

# **A Theoretical analysis of the Social and Political Factors influencing Tax Compliance in Greece**

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# Foreword to our Project

- Our aim is to **research and measure the various aspects of shadow economy in Greece**, including corruption, tax avoidance, social contribution avoidance, undeclared or illegal work, shelf consumption, illegal acts (black or underground economy).
- It will cover **all economic agents in Greece**, such as citizens and corporations (e.g. public and private individuals, companies and all professional categories, etc.)
- The research is also performed at **sector levels**, e.g. to identify the extent of tax evasion and corruption in the trading of oil in Greece.

# Foreword to our Project (*cont.*)

- Emphasis is given to the **qualitative analysis of questionnaire results** which it aspires to reveal the opinions of households, enterprises and institutional entities and public services.
- It does not aim to the precise percentage regarding the measurement of Greek shadow economy but aims to the **qualitative analysis and the comprehension of the problem** so that we can reach essential and thorough proposals to the government in order to minimize the problem.

# Agenda

1. Introduction
2. Aim of the paper
3. The interpretation of tax compliance by the Neoclassical economic theory
4. Criticism of the Neoclassical model
5. Alternative modern theoretical proposals
6. Our empirical research
7. Conclusions

# 1. Introduction

- Various studies have been conducted in the past to determine if **ethical values, cultural characteristics** and **habits** differ between residents of different countries as well as whether these differences can be measured and affect the **economic behavior** of citizens.
- One such field of research consists that of **tax compliance and tax ethics**. These concepts while are studied by the economic science, **can not be explained and fully understood in purely economic terms**.
- This means that people - **taxpayers do not act as purely economic entities** whose sole objective is that of maximizing profit or utility.

## 2. Aim of the paper

- To provide the theoretical basis for developing a **framework** to analyze the main **social and political factors** affecting **tax morale** and **compliance** in **Greece**.
- Accordingly, first, the **neoclassical economic theory** is presented;
- Second, **other contemporary theories and approaches** and, the key factors identified by these modern theories in shaping tax morality and tax compliance are critically analyzed and reviewed.

### 3. The interpretation of tax compliance by the Neoclassical economic theory

- This is a classic model developed by Allingham & Sandmo (1972), which presents the taxpayer as a person who seeks to maximize its utility under uncertainty.
- Tax evasion is compared with high-risk and high-yield investments, while the tax compliance is a risk-free and low-yield investment.
- Mathematically the **declared income** is formulated as following:

$$Y_d = F(I, t, p, f).$$

- The person declares income to the tax authorities ( $Y_d$ ) of which the size is a function of the following variables: real income ( $I$ ), taxation rate ( $t$ ), tax fine or penalty ( $f$ ) in the case of a tax audit and the likelihood of detection by the tax authorities ( $p$ ). The target is the maximization of utility  $E(u)$  of the taxpayer.

### 3. The interpretation of tax compliance by the Neoclassical economic theory (*cont.*)

- Empirical research in **developed countries** has shown that this theory leads to unrealistic conclusions, because if we accept the universal power and practices applicable in tax audits, the vast majority of citizens (if not all) ought to evade taxes, or, alternatively, they should exhibit an extremely high risk aversion index.
- Further, according to studies, it has been detected a substantially higher level of tax compliance than that proposed by the neoclassical model (Andreoni, Erard and Feinstein, 1998).
- A deficit in theory and practice related to tax compliance involves mainly **developing countries**, which typically exhibit a much higher level of tax evasion and underground economy. However, it is estimated that the causes of **low tax compliance is not purely of tax nature** as the ones proposed by this model.

## 4. Criticism of the Neoclassical model

- Despite the shortcomings and criticisms of the model of Allingham & Sandmo (1972), it **has achieved to identify the key financial and tax parameters affecting tax compliance.**
- The model **has occupied many scholars and later formed the basis** upon which almost all subsequent research developed on tax evasion. The proposed policies arising were focused on imposing repressive and preventing measures on tax violations (Deterrence policy).
- At the same time **another group of scholars** which considered the gap between reality and theoretical neoclassical models, **has tried to search for reasons to justify the tax treatment outside the established framework of individual economic rationality**, as in the cases of Frey (1997), Frey & Feld (2002), Posner (2000), Torgler (2001), Torgler (2007), Torgler & Schneider (2005), Bosco & Mittone (1997), Alm, Jackson & McKee (1992).

## 4. Criticism of the Neoclassical model (*cont.*)

- Because the economic logic imposes a recourse towards tax evasion these researchers reversed the classic question that originally occupied the scientific community, which is "Why do people evade taxes", and sought answers to the question "**why most people comply with their tax obligations**".
- Fortin, *et al.* (2007) expressed the extreme view that the model of Allingham & Sandmo (1972) presents the taxpayer as a completely **individualistic and immoral being**.
- According to Andreoni, Erard and Feinstein (1998, p. 118): "**The approach to tax compliance should be multifaceted**: it must be considered as a public economic theory, law enforcement, organizational design, labor supply and morality, or a combination of all the above."

## 4. Criticism of the Neoclassical model (*cont.*)

- In this context, **new economic theories and scientific approaches** have been developed in recent years with **sociological** and **psychological** backgrounds.
- Among them, the theories distinguished achieved to innovate by **using tools from other social sciences** while **maintaining the basic methodology of economics**.

## 5. Alternative modern theoretical proposals:

### **a. Social norms**

- Social norms could be defined as an expected social behavior based on beliefs and values formed by a society, the violation of which (behavior) have the effect of imposing **informal social sanctions**.
- Erard & Feinstein (1994) starting from the finding that tax compliance in the U.S. is much higher than that predicted by the classical model, **introduced in the utility function** of the taxpayer two unpleasant emotions: guilt and shame.
- The effort to avoid the feeling of shame is also the focus of the **altruistic approach** that attempts to explain why tax compliance is higher than expected from the neoclassical economic model.
- A specialization of the general theory of social norm is the **signaling theory**. Per Posner (2000), the fear of stigma and social disapproval, according to the signaling theory, is the source of tax compliance.

## 5. Alternative modern theoretical proposals:

### **b. Reciprocity – Justice**

- Tax compliance is attributed in this case in the sense of responsibility which governs citizens, knowing that they have received **tangible benefits from the state** and therefore must repay through taxation.
- Thus it can be interpreted as **an implicit contract between citizens and the state** in which the citizen declares and pays the respective tax subject to the condition that the government will manage public revenues wisely, offering the maximum in quality and quantity of public goods.
- An equally important parameter for determining the level of tax compliance is the perception of taxpayers on the **existence of justice**, or not, in the tax system. It is also one of the objectives of any tax system under the concept of **redistribution of income and wealth**.

## 5. Alternative modern theoretical proposals:

### **c. Intrinsic motivation (self-control – motivation)**

- In economics, the theory of intrinsic motivation was introduced in the early 1970s as an alternative presentation of the classical theory on supply.
- **Non-monetary incentives** include the so-called intrinsic motivation. As such are deemed the **moral duty** and **altruism**.
- Two diametrically opposed policies to combat tax evasion are on the one side the deterrent factors (**deterrence measurements**), and on the other side, **factors which aim to develop tax ethics**. Strategies to combat tax evasion should not be unilateral but include a package of measures in both directions (Frey & Feld, 2002).
- The theory of intrinsic motivation has become an important and original proposal in the explanation of tax compliance. Through this theory is **emphasized the importance of the way of functioning and behavior of tax authorities**.

## 5. Alternative modern theoretical proposals:

### **d. Other factors of tax behavior influence**

- Political institutions – Degree of democratic participation;
- Differences between actual and perceived characteristics of tax audit;
- Public perception about the extent of tax evasion.

## 6. Our empirical research

- Due the lack of detailed and reliable information regarding the behavior of taxpayers, the methods we used on our pilot level in the first Semester of 2014 to accumulate quantitative and qualitative data regarding tax compliance are the following:
  - The **laboratory experiment**, which is also used in a large scale by the economic science during the last 30 years to estimate the extent of tax compliance and the degree of responsiveness or reaction in key economic variables.
  - **Questionnaire survey / interviews** is the most widespread method. New empirical data are collected that can facilitate the assessment of the levels of tax compliance and morale, while by using appropriate scientific methods will be identified the main factors that influence it.

## 7. Conclusions

- The paper has attempted to provide the **theoretical basis for developing a framework** to analyze the main social and political factors affecting tax ethics and compliance in Greece.
- The explanation of tax compliance by **neoclassical** economic theory is presented, followed by a critical review of the neoclassical model.
- In turn, **contemporary theories** and approaches are presented and analyzed. The main characteristic of the interpretative power of these theories is that they have managed to innovate by using tools adopted from other social sciences while maintaining the basic methodology of economics.
- The assessment of all the aforementioned factors has highly facilitated the authors in the formulation of the questionnaire and the performance and completion of the **pilot questionnaire survey** in Greece during the first semester of 2014.