Economic and Societal Institutions and the Tax System: The Case of Greece

DRAFT VERSION

by

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The sudden outbreak of the severe fiscal crisis in Greece has been the result not only of inappropriate fiscal policies, but also of poor domestic fiscal governance and weak fiscal institutions. The combination of these factors allowed for large public deficits during a long period of time, and the accumulation of a huge public debt that went out of control because of the global financial crisis. The present paper aims at highlighting a number of shortcomings in the design and enforcement of the tax system, and how they have played a key role not only in the exacerbation of fiscal deficits, but also in making it a source of social injustice and a symptom of the lack of trust characterizing the state-citizen relationship. These shortcomings that result in low tax revenue, relate to the structure of taxation, the poor performance of tax administration, the high tax evasion, the high reliance on indirect taxation and the ensuing unfairness in the distribution of the tax burden. The recent economic crisis has made these features more evident and the need for the radical reform of the tax system very urgent.

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The Greek fiscal crisis and its massive domestic and cross-border effects have been at the epicenter of international interest for the last two years. Putting the Greek fiscal house back in order is the top priority of the three international organizations (the IMF, the ECB and the European Commission) presently covering the borrowing requirements of the government and averting Greece from officially defaulting on its public debt. The chances of overcoming the fiscal crisis in an effective way are enhanced if policy makers sufficiently understand the factors that led to this crisis in the first place. There is little doubt that the destabilizing effects of the global financial crisis and some inherent weaknesses that were being built up in the euro area since the introduction of the common currency, speeded up and accentuated the outbreak of the Greek fiscal crisis.[1] Moreover, certain features of the Greek economic and socio-political reality played a crucial role in making Greece the weak link of the Euroarea.

More precisely, the sudden outbreak of the severe fiscal crisis in Greece has been the result not only of inappropriate fiscal policies, but also of poor domestic fiscal governance and weak fiscal institutions. The combination of these factors allowed for large public deficits during a long period of time, and the accumulation of a huge public debt that went out of control because of the global financial crisis (Kaplanoglou and Rapanos 2011). The present paper explores aspects of some key ingredients of the Greek institutional fiscal framework, and particularly of the tax system.

The reasons for choosing the tax system are rather obvious. Failures in its performance were feeding into growing public deficits for a long period of time. As indicated by Kaplanoglou and Rapanos (2011), revenue targets were being missed by a large margin throughout the decade preceding the outbreak of the crisis. Furthermore, the structure of the tax system and the improvement of its overall performance have been issues of hot debate among the Greek political parties, and figure prominently in the reports assessing the compliance of the Greek authorities with the fiscal programme supplementing the support package for Greece (IMF 2011). The need for an overhaul of the present tax system has led the Minister of Finance to commit himself to presenting a new “National Tax System”.

In this paper, we will attempt to evaluate the Greek tax system and point out its particular features that make it not only inefficient in yielding adequate revenues to

[1] See, for example, European Commission (2010a).

the state, but also a source of social injustice and a symptom of the lack of trust in the state-citizen relationship. In the next section, as a first step, we will contrast the Greek case against international experience in terms of both the overall level of taxation and its structure. Such a comparison reveals that the tax-to-GDP ratio is particularly low and out of pace with the country's level of economic development. The structure of tax revenues reveals a heavy reliance on indirect taxation, which is again unusual among countries of similar income level.

The third section attempts to explain the above empirical findings in terms of the longstanding failures of *formal* institutions. Despite the fact that evidence is sparse and fragmentary, all available indicators point to the fact that the low and unfairly distributed tax yield is primarily due to the poor functioning of the tax administration, lax tax enforcement, inefficiency of tax collection, and the lack of effective dispute resolution mechanisms. Such failures result in high tax evasion and a thriving underground economy.

These findings cannot be interpreted in economic terms alone. The standard view of tax theory is that taxes are a necessary harm whose "excess burden" has to be minimized. Optimal taxation problems are thus set in the general context of minimizing the total burden of raising a certain amount of revenues needed to finance some undefined public expenditures. Standard tax evasion theory treats the decisions of individual tax payers with regard to their tax payments in a similar way (e.g. Allingham and Sandmo 1972, Yitzhaki 1974). However, as we will explain later, the conclusions of these theoretical models seem to come in contrast with empirical evidence. (Slemrod 2003, Feld and Frey 2002).

Two issues escape the attention of such models. The first one is that in the real world citizens of democratic political jurisdictions perceive a connection between the taxes they pay and the government services provided to them. In this context, citizens could "voluntarily" pay their taxes if they *trust* their government to deliver the services it has promised. The second issue is that, even if a citizen trusts her government, her behaviour will still be influenced by how she perceives other taxpayers to behave. In other words tax evasion should be treated not only as a pure economic but also a *social phenomenon* (Sandmo 2005).

In the fourth section, therefore, we will attempt to draw a link between failures of formal and *informal* institutions. Within this framework we argue that low tax revenues are partly to be explained in terms of low tax morale of Greek taxpayers and poor tax compliance behaviour, which are themselves a symptom of low levels of perceived fairness and of the lack of trust of citizens in their government and their fellow citizens. In this aspect, combating tax evasion, rebalancing the importance of different tax revenue sources towards a fairer direction and eventually increasing tax revenues in a sustainable manner appear to be much more complicated issues, which cannot be simply addressed just by altering tax rates or by increasing audit probabilities and making fines more severe.

Tax revenues and the structure of the tax system in Greece

According to a large strand of theoretical and empirical literature, increasing levels of economic activity go hand in hand with an expanding government sector. This literature dates back to the 19th century, when Wagner originally proposed that as nations industrialize, the share of the public sector in the national economy grows continually as the state expands its social activities, its administrative and protective actions, as well as its welfare functions (Wagner 1893). Among more recent approaches, public sector growth is considered a result of the utility maximizing behaviour of bureaucrats (Niskanen 1971), or seen from a public choice perspective as a consequence of expanding voting rights to lower-income voters who push for more and more redistributive expenditures (Meltzer and Richard 1981, Persson and Tabelini 1990), or explained as a process of enhancing the risk-reducing role of government consumption in a context of open economies exposed to increased external risk (Rodrik 1998). Empirical investigations of several versions of Wagner’s law are indeed extensive (for a recent synthesis of empirical evidence, see Shelton 2007), while the law seems to find empirical support in the Greek case (see, e.g. Sideris 2007, Loizides and Vamvoukas 2005).

While most of the above theoretical explanations try to establish a causal relationship running from higher economic activity to higher levels of public expenditures, the inevitable need to finance those expenditures tends to drive tax revenues on a concomitant upward trend. Indeed, GDP per capita is usually seen as a major determinant explaining differences in overall tax ratios among different countries. Taking a global overview, Table 1 shows that the tax ratio consistently varies with income level, rising from about 14 percent of GDP in low-income countries to 25 percent in high-income countries. The same trend is documented in a number of other studies (e.g. Tanzi 1987, Bird and Zolt 2005).

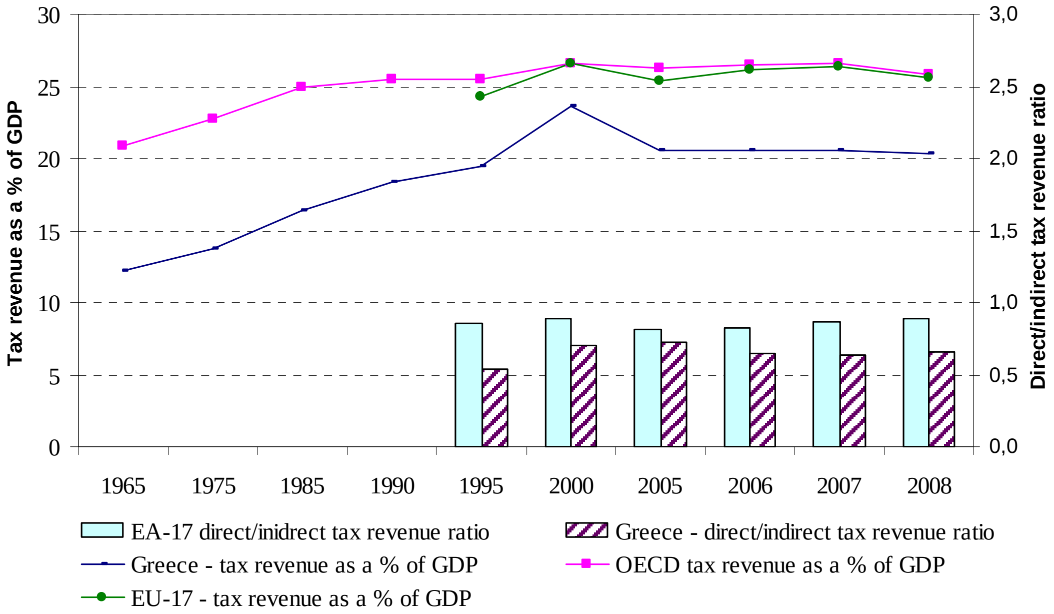
What gets taxed varies as widely as total taxes raised. In countries with higher income levels the main sources of revenue are income taxes, especially personal income taxes, and various consumption taxes (see Table 1). On the contrary, consumption taxes, along with border taxes, are by far the most important revenue sources of poorer countries, with personal income representing a relatively unimportant tax base. There are several explanations why the importance of income taxes, as a source of government revenue, grows at the expense of indirect taxes as a country reaches higher levels of economic development. A country's economic structure (e.g. the size of the agricultural sector), its administrative capacity, its political institutions, the degree of concern about fairness, the size of the informal economy are likely to critically influence the tax structure, and are themselves largely determined by the level of economic development (Tanzi 1987, Tanzi and Zee 2000, Fox and Gurley 2005, Bird 2007). Recent years have witnessed a trend in developed countries to shift the tax basis towards consumption; nevertheless the profound differences in tax structure according to income level are maintained.

Table 1 Level and sources of government revenue, 1996-2001

GDP per capita	Tax revenue (% of GDP)	Income taxes (% of tax revenue)	Personal income tax (% of income taxes)	Consumption and production taxes (% of revenue)	Border taxes (% of revenue)	Inflation rate	Informal economy (% of GDP)
<$745	14,1	35,9	16,6	43,5	16,4	10,6	26,4
$746-2975	16,7	31,5	16,0	51,8	9,3	15,7	29,5
$2976-9205	20,2	29,4	20,5	53,1	5,4	7,4	32,5
All developing	17,6	31,2	18,0	51,2	8,6	11,8	30,1
>$9,206	25,0	54,3	44,6	32,9	0,7	2,2	14,0
Greece - 2008 ($30,884)	20,4	36,9	24,7	55,7	0,002	4,2	26,5

Source: Gordon and Li (2009), World Development Indicators (World Bank, 2011), Government Finance Statistics (IMF, 2011)

Figure 1 Total tax revenue as per cent of GDP (excluding ssc) and the tax mix



Source: OECD Revenue Statistics 2010, European Commission, Tax trends in the EU, 2011.

How does Greece fit in the international picture? As is apparent from Figure 1, the tax ratio (measured on the left axis) did follow a rising path as the country reached higher levels of economic development, but remains distinctively lower than the OECD or EU-15 average. The tax/GDP ratio (excluding social security contributions) increased from around 12 per cent in the mid 60's to over 20 per cent in 2008, the year before the outbreak of the fiscal crisis. Yet it remains around 5 pp of GDP lower than the average of the OECD or EU-17 countries. Among all European Union countries, Greece's tax/GDP ratio is among the lowest, exceeding just that of certain easter-european economies, like Latvia, Romania or Slovakia. A similar picture is conveyed from Table 1, where Greece is compared to a wider set of countries around the world. On the basis of the tax ratio alone, Greece would be classified closer to the group of developing rather than developed countries.

What conveys an even more puzzling picture is the tax mix. Despite increasing levels of overall taxation, consumption seems to remain the most important tax base, contrary to what the theory and international experience would predict. The share of consumption taxes in total tax revenue remains exceedingly high, at least when compared to the set of countries with similar income level (see Table 1)[2]. At the

[2] Border taxes are hardly detectible in Greece as a result of EU membership.

same time, income taxes are less important, and personal income taxes in particular are half as important, as a revenue yielding source, when compared to the group of high-income countries.

Comparing Greece with the narrower and relatively more homogeneous group of Euroarea countries, we observe that Greece and Portugal have the lowest direct/indirect tax revenue ratio of around 0.64 (depicted on the right axis of Figure 1), while for the same period Greece has by far the lowest direct tax/GDP ratio of around 8.3 per cent, compared with a Euroarea average of 11.7 per cent. Taking the whole OECD area, taxes on income and profits in Greece in 2008 amount to 7.3 per cent of GDP (the lowest after Mexico, Turkey and Slovakia), compared to an OECD average of 12.5 per cent. Regarding the importance of personal income taxes in total tax revenue, Greece ranks 31 among the 33 OECD countries.

In summary, two main conclusions can be drawn from contrasting the Greek case against international experience: the first one is that despite increasing levels of taxation, the tax-to-GDP ratio remains lower than what one would expect. Do lower tax revenue ratios in Greece reflect lower preferences for public versus private goods or are they the symptom of other factors? The second one refers to the fact that the structure of tax revenue resembles that of a country at a much lower level of economic development, despite the fact that Greece has been under the influence of the European Union on tax matters for at least the last 20 years. Both paradoxes deserve closer scrutiny and an effort to be explained.

Failures of Formal Institutions

The first paradox can rather easily be resolved, if statutory tax rates are brought into the picture. Apparently Greece has adopted for most kinds of taxes statutory rates that are very close to the average of OECD or euro area countries (OECD 2011a). Taking 2009 as the reference year, the standard VAT rate in Greece was 19 per cent compared to a Euroarea average of 19.4 per cent. However, according to the European Commission estimates (European Commission 2011a), the implicit tax rate on consumption in Greece fell short of the euro area average by 6.4 percentage points[3]. According to the same source, the implicit tax rate on labour in Greece (29.7 per cent) is also lower than the euro area average of 33.5 per cent, despite the fact that the top personal income tax rate is by 3 percentage points higher than the Euroarea average.

A similar picture is conveyed when Greece is compared with other OECD countries. According to OECD (2011a), statutory tax rates for VAT and the corporate income tax are both higher than the respective OECD averages, yet effective tax rates are substantially lower[4]. Especially in the case of VAT, the OECD has employed the concept of the VAT revenue ratio (VRR), which measures the difference between the revenues that would arise from a theoretically "pure" VAT system with a single rate and 100 per cent compliance and the revenues actually collected. This ratio gives an indication of the efficiency of the VAT regime in a country compared to a standard norm. (OECD 2011b).[5] A value of VRR other than 1 indicates deviation from a single tax rate applied on all final consumption or a failure to collect all tax due. VRR varies considerably across OECD countries, ranging from 0.98 in New Zealand to 0.35 in Turkey and Mexico. Greece ranks 29th among 32 OECD countries, with a VRR value of 0.46 for 2008. This implies that the current VAT system raises less than half of the potential revenues that could be raised, if the standard VAT rate was effectively applied to final consumption expenditure. Further evidence, from the USAID's Fiscal Reform and Economic Governance Project, indicates that a similar measure of the "productivity" of major taxes in Greece, namely the VAT, the corporate and the personal income tax, ranks Greece lower than the average of 23 high income countries.[6]

Deviations between statutory and effective tax rates could be attributed either to legal provisions which narrow the tax base, e.g. through the use of generous exemption schemes, high thresholds, reduced rates etc., or to the ineffective enforcement of the tax law. It is true that in certain cases, exemptions and generous thresholds do limit the tax base to an extent beyond what is the norm in other

[3] Implicit tax rates are computed as the ratio of total tax revenues of the category (consumption, labour, and capital) to a proxy of the potential tax base defined on the basis of national accounts.

[4] The effective VAT rate is calculated as the ratio of VAT revenue to private consumption, while the effective corporate tax rate is calculated as the ratio of corporate taxes to GDP.

[5] Technically, $VRR = VR / B\, r$, where VR stands for actual tax revenues, B represents the potential tax base (namely final consumption expenditure) and r is the standard VAT rate.

[6] Tax "productivity" is a revenue performance indicator, measuring net tax receipts as a per cent of GDP divided by the standard tax rate, see http://www.fiscalreform.net/index.php?option=com_wrapper&Itemid=132

Euroarea or OECD countries. The tax free threshold of the personal income tax, for example, was until recently, about 78 per cent of per capita household disposable income, a lot higher than in most other OECD countries (OECD 2011a). The income tax base is further shrinked by numerous tax allowances and deductions.[7] In the case of VAT, reduced rates are applied to a relatively large base, while certain specific rates applied to the frontier islands are indeed hard to justify.

Nevertheless, there is rampant evidence that low tax revenue yields in Greece are mainly the result of failures of the formal institutions in place, namely poor functioning of the tax administration, lax tax enforcement, inefficiency of tax collection mechanisms and ineffective dispute resolution mechanisms. A clear manifestation of such failures is the size of the shadow economy.[8] Despite the fact that Greece officially belongs to the group of high-income countries, the size of its shadow economy (27.5 per cent of GDP on average in the period 1999-2007) brings it closer to the average of developing or transition economies (35.8 per cent and 35.1 per cent respectively), rather than the OECD, where the average is 17.1 per cent.[9]

Taking the example of VAT once more, according to a recent European Commission study (EC 2011b), the low VAT collection rate is mostly due to fraud and evasion. This study quantifies the VAT "compliance" gap in EU-25 Member States by comparing the accrued VAT receipts with a theoretical net VAT liability, the latter being calculated by identifying and measuring the categories of expenditure that make a net contribution to the total VAT base and combining them with appropriate VAT rates. The study also takes into account the categories of expenditure that give rise to irrecoverable VAT, such as expenditure on inputs used in the supply of exempt goods and services on which VAT cannot be reclaimed (e.g. financial services, education)and combines them with appropriate VAT rates. The VAT gap thus measures the difference between the actual tax revenue and what theoretically should be raised given the VAT rate structure and exemptions provided in the law. The VAT gap in Greece is the highest among all EU-25 Member States,

[7] For an analysis of the distributional effects of personal income tax expenditure programmes, see Loizides and Kaplanoglou (2006).

[8] Tax evasion and the shadow economy are not identical terms, but are highly related (Kalyvianakis 1993).

[9] The influx of immigrants during the last 20 years is among the factors contributing to the size of the shadow economy. According to the OECD International Migration Outlook for 2009, Greece has the highest number of illegal employed immigrants as a share of total employment, among 12 surveyed OECD countries (4.4 compared with an average of 1.6).

amounting to 30 per cent of theoretical VAT liability in 2006, compared to an EU-25 weighted average of just 11 per cent.[10] Taking into account that VAT revenues in 2006 amounted to 7.8 per cent of GDP, we can deduce that the revenues foregone were around 3.3 per cent of GDP. To gain an idea of the order of magnitude, this is 1.5 times the total fiscal consolidation envisaged for 2012 in the Draft Budget submitted last October by the government to the Parliament.

Income taxation and particularly the personal income tax seems to be the most thriving field of tax evasion, which perhaps explains the low direct/indirect tax mix identified in the previous section. It is worth noting that the self-employed and certain types of personal companies (e.g. general or limited partnerships) are also subject to this tax, so that a large fraction of business income is taxed under the provisions of the personal income tax. Revenues from this tax are more than four percentage points lower than the Euroarea average, despite comparable statutory rates and similar levels of income (OECD 2011a). According to the latest available data, provided by the Greek Ministry of Finance (GSIS 2011), regarding tax declaration forms for incomes earned in 2009, almost 60 per cent of the Greek taxpayers reported incomes below the tax free threshold and did not pay any income tax. For 2009, almost 90 per cent of individuals reported annual incomes below 28,000 euros, while only 1,700 individuals reported incomes of 250,000 euros or more. Consequently tax payments were highly concentrated to the upper part of the income distribution, with 30 per cent of taxpayers paying 95 per cent of the total personal income tax.

Further insights can be gained by comparing the declared incomes of employees/pensioners (who are less likely to hide earned incomes) with the incomes of the rest of the taxpayers. For 2009, around 42 per cent of employees/pensioners reported incomes below 10,000 euros, while the respective proportion for the remaining occupational groups is twice as high (83 per cent). Such figures are indeed hard to rationalize. Contrasting reported incomes and consumption expenditures of different occupational groups, from different statistical sources, provides further evidence that certain groups significantly underreport their incomes (see Table 2). Such a comparison reveals that, for example, in expenditure terms farmers are the least well-off compared to the population average, but by a far smaller degree than in

[10] This estimate is close to the findings of Kanellopoulos, Kousoulakos & Rapanos (1995) for 1988, who by comparing national accounts and Household Expenditure Survey data, estimate that the evasion of VAT corresponds to 38 per cent of collected VAT revenue.

income terms.[11] The group of liberal professionals, traders, industrialists, etc. who in income terms are around the population average, are by far the most well-off group of the population when judged by their expenditure levels. Wage-earners, who in income tax declarations appear to be the richest in income terms, are well behind the liberal professionals etc. group when data from Household Expenditures Survey are considered. Pensioners are slightly below average in both income and expenditure terms.

Table 2 Reported income and consumption expenditure of occupational groups

Occupational group	Taxpayers (as a % of total) (1)	Average income tax burden (% of total taxable income) (2)	Income as a % of population average (3)	Expenditure as a % of population average (4)	Non-durable expenditure as a % of population average (5)
Traders, liberal professionals, rentiers	29.3%	12.1%	103.0%	125.7%	123.0%
Farmers	6.9%	6.5%	66.3%	81.1%	80.7%
Wage-earners	35.9%	8.6%	110.8%	106.3%	104.9%
Pensioners	28.0%	7.4%	91.3%	84.9%	87.5%

Sources: Own calculations from Ministry of Finance (2011) – columns (1)-(3), own calculations from 2008 Household Expenditure Survey conducted by the Hellenic Statistical Authority.

The structure of the Greek economy with little doubt aggravates the problem of tax evasion. The income of the self-employed, who presumably can more easily under-report their income, is a far larger fraction of GDP compared to the Euroarea average (24 per cent as opposed to 12.5 per cent of GDP respectively, for the period 2005-2009, OECD 2011a). Furthermore, Greece displays the highest proportion of the non-financial business economy workforce being employed in very small businesses across EU-27. More specifically, around 58 per cent of this workforce works for "micro enterprises" employing 1-9 persons, compared to a EU-27 average of just 30 per cent (Eurostat 2008). At the same time, the number of persons employed per enterprise (considering all small and medium sized enterprises, i.e. with less than 250 employees) is the lowest among all EU-27 countries, namely three per cent in 2008 (European Commission 2010b). The abnormally high number of self-employed and very small businesses makes tax auditing a challenging task for tax administration.

[11] This is to a large extent explained by the fact that expenditure includes home-production and imputed rent.

The persistence of high tax evasion reveals that tax administration and enforcement mechanisms appear particularly weak. An extensive analysis of such weaknesses is perhaps beyond the scope of the present paper.[12] Nevertheless, among their major manifestations is the fact that tax arrears in the end of 2010 had reached 14.5 per cent of GDP and that another 13.2 per cent of GDP of assessed tax revenue was disputed in courts. A clear indication of the inexistence of an effective dispute resolution mechanism is the fact that over 150,000 cases are pending before the tax courts, each of which takes 7 to 10 years, on average, to be given a final verdict.

Tax audits are sparse, leading to an accumulation of unaudited tax declaration forms. The Ministry of Finance thus proceeds to "settling" such cases by resorting to tax amnesties every 3 to 5 years, the latest one being effected just a few months ago, in September 2011. Such practices reward tax evaders, and act like a punishment for honestly reporting taxpayers. Taxpayers themselves perceive tax authorities as ineffective. Taking the example of undeclared work, according to the 2007 Eurobarometer for the 27 EU countries, Greeks report the highest number of hours in undeclared work (see Figure 2 in the next section) and at the same time the lowest percentage of those expecting a sanction to be fine or prison. Extensive use of presumptive taxation is yet another indication of the reluctance of policy makers to establish a tax system where the proper tax basis is correctly assessed. Evidently, the complexity of the tax code and its constant modifications (approximately 2 to 3 tax laws are voted every year) act as further impediments to the proper functioning of tax administration and enforcement mechanisms.

A meaningful comparison of the efficiency of the Greek tax administration with those of other OECD countries is severely constrained by the lack of data for Greece. Sparsely available indicators paint a gloomy picture. For example, the number of active taxpayers per tax administration employee is lower in Greece than the average of a sample of 23 high-income countries examined by USAID[13] (778 compared to 848 respectively). Yet, apparently this staff is not efficiently used. According to another international study (OECD 2009, p. 95), Greece displays a very low proportion of tax administration staff used for tax auditing and investigation (21.5 per cent in 2007) compared to an OECD average of over 35 per cent. In 2009, end-

[12] For such recent analysis and proposals for improvement, see Bank of Greece (2010), pp. 170-181, Rapanos and Kaplanoglou (2011), OECD (2011a).

[13] http://www.fiscalreform.net/index.php?option=com_wrapper&Itemid=132.

year tax arrears (i.e. all unpaid taxes excluding those where a dispute is involved) as a percentage of annual net revenue collections of all taxes reached an outstanding 72 per cent, followed by Slovakia (59.5 per cent) and Belgium (34.9 per cent) and compared with an OECD average of just 14.4 per cent.

The failures of formal institutions haunting the Greek tax system had immense repercussions at the macro-public finance level. Over the ten-year period preceding the recent fiscal crisis, fiscal targets set by Greek governments were constantly being missed by a large margin. There is a widely held view that in many EU countries including Greece, politically motivated systematic optimism concerning economic growth was a key factor behind such deviations (Jonung and Larch 2006, IMF 2006). More specifically, the argument has been put forward that in the context of Stability and Growth Programs submitted to the European Commission, several governments consistently based their fiscal forecasts on an overly optimistic outlook for the economy, thus inflating revenue forecasts and underestimating public expenditures. Subsequent deviations from the fiscal targets could then be attributed to the actual economy growing at a lower pace than anticipated. However, as Kaplanoglou and Rapanos (2011) argue based on data for the last decade, in the case of Greece macroeconomic forecasts on which fiscal targets were based were actually quite accurate. Fiscal targets were being missed primarily because budgeted revenues were not finding their way into the public purse as a result of the aforementioned institutional failures, while at the same time primary expenditures were also not kept under planned control. Citing just the example of the personal income tax (PIT), a recent study by Mylonas, Magginas & Pateli (2010) provides estimates that the margin for raising government revenue from PIT through tackling evasion would amount to about two and a half per cent of GDP. Similar estimated are presented by Flevotomou and Matsaganis (2010).

A critical issue that inevitably arises is whether there are additional factors explaining the aforementioned failures of formal institutions and the extent of tax evasion practiced by taxpayers and tolerated by tax authorities. This is the issue to which we now turn.

Failures of Informal Institutions: Taxation and Trust

As we have already mentioned earlier, most economic models of tax evasion, in the tradition initiated by Allingham and Sandmo, (1972) assume that people behave in an economically rational way. So, whether a taxpayer complies or not with the tax rules is the result of a cost - benefit calculation. According to these models' logic the degree of tax compliance will increase if the government is able to increase the frequency of audits and the severity of fines. These models, however, hardly explain actual levels of tax compliance. If people made their decisions as to whether or not to pay taxes on the basis of purely economic factors, then most taxpayers would be involved in tax evasion or fraud because of the low probability of detection and the small relative to evasion penalties. As Alm, McClelland & Schulze (1992) stress a '… purely economic analysis of the evasion gamble implies that most individuals would evade if they are rational because it is unlikely that cheaters will be caught and penalised'. In their survey Andreoni, Erard & Feinstein (1998) present a large number of studies to demonstrate that tax compliance exceeds the predictions of the models in the Sandmo and Alingham (1972) vain of analysis. Moreover, the standard theory of tax evasion cannot adequately explain differences in tax evasion across countries. However, this has not resulted in a model that effectively describes and predicts tax behaviour (Kirchler 2007).

These shortcomings of the classic models of tax compliance have led many researchers to seek alternative explanations for tax behaviour, by focusing on sociological and psychological factors. Based on the findings of this rather new branch of research, there are several non-economic factors and drivers behind taxpayer compliance behaviour. Two categories of such factors that, in our view, play an important role, particularly in Greece, are:[14]

1. Personal and social norms and,
2. Trust, both in the government or state institutions and in other taxpayers.

A rather selective review of this literature has shown that moral or normative considerations are found to be an important determinant of tax compliance. Taylor (2001) points out that although there is a connection between risk of detection, formal

[14] For a more detailed analysis of these factors see OECD (2010).

sanctions and compliance, he presents evidence which shows that the fear of experiencing feelings of guilt and the risk of social stigmatisation has a considerably greater deterrent effect. This kind of drivers behind taxpayer behaviour has attracted more and more attention over the past few years. Studies so far have generally focused on personal norms, often referred to as tax ethics, tax mentality or tax morale but also on social norms and trust.[15]

Personal norms can be defined as the deeply rooted convictions about what one ought or ought not to do. According to Kirchler (2007) personal norms with regard to taxes reflect a taxpayer's values and tax ethics, defined as 'a belief that there is a moral imperative with which one should deliberately comply'. Personal norms are rooted in core values and develop as a result of long-term socialisation processes. Several studies on a person's honesty and tax compliance have found that honesty is significantly related to compliance variables, such as previous underreporting of income and previous evasion, perceptions about the fairness of the tax system, and the tax evasion by others.[16] Hence, besides personal norms, social norms seem to play a very important role on compliance. But, what do we mean by social norms?

According to Leslie, Larson & Gorman (1973, p. 99) '…social norms are rules developed by a group that specify how people must, should, may, should not, and must not behave in various situations'. Hence, social norms are not static but evolve and change over time through social processes within and between groups. Research has shown that opinions and behaviours of others, or the ideas one has about the opinion and behaviour of others, are of great importance for taxpayer compliance behaviour (e.g. Wenzel 2004). Several studies show that people tend to follow the behaviour they see others to exhibit. In the area of tax compliance, several studies have found a relation between perceptions of the behaviour of others and the attitudes towards tax evasion. In a very interesting study, Scholz and Lubell (1998) show that people tend to meet their tax obligations when they trust that others will also pay their fair share of taxes. Other studies have found that perceptions of how others will judge tax evasion, affects one's own tax compliance. People, who believe that others do not comply with the tax rules, will also try to object paying their taxes.

This strand of research recognizes the importance of personal and societal norms on tax compliance, and poses therefore the question of trust between citizens

[15] See for example Braithwaite (2003, 2009), Kirchler (2007), Torgler, B. (2003), Traxler C. (2005).

[16] See e.g. Erard and Feinstein (1994), and Porcano, (1988).

themselves, but also the question of trust to the government and public institutions in general. Trust generally is considered as an important element of any well-functioning society. As stressed by Kenneth Arrow (1972), 'Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence'.[17]

A growing number of studies, over the last few years, suggest that trust in institutions influences economic and social behavior and is considered as a prerequisite for the exercise of an efficient and effective public policy (Putnam 1994). In an interesting paper La Porta *et. al* (1997) confirm empirically that, across countries, trust in institutions has important (i.e. large and statistically significant) effects on economic performance. In this vain of research Torgler (2003c, 2005) has shown that trust in government and in public institutions has a systematic positive influence on tax compliance. Other empirical work has found that trust in the government, public officials and in the legal system has a significant positive effect on tax morale (e.g. Scholz & Lubell 1998 and Torgler 2003, 2005). In other words if someone believes that the government collects taxes and spends the revenues in a fair and efficient way, then she will be more willing to pay taxes.

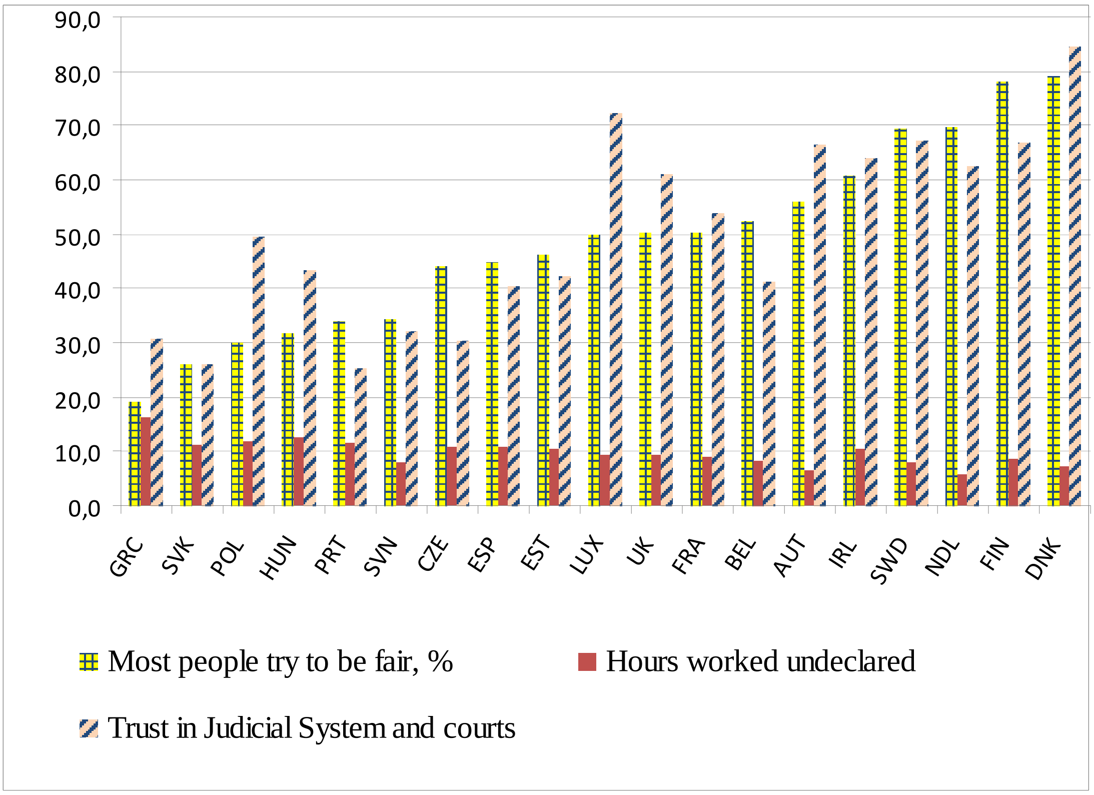
As we mentioned earlier, the level of the underground economy and tax evasion in Greece are quite high, in comparison with other EU and OECD countries. In the previous section we argued that tax evasion in Greece could be explained, at least partially, in terms of the structure of the Greek economy and the poor functioning of formal institutions, like the tax administration, etc. Now we will attempt to see how societal factors and norms, such as trust and fairness, may affect tax compliance. As already stressed, such factors seem to play a crucial role in explaining levels of voluntary compliance and why some people are motivated to evade taxes (Kirchler 2007). Based on evidence provided by Schneider (2011) and data from a range of sources reported by the OECD (2011a, 2011b) we have constructed some indices that are presented in Figures 2 and 3.

In Figure 2 we attempt to draw a link between perceived fairness and the size of the underground economy based on data for several OECD countries. Underground economy is proxied by the number of hours of undeclared work. We also use two

[17] For a detailed treatment of the role of trust in public economics, see Slemrod (2003).

proxies of perceived fairness; the one refers to how people perceive their fellow citizens to behave (namely whether they think that most people try to be fair). As a second proxy we use the trust of people in the judicial system of the country, since trust in justice may imply that in case citizens feel they are treated in an unfair way by the tax authorities, they can resort to the judicial system.

Figure 2 Fairness and the underground economy

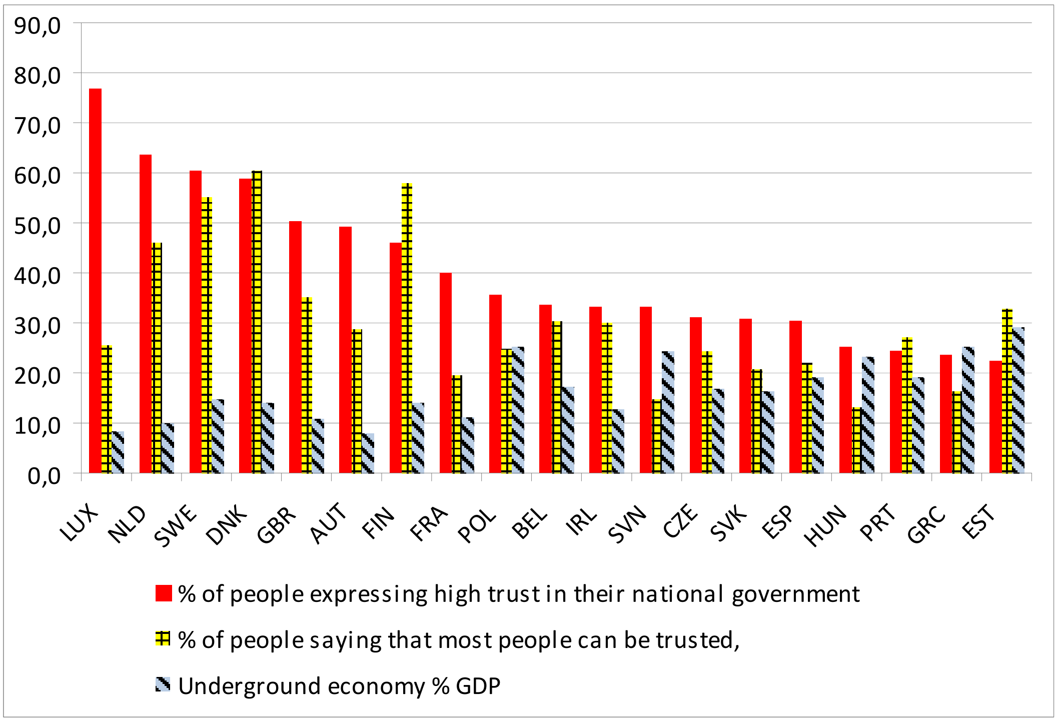


Sources: Euro Barometer 2007 Survey of undeclared work in the European Union, European Social Survey and OECD (2011) "How's life? Measuring well-being", Paris.

Similarly, in Figure 3 we examine whether there is a connection between the level of trust in government and in other people, and the size of the underground economy. It would be more appropriate to use indices for tax evasion. However, since we have very few comparable data for tax evasion in Greece and other European countries, we can consider the size of the underground economy as a very good indicator of the extent of tax evasion.

The data in these two figures seem to explain, at least partially, the unwillingness of Greeks to pay their taxes. It appears that such unwillingness is rooted in the low level of perceived fairness, and the apparent lack of trust in the national institutions, in the judicial system and also in their fellow citizens. So, from a policy point of view, the policy agenda of Greek authorities should take into account not only the inefficient structure of the tax system, the reform of tax administration, simplification of the tax laws, etc. but also issues regarding the ways they can improve the tax morale of the people, by restoring confidence in public institutions, and enhancing fairness in the treatment of citizens by these institutions.

Figure 3 Trust and the underground economy

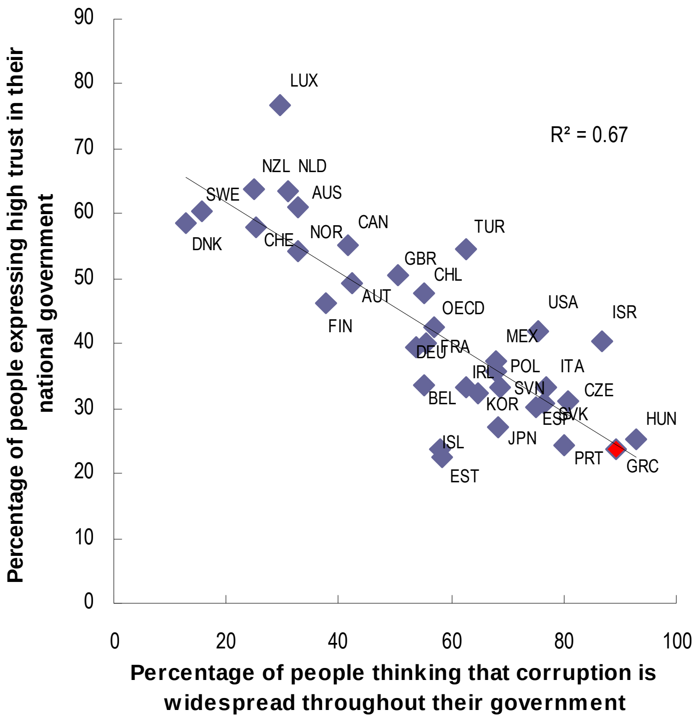


Sources: OECD (2011) “How’s life? Measuring well-being”, Paris and Schneider et al (2010).

Another issue that is closely related to that of tax evasion is corruption (*i.e.* the misuse of public office for private gain). Corruption is difficult to measure because it is hidden and can take a wide range of forms. Perceptions of corruption, however, matter in themselves, as they indicate that citizens do not trust their governments and public institutions. As indicated by the research of Transparency International, Greece ranks very low on the scale of the corruption perception index. More specifically, out of the 182 countries surveyed by Transparency International in 2010 Greece ranks 80th.

It is well established in the literature that corruption can undermine the trust in public institutions through a variety of channels and thus endanger the relationship of government and citizens. As Clausen et.al (2011) have shown “*in countries where respondents report a high incidence of personal experiences with corruption, and in* *which corruption is perceived to be widespread, confidence in public institutions is also low. Much more interestingly, we show that this pattern also holds across individuals within countries: individuals who experience corruption and who report that corruption is widespread also tend to have lower confidence in public institutions*".

Figure 4 Trust in institutions and corruption in government



Source: OECD (2011) "How's life? Measuring well-being", Paris.

This could be explained for the following reasons. First, corruption or the perception of citizens for widespread corruption in elected politicians makes the citizens to lose their confidence to democracy and this may threaten political and social cohesion. Second, if public officials are corrupt then the confidence of citizens to public institutions is undermined and this undermines the efficiency and effectiveness of the tax system.

Figure 4 suggests that there is a strong negative relationship, across countries, between the percentage of people that express high trust in the national government and the percentage of people thinking that corruption in the government is widespread. This relationship, however, does not say much about the direction of causality between the two variables. From a policy perspective, however, understanding this direction is essential. Clausen et.al (2011) argue that it is very likely that the causation goes from corruption to confidence and not vice versa. Uslaner (2002) has also found that societies where trust in institutions is strong and corruption is low have better governance, stronger economic growth and greater respect for the law among the citizenry. In the same study Uslaner derives evidence from some cross-sectional data that reducing the level of corruption may improve the level of trust. Moreover, as Warren (2006) suggests, it is not enough for political leaders to fight corruption; they also have to avoid appearing as corrupt. The corruption perception index is, however, a subjective measure of corruption and for a better shaping of the policies to fight the phenomenon, this kind of measures have to be complemented with objective indicators aimed at assessing the level of corruption. In any case, Greece appears in the lower right end of the figure, indicating that a high level of corruption goes hand in hand with low levels of trust in the national government. It seems therefore, that there is indeed a huge scope for improvement in how Greeks view public institutions, in forging trust, in enhancing the functioning of informal institutions, and eventually in increasing levels of *voluntary* compliance to the tax system.

Concluding Remarks

The tax system in Greece has played a prominent role in the creation of deficits that led to the current sovereign debt crisis. Its disfunctionings seem to have affected both the total level of tax revenues, as well as their structure. Revenue shortfalls have been a constant feature of the execution of government budgets, throughout the decade preceding the outbreak of the fiscal crisis in November 2009. It is also worth noting that the importance of personal and business income as a tax revenue base is abnormally low at least for Euroarea standards. Perhaps more surprising is the degree at which these features seem to persist even after Greece was subjected to an ambitious fiscal adjustment programme by the three international organizations surveilling the Greek economy since May 2010. Even under the threat of default, efforts to improve the performance of the tax system are not met with adequate success.

At a first level of interpretation, these shortcomings are attributed to the structure of the Greek economy, which makes tax auditing a difficult task, to the poor tax administration and the inefficiency of tax authorities in enforcing tax laws, and to the ineffective dispute resolution mechanisms. Such factors allow for the existence of a large shadow economy and the concomitant thriving tax evasion. However, taking a wider perspective in explaining tax compliance behaviour, recent research has shown that levels of tax compliance and their differences across countries cannot be explained simply by the effectiveness of tax authorities in enforcing tax laws. What appears to play a crucial role and to vary substantially across countries is the intrinsic motivation for individuals to pay taxes. Taxpayer values are influenced by cultural norms, with different societal institutions acting as constraints and varying between different countries. These values, social norms and attitudes (termed as informal institutions) have measurable effects on economic behaviour and, hence, on voluntary levels of tax compliance. What is more, some studies show that tax authorities which treat taxpayers in an authoritarian way using forceful instruments of deterrence reduce the incentive to evade taxes on the one hand (by increasing the probability of being punished), and on the other hand crowd out the intrinsic motivation to pay taxes (Feld and Frey 2002).

What this paper attempted to establish is that in Greece the failures of formal institutions are rooted in and at the same time reinforce failures of informal institutions. Sparse available empirical evidence suggests that the unwillingness of Greeks to pay their taxes is partially explained by their low level of perceived fairness and high level of perceived corruption, the apparent lack of trust in the national institutions, in the judicial system and also in their fellow citizens. At the same time, the resulting disfunctionings of the tax system are themselves perceived to lead to an unfair distribution of tax burdens and are a source of income and wealth inequality. Taking this argument to the extreme, low levels of tax effort may often be interpreted as lack of solidarity in particular by the richest small percentage of the population to provide for increasing the welfare of the majority (Bird, Martinez-Vazquez & Torgler 2006). Since the fiscal system is perceived not to effectively address social objectives with respect to fairness, social justice and redistribution, people lower their level of trust in institutions and the vicious cycle is reinforced.

It becomes sufficiently clear that addressing the failures of the tax system in Greece requires a multi-faceted approach. Reorganising tax offices, simplifying tax laws, rationalizing fines, improving tax audits and establishing credible dispute resolution mechanisms are necessary, but not sufficient steps. Any meaningful and long-lasting improvement has to emerge from a change in the way Greeks view public and societal institutions and from fostering higher levels of trust of people to the government and to their fellow citizens. However, if policy makers are successful in introducing reforms that will enhance the efficiency of the tax administration, this may be the first step in restoring confidence in public institutions. The change in social and personal norms cannot arise in a magic way. It takes time and this is an issue beyond the scope of the present paper that deserves a multi-disciplinary approach. However, the movement of Greek society towards this direction will yield benefits that will indeed be far reaching and well beyond a well-functioning tax system.

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