It is never justifiable accepting a bribe"; (c) 23.7% agree with the statement "Most people can be trusted"; (d) 85.7% have "no confidence in civil services"; These numbers differ substantially from those in other countries, even with a lower CPI, e.g., India and China. For further details, see Litina and Palivos (2013).

[3] There is extensive literature that assumes the presence of a social stigma cost; see Section 4 below.

[4] The discussion in Section 4.2 lists a number of policies that a government can adopt in order to increase the social cost associated with evasion/embezzlement, as well as several examples of implemented policies in a number of developed and developing countries.

[5] Mauro (1995) reports that a decrease in corruption by 1.5 units in the BI corruption index could increase spending on education up to 0.6%.

[6] For example, the average audit rate for individual tax returns in the US is less that 1% (McCaffery and Slemrod, 2006). Given such a low rate, the compliance rate is high. In fact, the rates of tax evasion in most western developed countries are estimated around 5–25% of potential tax revenue (Pyle, 1989; Thomas, 1992). In developing countries, tax evasion rates are higher (Tanzi and Shome, 1994).

[7] Besides social and cultural influences, additional factors can also account for differences in the levels of tax compliance across countries. For example, Kleven (2014) attributes the high tax compliance rates found in the Scandinavian countries to the well-developed system of third-party information

Please cite this article in press as: Litina, A., Palivos, T., Corruption, tax evasion and social values. J. Econ. Behav. Organ. (2015), http://dx.doi.org/10.1016/j.jebo.2015.09.017