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Institutional Quality and Tax Compliance: A Cross-Country Regression Evidence

Authors : Debi Konukcu Onal, Tarkan Cavusoglu

Abstract : In modern societies, the costs of public goods and services are shared through taxes paid by citizens. However, taxation has always been a frictional issue, as tax obligations are perceived to be a financial burden for taxpayers rather than being merit that fulfills the redistribution, regulation and stabilization functions of the welfare state. The tax compliance literature evolves into discussing why people still pay taxes in systems with low costs of legal enforcement. Related empirical and theoretical works show that a wide range of socially oriented behavioral factors can stimulate voluntary compliance and subversive effects as well. These behavioral motivations are argued to be driven by self-enforcing rules of informal institutions, either independently or through interactions with legal orders set by formal institutions. The main focus of this study is to investigate empirically whether institutional particularities have a significant role in explaining the cross-country differences in the tax noncompliance levels. A part of the controversy about the driving forces behind tax noncompliance may be attributed to the lack of empirical evidence. Thus, this study aims to fill this gap through regression estimates, which help to trace the link between institutional quality and noncompliance on a cross-country basis. Tax evasion estimates of Buehn and Schneider is used as the proxy measure for the tax noncompliance levels. Institutional quality is quantified by three different indicators (percentile ranks of Worldwide Governance Indicators, ratings of the International Country Risk Guide, and the country ratings of the Freedom in the World). Robust Least Squares and Threshold Regression estimates based on the sample of the Organization for Economic Co-operation and Development (OECD) countries imply that tax compliance increases with institutional quality. Moreover, a threshold-based asymmetry is detected in the effect of institutional quality on tax noncompliance. That is, the negative effects of tax burdens on compliance are found to be more pronounced in countries with institutional quality below a certain threshold. These findings are robust to all alternative indicators of institutional quality, supporting the significant interaction of societal values with the individual taxpayer decisions.

Keywords : institutional quality, OECD economies, tax compliance, tax evasion
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