

## **Non-technical summary, GDN Project RRCII+73**

### **Measurement and Interpretation of Tax Evasion in Eastern European Countries, with Particular Emphasis on the Czech Republic**

Tax evasion is one of the central problems facing the governments of transition countries. Corrupt tax officials, lack of resources to collect taxes, and populations versed in skirting rules, force transition countries to adopt systems of taxation that unduly target those narrow groups from who money can be extracted. This narrow targeting violates the central principle of efficient taxation, which is to tax at low rates on a broad base. Tax evasion raises what Browning (1976) calls the marginal cost of public funds.

Governments of transition countries have attacked the problem of tax evasion by cracking down on evaders. The present paper suggests a supplementary approach might be in order. In a survey of the Czech and Slovak Republics, Hungary, and Poland, we find strong evidence that citizens will avoid taxes if they do not believe they are getting quality government services for the taxes levied upon them.

At first this result may appear odd. Why should a rational factor the quality of government services into his evasion decision? Theoretical models of why people evade taxes hold that individuals will evade taxes if they do not fear risk, and if find they find low the chances of being caught and the penalty for being caught. These models assume the worst of taxpayers. People will free ride on government services if not whipped into paying their taxes. No theoretical model discusses the possibility that an individual's perception of the quality of government service might influence his decision to evade

taxes. A similar omission can be found in research on why people vote. The famous Downsian voter hypothesis suggests that people vote for instrumental reasons. If no one believes they can influence the outcome of an election, no one will vote. The Downsian voter hypothesis is now in retreat in face of data studies (summarized in Matsusaka and Palda 1993) showing it to lack explanatory power. Slemrod and Yitzhaki have cast similar doubt on the instrumental tax evasion model. In a major survey of tax evasion Slemrod and Yitzhaki (2000) have stated that the central mystery of taxation is not why people evade taxes, but why they pay taxes. The instrumental models of tax evasion developed by Allingham and Sandmo (1972) and a fleet of subsequent researchers (surveyed in Palda 1998), predict more tax evasion than we observe. The chances of being caught evading taxes in the U.S. are minuscule. According to Slemrod and Yitzhaki scarcely 1.5% of returns are audited and a small fraction of these is subject to penalty. As if ignoring these odds in favour of cheating, the majority of Americans choose to pay their taxes to the full.

Whenever a model lacks explanatory power researchers must scramble to find the forces that the model has overlooked. Our candidate for the missing force in tax evasion is the citizen's perception of the quality of government services. This search is not just of academic interest. We believe that governments wishing to reduce tax evasion must attack the problem in a pincer movement. One flank of evasion must come under attack from officers of the excise wishing to coerce citizens to pay. The other flank must be turned by a government wishing to prove to its citizens that their money is being well-spent.

Our research is of more than academic interest. We show that transition governments could make significant gains in revenue if they raised the perceived quality of the services which they provide their citizens. By encouraging more people to pay their taxes these transition countries could lower the deadweight cost associated with every dollar of tax raised and so allow governments to undertake the investments needed to foster economic growth.

The present research project has analysed tax evasion in the Czech and Slovak Republics by using a 2002 survey of 1089 Czechs and 501 Slovaks. We also analysed a more limited survey of Hungary and Poland. We have focused our attention on whether people who believe they are getting quality services are more willing to pay their taxes than are the disgruntled. We wish to do this in order to help governments develop efficient, minimally intrusive tools for encouraging people to pay taxes. The prevailing thinking in government and among academics has been that coercion is the way to get people to pay. Tax withholding already takes away much choice from individuals and the threat of audits and penalties is sustained by thousands of civil servants who form an elite caste of government with extraordinary powers of coercion. Economists by and large have made punitive enforcement the subject of their theoretical studies. Very few are those who have suggested that people may be convinced to pay their taxes without being prodded by inspectors. Friedrich Schneider is among the few to have suggested that tax evasion may be a form of protest against government. In all four countries of our survey we found strongly that those who believe they are getting quality government services also tend to

evade much less than those who do not believe they are getting quality services. A government keen on reducing tax evasion cannot just bark commands at its subjects. Governments are constrained in their tax collection by the perceptions people have of the quality of government services they receive. The Soviets used to say of their leaders “You pretend to pay us, and we pretend to work.” The present paper suggests that governments that pretend to provide quality services will preside over a mass that pretends to respect the tax code.

We noted that tax evasion by individuals is on the rise in both republics. We sought to explain why people evade taxes in both republics and found that, among other forces driving tax evasion, the willingness of citizens to pay increases as they perceive the quality of government services to be good. A similar finding holds for Hungary, and Poland, though our survey for these countries was more limited than that for the Czech and Slovak Republics.

Papers finished within the project:

Hanousek, J. and Palda F. (2002) “Quality of Government Services and the Civic Duty to Pay Taxes in the Czech and Slovak Republics, and other Transition Countries”

Orviská, M., Čaplánová, A, Medved’, J. and Hudson, J. (2002) “A Cross Section Approach to Measuring the Shadow Economy”