

TAX MORALE FOR OVERCOMING THE SHORTCOMINGS OF SHADOW ECONOMY

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Abstract

The study considers the basic problems of the shadow economy in the context of investigating its exposure to the market environment market. The tax morale concept was used as an example. The key study objective is to provide a rationale for estimating the tax morale effects on the Russian shadow economy size and manifestations. This research utilized both Russian and international studies on the subject.

Keywords: shadow economy, tax morale, tax morale effects on the shadow economy size.

JEL Classification: H26

1. Introduction

There are objective reasons for the imminent presence of shadow economy throughout human history. They are anthropogenic, social, economic, political, legal, ethical, cultural, religious, etc. Regardless of the impact of each factor, it should be acknowledged that nowadays there are significant differences between the shadow economy scales and manifestations in countries at various stages of development. As the World Bank reported in 2016, the informal sector accounts for about a third of GDP and 70 percent of employment (of which self-employment is more than a half) in emerging market and developing economies (GLOBAL ECONOMIC PROSPECTS, 2019). The most extensive shadow employment areas in these countries are in small businesses: the household sector, small and medium companies. To a larger extent, the reason is the specific features of such national economies formation and structural problems with their emerging governmental and socio-economic institutions. In most developed countries, e.g., in the European Union, the shadow economy share is insignificant and amounts to 5...10% of GNP, while in Russia the share is about

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47% of the GNP (Hassan Mai and Schneider Friedrich, 2016). Although the shadow economy manifestations in the European countries and Russia are similar, substantial differences in the conceptual approaches to the understanding its nature, threats, and countermeasures should be noted. The existing theoretical concepts of shadow economy offer a wide range of approaches: legal, economic, statistical, cultural, sociological, etc. It is believed that the most comprehensive way to reveal the essence of the shadow economy is an institution-based approach within the framework of the new institutional theory of economic systems. The shadow economy is considered as a complex, multidimensional, and interdisciplinary phenomenon. The most significant works related to the concepts and principles of neo-institutionalism as applied to the shadow economy studies are R. Coase (2015), D. North (2000), G. Myrdal (1972), Hernando de Soto (1995), G. Becker (1993), and others.

The Russian institutional-based studies of shadow economy worth mentioning are A. Ausan (2010), D. Yendovitsky, D. Lomsadze (2019), Yu. Latov (2006), R. Nureev (2010), A. Oleynik (1999), Yu. Popov (2005), V. Radayev (2001), V. Samarukha and V. Burov (2010), V. Tambovtsev (2014), L. Timofeev (1993), and others.

Therein it should be noted that both the institutional theory and methodology of studying the shadow economy problems and its practical applications that to a larger extent help constraining the shadow economy abroad, are underdeveloped in Russia.

Nowadays, the legal approach shaped a long time ago within the obsolete socialist economy dominates the shadow economy countermeasures in Russia. The neoclassic economic theory that excludes any effects of informal institutions on the domestic economic processes is also popular.

For this reason, studying the Russian shadow economy is impossible without analyzing the country's transition towards market economy after the USSR collapse that resulted in a long-standing extractive economy, decline in several national industries, while the shadow sector expanded and now accounts for a substantial part of the national economy.

Along with other basic reasons for the existence of such a large shadow economy in Russia, it is believed that one of the major ones is the underestimation of the informal market institutions and the Russian iconic low level of tax morale. The tax morale is a part of the common national morale that is shaped, accumulated, and developed by the existing moral and ethical values and objectives of the society, and its understanding of the significance of taxation for the state and for the society itself.

Unfortunately, the Russian practice and the very approaches to understanding the tax morale essence and contribution to the creation of competitive economic relations are quite slanted and underestimated, since they completely ignore the tax morale correlation with the shadow economy size. All the while, modern studies proved there is a direct relationship between the shadow economy size and tax morale acceptance. Such an acceptance also depends on many factors: state structure,

quality of governmental institutions, level of social and economic development, moral and ethics of the population, socially acceptable behavior, etc.

The Russian Federation (former Russian Soviet Federative Socialist Republic), just like most other transition economy countries, initially lacked such experience due to the long-lasting planned economy taxation engraved into the people minds. Since the socialist system spared its citizens from any direct taxation practices (its indirect taxation was virtually invisible for the taxpayers), the introduction of direct taxes in the market economy period usually was not welcomed by many tax subjects. A certain adaptation period was needed to adapt and to build new tax ethics and traditions.

Nowadays, in many developed countries, it is taken for granted that their high level of tax morale and tax relations contribute to the steady growth of tax revenues. It is a pillar of national prosperity and well-being of the citizens. In that prospect, the European experience may be the most important for Russia since these countries have always paid more attention to supporting the high level of tax morale, differential approaches to tax relations, and respective alignment with the national economic development models (Yendovitsky, Lomsadze 2019). Particularly, with the European Union's experience with the shaping and promoting the common tax morale one can analyze the range of factors such as cultural diversity and specific features of each EU country as the key categories that affect the tax morale development in their citizens, and also to identify the governmental and public actions used by the EU governments to control the shadow economy and maintain the high level of tax morale and ethics.

2. Basic Theory

Having studied the evolution of scholarly views on the tax morale phenomenon, the author questions the concept claiming that the tax morale exclusively depends on tax subjects (taxpayers and tax authorities). With our primary hypothesis, tax morale is considered as an integral part of the general national morale using the institutional approach. It manifests itself as individual behaviors in a complicated network of informal relations between the state, the society, and the business entities. The author applied the fundamentals of new institutionalism: tax morale should be perceived as a required and important market institution that enables a range of stable economic and social behavior patterns. To provide a rationale for and to confirm the hypothesis, this study shows that international researchers have long used a similar approach and have gained significant experience with estimating the degree of tax morale effects on the shadow economy using both direct and indirect methods. These methods yield a valid proof of the fact: the higher the tax morale level, the smaller the shadow economy. The author confirmed the hypothesis about the relation and correlation between the shadow economy size and the development of informal market factors using the tax morale institution as an example. In this way, the need

for applying the institutional approach to the Russian shadow economy studies is highlighted.

3. Methodology

While investigating the evolution of views on the problem, it may be noted that the tax morale concept is most comprehensively represented in the works by J. A. Schumpeter (1929), A. Pausch (1992), J. Alm, B. Torgler, (2006), F. Schneider (2009), K. Murphy (2004), Gebhard Kirchgässner. (2011), Sevcan Güneş (2016), and others.

J. Schumpeter was the first to use the “tax morale” term in his paper *Ökonomie und Soziologie der Einkommensteuer (Economics and Sociology of Income Tax)*, where he emphasizes the cyclic nature of its evolution: “As any other social institution, each tax lives through the age of its economic and psychological feasibility. And, just like in any other social institution, anything is not established in the tax system does not live forever. The wave of evolution slowly erodes it” (J. A. Schumpeter, 1929). He refers to “tax morale” exclusively in the context of the tax system formation and development processes. For instance, he sees the income tax as an “apex” of the tax morale, and the ultimate achievement of the taxation. It is clear that for J. Schumpeter, “tax morale” is just a certain degree of advancement and soundness of the tax code. He considers taxation as art, so “tax morale” is understood as an “art of creating cultural values” to differentiate it from the conventional perception of taxation as just a “craft”. Therefore, the Schumpeter’s “tax morale” focuses on the overwhelming contribution of its “founding fathers”: the tax economists and tax politicians who professionally establish a human-made tax harmony: a national taxation system.

A similar attitude can be traced to the modern-day concepts claiming that the very notion of “tax morale” is directly and inseparably linked to the persons who control the national tax system development (Pausch A., 1992). Such an approach strengthens Schumpeter’s views where tax morale is a special manifestation of human spirituality and creativity.

A logical follow-up to this concept is an idea that “tax morale” is directly related not only to the tax system ideologists and developers but to the “morale of taxpayers” and the morale of tax authorities (Martinez-Vazquez, Jorge / McNab, Robert M., 2000). Particularly, they claim that tax reform can be successfully implemented only if the “taxpayer morale” evolution is properly considered by the tax authorities. Moreover, the “tax morale” studies present an objective necessity to stimulate its development as a key link between the taxpayer and the Internal Revenue Service (IRS). Within such an approach the very existence of the court investigation procedure for tax official power abuse and corruption cases and subsequent compensation of damage caused by such illegal actions are considered as a manifestation of tax

morale. It concludes that the tax morale role is to harmonize the relations between tax authorities and taxpayers and to shape their behaviors.

Later studies of tax morale also closely follow the classical Schumpeter's approaches since they conventionally consider either taxpayers only or their relations with tax authorities. Still, it is believed that studying the "tax morale" phenomenon only as the relations between these two entities is too restricted since the important stages of the tax relation system evolution affected by such a significant public institution as national morale are highly underestimated.

For this reason, the most promising approach to analyzing the nature of tax morale is the new institutional approach within the framework of the new institutional economic theory. It considers tax morale as a manifestation of the accepted "rules of the game" existing in the country's economy. These rules are based on the basic official and unofficial public institutions. The core category of the institutional approach is the very concept of "institution" as a consistent behavior pattern expressed as a multitude of models applied to the economic and social life. That said, the "institutions" (traditions, customs, accepted legal and social behavior patterns) are considered as the existing "rules of the game" that restrict and guide the individual's behavior and coordinate the relations between the state, the society, and the business entities.

On one hand, the tax behavior morale is expressed as the behavior of economic entities within the *bounded rationality* model (Simon G., 1993), and, on the other hand, within the model of *opportunistic behavior* (O.E. Williamson, 1993). The new institutional theory gives the best possible understanding of the nature of irrational economic behavior of business entities. It explains the phenomenon only through the drawbacks of the very human nature such as limited intellectual abilities, knowledge, and skills required to make rational solutions. In terms of new institutionalism, the opportunistic behavior model is also explained through its anthropogenic origin being the result of satisfying the selfish human interests and needs not restricted by any public morale. In terms of new institutionalism, the *opportunistic behavior* model is also explained through its anthropogenic origin being the result of satisfying the selfish human interests and needs not restricted by any public morale. In terms of ethology (the science that studies behavioral economy in anthropoid apes), such a rational-opportunistic human behavior is a result of their biological, intrinsic instincts aimed at getting benefits both for an individual organism and for a population of the species. In ethology, value means ensuring survivability both of an individual organism and the species and enabling some kind of association between different species. Similar processes can be observed in human societies (wars are just one example). That is why a certain social, and also economic instinct in humans that expresses itself, for instance, as "maximization of benefit" (R.M. Yasmilov, 2015) should be noted.

Total absence or weakness of social institutions (for instance, the tax morale institution) is one of the prerequisites for the development of an informal shadow economy environment best suited to implement human opportunistic behavior. O.E. Williamson (1993) states that are expressed as "...following one's own interests, even through deception, including but not limited to...such obvious kinds of deception as lies, theft, fraud". Under the new institutional concept, "tax morale" is a significant social institution in the market environment. It governs publicly accepted behavior patterns and the corresponding enforcement measures as a part of the business entity economic behavior model. It is the tax morale that is expected to reduce the negative impacts of unfair competition, limited rationality and opportunistic behavior of economic entities involved in various forms of shadow activities. It can be concluded that since its nature is objective, the role of tax morale as an important public institution is the formation of a system of priorities and stimuli that govern the business entity social behavior models and, therefore, making the economic environment more (or less) certain.

This conclusion is important in the context of today's shadow economy analysis since based on the natural anthropogenic nature of tax morale one can trace its effects on economic processes through studying the ethical factors invoked by weak (or strong) business environment institutions. It should be noted the importance and significance of considering the national morale features and religious customs that directly affect the values and social behavior through the public conscience. O.N. Pryazhnikova (2015) states that the very attitude towards entrepreneurship is a manifestation of religious customs engraved in the national morale. The morale directly affects the economic activity outcomes: "such an effect seems to be comprehensive, indirect, and being dependent on the unique traits of the person, their ethnicity, social networks, education, political regime, etc." Cultural traditions affect the creation of a national business environment and, correspondingly, the business entity economic behavior models including making decisions whether to legally pay taxes, or stay "in the shadow". While in the West the Protestantism and its business ethics and labor morale established a consistently positive social attitude towards private property and personal enrichment (Max Weber, 2002). Conversely, in Russia, the Orthodox religious tradition and the former Soviet "builders of Communism" ideology to a larger extent resulted in a reserved attitude towards material values focusing on spiritual and ethical self-development. A logical follow-up would be the application of the ethical approach to tax morale studies since in this case, the moral aspects of economic activity prevail. Its essence is that any economic system has its traditions and commonly accepted moral standards that serve as core ethical institutions.

The conclusion is: the "moral" component in this context is the most important one for studying this phenomenon. The "morale" itself can be considered as "mass mind programming", and a system of meanings or interpretations (including values) shared by a group of entities (Panther, Stephan, 1999). Such approaches reveal that

the very “tax morale” just like any other cultural phenomena are changed continuously as stimulated by internal and external factors and circumstances.

The hypothesis by Nerre B. (2001) can be supported: tax morale is a manifestation of economic socialization in the society is a “totality of all suitable formal and informal institutions related to the national tax system and its operations that are historically embedded in the national morale of the country”.

To summarize, it can be claimed that the evolution of socio-economic systems includes objective reasons for any tax system being imperfect since the existence or creation of a general-purpose, perfect tax system is impossible. Buchanan, James M. (1995) notes that for this very reason a unique national “tax morale” emerges within each historical age in the country while the country develops following its own well-established taxation traditions that suit the relations between the entity and the cultural values. It also follows such informal institutions as honesty, justice, duty, etc.

4. Results and Analysis

It is quite natural to ask: how is it possible to prove the relation and interdependence between tax morale and shadow economy?

Method #1: estimate the role and significance of tax morale with surveys when the respondents are asked directly about their attitude towards tax violations. For example, the World Values Survey, WVS, 2000 respondents were specifically asked if they would use tax fraud or not. Over 60% of the respondents said that fraud was unacceptable for them in any circumstances. Over 80 % of the respondents also gave a negative answer (8 or more points out of 10, where 10 corresponds that fraud can never be justified. Still, determining the relation between tax evasion rate and tax morale metrics (or other forecasting variables) usually requires many assumptions concerning the methods used to assess shadow economic activities. For this reason, the most common approach used internationally to analytically assess tax evasion and shadow economy size is the simulation method by Prof. F. Schneider (2005) based on the multiple indicators multiple causes (MIMIC) method.

Method #2: estimate the significance of the tax morale factor. It is an indirect method that estimates the forecasted rate of adherence to the national tax regulations also considering the law enforcement practices. At the same time, such an approach does not consider that an objective assessment of tax evasion rate by auditors would certainly be affected by large discrepancies between the financial statements submitted by employees and employers. For example, it is improbable that the US citizens evade the income tax since their employers submit the W-2 form to IRS, and since they know that chances of discovering such evasion are very high. Such a situation may result in low tax evasion rates, rare audits, and penalties. Even for incomes not covered by third-party financial statements the adherence to

tax regulation is often higher than expected based on the tax audits, penalties, and the probable risk rejection rate.

There are other methods to estimate potential tax evasion rates. One of them is a taxpayer survey to identify their attitude towards paying taxes. The key benefit of this method is that it is comprehensive and covers many indicators reflecting social, economic, demographic, legal, cultural, ethical, and other aspects. It enables to study the interrelated institutional problems and identify the most significant variables that govern the taxpayer behavior.

Another method uses the data obtained through tax audits. For example, just like in Russia, the US tax authority (IRS) has the Taxpayer Compliance Measurement Program (TCMP) for selected tax declaration audits. The information provided by TCMP helps in assessing tax evasion rates and hidden revenues. It should also be noted that such IRS programs to some degree can provide real tax evasion data since they only use the information provided by the taxpayers.

Some indirect methods are also suitable for a more accurate assessment of hidden revenues. For example, the Palermo method is one of the most efficient such methods. It compares incomes and expenditures at the national and household levels. In another indirect tax evasion assessment method, the discrepancy between officially declared and actual work time balance is analyzed: it is possible to estimate actual taxpayer revenues based on the hidden workload. The third indirect method is monetarist-based. It tries to identify the discrepancy between cash turnover and bank deposits, and the increase of the large face value banknotes in the circulation.

Unfortunately, all these indirect methods are not highly accurate since they automatically attribute any mismatches and technical errors to undeclared revenues. This should be considered as an inevitable error of such methods.

Method #3: confirming the tax morale significance for taxation by studying human behavior in terms of tax compliance when tax enforcement is limited or does not exist at all while private benefits from complying with the tax legislation would probably be negligible. This phenomenon was studied by analyzing the Protestant church tax collection in Bavaria (Dwenger N., H. Kleven, Imran Rasul, and Johannes Rincke. 2014). Under the German legislation, the church tax can be collected by the church or the tax authority. It is defined as a voluntary donation to the religious denomination the taxpayer belongs to. The church tax collection in Germany is not enforced. Despite this, about 20% of the taxpayers accept and pay the church tax. It points to the important role of informal institutions: in this example, the religion-induced tax behavior traditions.

Method #4: estimating the tax morale significance in terms of tax compliance through studying the behavior of taxpayers who vary greatly in their level of tax morale while operating in the same environment. The US research (DeBacke J., B.T. Heim, A. Tran., 2012) showed that corporations with owners from countries with higher corruption norms evade more tax in the U.S. Since the American business en-

vironment is the same for every business entity, the very traditions of corruption and tax evasion in home countries of such international tax residents may govern their destructive tax behavior in the USA. An important feature of that research is that it is based on a high database of over 25,000 corporate tax audits. The audits identified that corporations with owners from countries with higher corruption norms evade more tax in the U.S. This effect in terms of economics is quite statistically significant: an average-sized company owned by a person with a Nigeria-like level of corruption has an 8% tax evasion rate which is higher than a similar company from Switzerland. Since the corruption level in the home country itself does not reflect all the aspects of the company owner tax morale (that is, owners from the same country may have very different tax morale levels), the corruption rate can probably be used as a baseline to estimate the cumulative effect on the tax morale level.

Subsequent comparative studies in many countries found a cause-and-effect relationship between tax morale and shadow economy and provided valid proofs of the fact that a higher level of the population's tax morale leads to a lower shadow economy size (Alm, J. and Torgler, 2006). The linear relation (simple regression) analysis shows that the "tax morale" variable accounts for more than 20% of the mismatch with the "shadow economy size" variable.

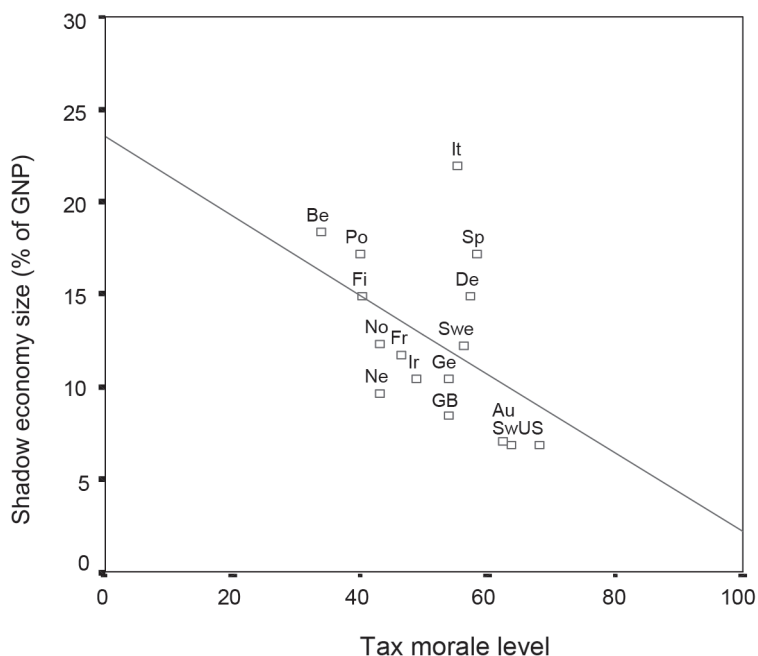


Fig. 1. Tax Morale vs. Shadow Economy Size

Source: Alm J., B. Torgler (2006). *Culture differences and tax morale in the United States and in Europe*. Journal of Economic Psychology 27 (2), pp. 224 – 246.

Fig. 1 shows the relation between the tax morale level and the shadow economy size in the EU and the USA. Au: Austria, Be: Belgium, De: Denmark, Fi: Finland, Fr: France, Ge: Germany, GB: United Kingdom, Ir: Ireland, It: Italy, Ne: the Netherlands, No: Norway, Po: Portugal, Sp: Spain, Sw: Switzerland, Swe: Sweden, US: USA. There is a strong inverse correlation (Pearson r is -0.460) significant at 0.05.

5. Conclusions

This study concludes that the institutional approach within the framework of the new institutional theory applied to assess the effects of non-economic market environment factors on the shadow economy identified the relation and correlation between them. Using tax morale as an example it is possible to show that the establishment and evolution of such an informal institution contributes a lot to the proper development of social and economic relations, and ultimately minimizes the negative effects of the shadow economy. Underestimating this factor within the legal approach commonly used in Russia to a larger extent hampers the efficiency of government actions to fight the shadow economy. This study shows that with the global methods of estimating tax morale effects on shadow economy it is possible to identify an inverse correlation between tax morale and shadow economy size. Our research confirmed that tax evasion rate is reduced when the system of relations between businesses, society, and the government is based on well-established informal institutions such as the traditions of tax behavior and tax morale, on a transparent, easy-to-understand, and balanced national tax system, and trustful (not punishing) treatment of taxation issues. As to the estimation of the low tax morale results in Russia, the author believes this subject is mostly neglected in domestic research. It should become a dedicated area of Russian research and should be brought to public attention. It is also believed that the very subject of this research is not purely theoretical but can become a foundation for real-life economic policy decision-making in Russia to take effective measures against the shadow economy.

Przewyciężanie wad szarej strefy przez moralność podatkową

Streszczenie

W opracowaniu rozważane są podstawowe problemy szarej strefy w kontekście badania jej ujawnienia w otoczeniu rynkowym. Jako przykład posłużyła koncepcja morale podatkowego. Główny cel badania polega na dostarczeniu uzasadnienia dla oszacowania wpływu morale podatkowego na rozmiar i przejawy rosyjskiej szarej strefy. W badaniach wykorzystano zarówno rosyjskie, jak i międzynarodowe opracowania na ten temat.

Słowa kluczowe: szara strefa, morale podatkowe, podatki a szara strefa.

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