

# Local autonomy, tax morale, and the shadow economy

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**Abstract** Policymakers often propose strict enforcement strategies to fight the shadow economy and to increase tax morale. However, there is an alternative bottom-up approach that decentralises political power to those who are close to the problems. This paper analyses the relationship with local autonomy. We use data on tax morale at the individual level and macro data on the size of the shadow economy to analyse the relevance of local autonomy and compliance in Switzerland. The findings suggest that there is a positive (negative) relationship between local autonomy and tax morale (size of the shadow economy).

**Keywords** Tax morale · Shadow economy · Tax compliance · Tax evasion · Local autonomy · Federalism · Institution

**JEL Classification** H260 · H730 · D700

## 1 Introduction

Why do people pay taxes? This question has attracted increased attention in the tax compliance literature over the last few years. It can be supposed that nobody likes to pay taxes.

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One possibility is to “force” people to pay their taxes by establishing a deterrence policy. In line with the economics-of-crime approach based on the expected utility maximisation calculus, Allingham and Sandmo (1972) presented a formal model showing that the extent of tax evasion is negatively correlated with the probability of detection and the degree of punishment. However, this seminal model has since been criticised by many authors (see, e.g., Graetz and Wilde 1985; Alm et al. 1992; Frey and Feld 2002). A great deal of dispute surrounds the empirical and experimental findings, as these deterrence models predict a comparatively high incidence of tax evasion. In many countries, the actual level of deterrence is too low to explain the high degree of tax compliance. Furthermore, there is a considerable gap between the amount of risk aversion that is required to guarantee such compliance and the effectively reported degree of risk aversion. For the United States, the estimated Arrow–Pratt measure of risk aversion is between one and two, but only a value of 30 would explain the observed compliance rate (see Graetz and Wilde 1985; Alm et al. 1992). Similarly, in Switzerland, the relative risk aversion varies between 1 and 2, but a value of 30.75 would be necessary to reach the observed level of tax compliance of 76.52% (see Frey and Feld 2002). Furthermore, tax compliance experiments mostly report a higher level of income declaration than the expected utility model would predict (for a survey, see Torgler 2002).

To resolve this puzzle of tax compliance, many researchers have argued that tax morale<sup>1</sup> can help explain the high degree of tax compliance (for empirical and experimental papers see, e.g., Schwartz and Orleans 1967; Lewis 1982; Roth et al. 1989; Alm et al. 1992, 1999; Pommerehne et al. 1994; Frey 1997; Frey and Feld 2002; Feld and Tyran 2002; for a survey, see Torgler 2001). A theoretical approach by Erard and Feinstein (1994) demonstrates the relevance of integrating moral sentiments into the models to provide a reasonable explanation of actual compliance behaviour. Moreover, in their overview paper on tax compliance, Andreoni et al. (1998) point out that “adding moral and social dynamics to models of tax compliance is as yet a largely undeveloped area of research” (1998, p. 852). Many researchers find that a considerable portion of taxpayers are always honest. Some taxpayers are “simply predisposed not to evade” (Long and Swingen 1991, p. 130), and thus do not even search for ways to cheat at taxes (see Frey 1999). Increasing numbers of papers go beyond treating tax morale as a black box, a residuum, and analyse which factors shape or maintain tax morale (for an overview, see Torgler 2007). In addition, policymakers have become interested in understanding the driving forces of tax morale and the possibility that it influences willingness to pay taxes.

In the first part of the paper, we use Swiss data to investigate whether there is a relationship between decentralised political competencies and the willingness to comply. Thus, we evaluate whether local autonomy is correlated with tax morale (controlling for other factors). For this first section, we investigate a cross-section of individuals throughout Switzerland using the International Social Survey Programme (ISSP) data set “Religion II”. The second part of the paper explores the same question but uses the size of the shadow economy instead of tax morale as the dependent variable. Use of this variable addresses a relevant issue: whether results obtained on tax morale are also reflected in real or observed behaviours. To this end, we complement the attitudinal level investigation of tax morale with a more output-oriented variable, namely the shadow economy. Further, it is possible that the

<sup>1</sup>First important findings in the tax morale literature date from the 1960s and 1970s by German scholars around Günter Schmolders (1951/1952, 1960, 1962, 1970) known as the ‘Cologne school of tax psychology’. They have emphasised that economic phenomena should not be analysed only from the traditional point of view. They saw tax morale as an attitude regarding tax (non-)compliance (see, e.g., Schmolders 1960).