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Working Paper

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CREMA Working Paper, No. 2008-24

Provided in Cooperation with:

CREMA - Center for Research in Economics, Management and the Arts, Zürich

Suggested Citation: Torgler, Benno; Schneider, Friedrich; Schaltegger, Christoph A. (2008) : Local Autonomy, Tax Morale and the Shadow Economy, CREMA Working Paper, No. 2008-24, Center for Research in Economics, Management and the Arts (CREMA), Basel

This Version is available at:

<https://hdl.handle.net/10419/214418>

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Center for Research in Economics, Management and the Arts

Local Autonomy, Tax Morale and the Shadow Economy

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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 also a bottom-up approach such as, for example, decentralizing the political power to those who are close to the problems. Thus, this paper analyses the relationship between local autonomy and tax morale or the size of the shadow economy. We use data on tax morale at the individual level and macro data of the size of the shadow economy to systematically analyse the relevance of local autonomy and compliance in Switzerland, a country where the degree of federalism varies across different cantons. 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

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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. One possibility is to “enforce” people to pay their taxes establishing a deterrence policy. In line with the economic-of-crime approach based on the expected utility maximisation calculus, Allingham and Sandmo (1972) presented a formal model with the insight that the extent of tax evasion is negatively correlated with the probability of detection and the degree of punishment. However, this pathbreaking model has been criticised by many authors (see, e.g., Graetz and Wilde 1985; Alm, McClelland and Schulze 1992; Frey and Feld 2002). A main point, which is connected to the empirical and experimental findings, is that these deterrence models predict too little tax evasion. In many countries the level of deterrence is too low to explain the high degree of tax compliance. Furthermore, there is a big gap between the amount of risk aversion that is required to guarantee such a 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, McClelland and Schulze 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 percent (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 morale¹ can help explaining the high degree of tax compliance (for empirical and

¹ First important findings in the tax morale literature date from the 60s and 70s by German scholars around Günter Schmolders (1951/1952, 1960, 1962, 1970) known as the ‘Cologne school of tax psychology’. They have

experimental papers see, e.g., Schwartz and Orleans 1967; Lewis 1982; Roth, Scholz and Witte 1989; Alm, McClelland and Schulze, 1992, 1999; Pommerehne, Hart and Frey 1994; Frey 1997, 2003; Frey and Feld 2002; Feld and Tyran 2002; for a survey see Torgler 2001). Erard and Feinstein (1994) in their theoretical paper stress the relevance of integrating moral sentiments into the models to provide a reasonable explanation of actual compliance behaviour. Moreover, Andreoni, Erard and Feinstein (1998) point out in their tax compliance survey that “adding moral and social dynamics to models of tax compliance is as yet a largely undeveloped area of research” (p. 852). Many researchers stress 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). More and more papers go beyond treating tax morale as a black box, a residuum, analysing which factors shape or maintain tax morale (for an overview see Torgler 2007). Also, there is an increased attention by policymakers to understand the driving forces of tax morale and the possibilities to influence the willingness to pay taxes.

In the first part of the paper, we investigate using Swiss data whether there is a relationship between decentralizing the political competencies to those who are close to the problems and by giving them the final say and the willingness to comply. That means we evaluate local autonomy are correlated with tax morale controlling for other factors. For this, the study investigates 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 using the size of the shadow economy instead of tax morale as dependent variable. A relevant issue is whether influences obtained on tax morale are also reflected in real, or observed, behaviors. Thus, it may be interesting to complement an approach at the attitudinal level with a more output oriented variable, namely the shadow

emphasised that economic phenomena should not only be analysed from the traditional point of view. They saw tax morale as an attitude regarding tax (non-) compliance (see, e.g., Schmolders 1960).

economy. Moreover, Alm, Martinez-Vazquez, and Schneider (2004) argue that the size of the underground economy can serve as a useful, if somewhat imperfect, measure of the extent of tax evasion. Thus, in the second part of the paper we will investigate to which local autonomy affect the size of the shadow economy using also Swiss data complemented the micro approach with a macro approach at the cantonal level. It is essential to analyze under which conditions it is more likely that citizens pay their taxes. Switzerland is chosen because it allows to observe the influence of institutional factors because cantons have different degrees of fiscal decentralization.

Interestingly, the link between local autonomy and tax morale, tax compliance or the size of the shadow economy has been disregarded in the literature. Most of the papers using Swiss data focus on direct democracy. Estimating a cross section/time series multiple regression Pommerehne and Weck-Hannemann (1996) found that in cantons with a high degree of direct political control tax evasion is – *ceteris paribus* – about SFr 1500 lower as compared to the average of the cantons without such direct influence. Feld and Frey (2002b) analysed how tax authorities treat taxpayers in Switzerland and found that tax authorities of cantons with more direct participation rights, compared to cantons with less direct democracy, treat taxpayers more respectfully and are less suspicious if taxpayers report too low incomes. On the other hand, not submitted tax declarations are more heavily fined. Looking at the experimental evidence, Alm, McClelland and Schulze (1999); Feld and Tyran (2002); Torgler and Schaltegger (2005); and Torgler, Schaltegger and Schaffner (2003) found that voting on tax issues has a positive effect on tax compliance. The experiments were conducted in the United States, Latin America and Switzerland. Torgler (2005) also shows a positive effect of voting on tax morale using Swiss data. Tyler's research (1990a, 1990b, 1997) also provides support for the importance of legitimacy and allegiance to authority in compliance decisions. Alm, Jackson and McKee (1993) analyze the effects of fiscal institutions on compliance by varying the process by which tax collection becomes a public good (voting versus

imposition). Donations given to a campus organization were taken as public good. So, the public good was not distributed directly to the subjects, but sent to a specific organization. The experimental results provide evidence that tax compliance is higher when individuals can vote on the use of their taxes than when there is no voting over alternatives. Individuals are more likely to comply with their taxes when they are able to select themselves the public sector expenditure program. On the other hand tax compliance is lower when subjects cannot control the use of their tax payments. Thus, the way people are treated by the authorities affects their evaluation of these authorities and their willingness to co-operate (see, e.g., Tyler, Casper and Fisher 1989). Working with the World Values Survey, Torgler and Schneider (2007a) also explore the relevance of culture in three multicultural European countries, namely Belgium, Spain and Switzerland. Other studies such as Torgler and Schneider (2007b) or Friedman et al. (2000) explore the importance of institutional quality at the international level. Torgler and Schneider (2007b), for example, using more than 25 proxies that measure governance and institutional quality they find strong support that its increase leads to a smaller shadow economy. However, they disregarded the analysis of decentralization and local autonomy.

In Section 2 theoretical considerations are presented focusing on local autonomy. Section 3 and 4 present the empirical findings and Section 5 finishes with some concluding remarks.

2 Decentralisation

The literature on fiscal federalism pioneered by Oates' (1972) work on the advantages of a decentralized provision of publicly provided goods has discussed the pros and cons of decentralisation at length (for a survey, see Oates, 2008). In short, the main advantages of decentralization are seen in better tailored public goods to the needs of the voters (Oates,

1972), in endogenous restrictions to a Leviathan-behaving government (Lockwood, 2006) and in incentives for political innovations (Rose-Ackerman, 1980). Whereas disadvantages of decentralisation are seen in various kinds of distortions: namely urban externalities, fiscal externalities (vertically and horizontally) and local protection which may result in a race to the bottom with taxes and consequently an underprovision of public goods (see Oates, 1999 for a survey).

Also in the case of tax policy, small structures have the advantage that citizens' preferences can be met better than in a framework where a uniform tax system is designed for a population with heterogeneous preferences. Moreover, there is an intensive every-day interaction between taxpayers and local politicians and bureaucrats. This closeness between taxpayers, the tax administration and the local government may induce trust and thus enhance tax morale. Politicians and members of the administration are better informed about the preferences of the local population. Furthermore, there is a politico-institutional aspect: if politicians are elected at the local level, they have an incentive to put preferences of their constituency into account and thus to spend the local tax revenues according to local preferences (see Frey and Eichenberger 1999). Decentralisation brings the government closer to the people. Many economists point out the relevance of giving sub-national governments the taxing power (see, e.g., Bahl 1999). One of the strengths of a decentralised system is a higher transparency between the tax price and the received public services. Taxes are as prices in some sense, especially on the local level (Blankart, 2002). Even the (progressive) income tax is a good instrument for a local structure. It is always under individuals' test, who have the opportunity to use the instruments of exit and voice (see Hirschman 1970). The mechanism of fiscally induced migration in federal states provides a strong incentive to provide public services in accordance to taxpayers' preferences. Moreover federalism and local autonomy is combined with innovation. Federalism serves as a laboratory for policy inventions (Oates 1999). In the words of U.S. Supreme Court Justice, Louis Brandeis in 1932: "It is one of the

happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country” (Oates 1999, p. 1132). Feld and Schnellenbach (2004) have analysed different policy fields at the Swiss local level, where this kind of laboratory federalism in fact worked as a breeding ground for innovations. If voters can compare the performance of their government with the performance of neighbouring governments with similar conditions, there is also some kind of yardstick competition.² Thus, this leads to the following hypothesis:

Hypothesis 1: The more extensive the local autonomy, the higher ceteris paribus tax morale and the lower the size of the shadow economy³.

3 Empirical results on tax morale

3.1. Model

In order to examine our hypotheses derived in section 2, the following estimation equation is postulated for tax morale:

$$TM_i = \beta_0 + \beta_1 \cdot LA_c + \beta_2 \cdot DD_c + \beta_3 \cdot D_c + \beta_4 \cdot T_i + \beta_5 \cdot Y_i + \beta_6 \cdot CTL_i + \beta_7 \cdot TR_i + \varepsilon_i$$

where TM_i denotes the individual degree of tax morale. The general question to assess the level of tax morale from the ISSP (year 1999) was:

Do you feel it is wrong or not wrong if a taxpayer does not report all of his or her income in order to pay less income taxes? (1= not wrong, 2= a bit wrong, 3= wrong, 4=seriously wrong).

² The seminal contribution on yardstick competition stems from Besley and Case (1995).

³ However, it should be noticed that in Switzerland local authorities administer the largest part of income taxpayers. The cantonal level, which is the focus in this paper, copes only a smaller share of taxpayers directly.

The measurement of tax morale is not free of bias. First, because the available data are based on self-reports in which subjects tend to overstate their degree of compliance (Andreoni, Erard, and Feinstein 1998), no objective or observable measure of tax morale is available. Moreover, Elffers, Weigel, and Hessing (1987) found strong differences between actual evasion assessed and evasion reported in survey responses. Nonetheless, because the way we define tax morale is less sensitive than asking whether a person has evaded taxes, we expect the degree of honesty to be higher. Moreover, the dataset is based on wide-ranging surveys, which reduces the probability of respondent suspicion and the framing effects of other tax context questions. It can still be argued, however, that a taxpayer who has evaded in the past will tend to excuse this kind of behavior and report a higher tax morale in the survey.

In general, the use of such a single question has the advantage of reducing problems of index construction complexity, especially as regards measurement procedure or low correlation between items. Nonetheless, it can also be argued that tax morale is a multidimensional concept that requires a multi-item measurement tool and the likelihood of a multi-item index being adversely affected by random errors will produce more reliable measures. However, several previous studies have found consistent results using single-item survey measurements and laboratory experiments (e.g., Cummings et al., 2009; Alm and Torgler 2006).

Our key independent variable is local autonomy (LA_c). Local autonomy is measured at the cantonal level (c) with an index developed by Ladner (1994) based on survey results where chief local administrators in 1865 Swiss municipalities were asked to report how they perceive their local autonomy on a 10 point scale. (1= no autonomy, 10 = very high communal autonomy).

The other independent variables are specified as follows:

1. DD_c : For the degree of direct democracy the six point scale index developed by Stutzer (1999) and applied, e.g., by Frey and Stutzer (2000, 2002); Frey and Feld (2002); Feld and Frey (2002a, 2002b) has been used. The index reflects the extent of direct democratic participation (1= lowest and 6 highest degree of participation) at the cantonal level.⁴ As indexes do not tell as much as a single instrument, we are going to measure the degree of direct democratic participation with a dummy on legislative referendum and degree of signature requirements for legislative initiatives.
2. T_i : Individual tax rate and Y_i : The individuals' household income (*see Appendix*).
3. CTL_i : a panel of control variables at the individual level covering: age, gender, education, marital status, employment status.
4. TR_i : measures in the ISSP data set the confidence in the courts and the legal system⁵.
5. D_i : measures deterrence focusing on the audit probability using as an approximation the number of tax auditors per taxpayer (in %) in each canton c and the penalty tax rate approximated by the standard legal fine as a multiple of the evaded tax amount (in percent) in a canton c ⁶.
6. CTL_i : further control variables (age, gender, education, marital and employment status and religiosity. As a robustness test we are also going to control for cultural differences.

1. Political Participation

⁴ The index includes the four legal instruments: the popular initiative to change the canton's constitution, the popular initiative to change the canton's law, the compulsory and optional referendum to prevent new law or changing of a law and the compulsory and optional referendum to prevent new state expenditure. The index is based on the degree of restrictions in form of the necessary signatures to use an instrument, the time span to collect the signatures and the level of new expenditure which allows to use the financial referendum (for a detailed discussion see Stutzer, 1999).

⁵ How much confidence do you have in courts and the legal system (5=complete confidence to 1=no confidence at all).

⁶ The information about the probability of detection and the fine for tax evasion has been collected by Lars P. Feld and Bruno S. Frey with a questionnaire. The following contributions are based upon this data set: Feld and Frey (2002a), (2002b); and Frey and Feld (2002).

Tax morale and the shadow economy might depend on the type of institutional settings. Institutions that respect the preferences of the citizens will have more support by the people than a state that acts as a Leviathan (see Prinz 2002). Levi (1988) points out that a possibility to create or maintain compliance is to provide reassurance by the government. A government that precommits itself with direct democratic rules imposes itself restraints on its own power and thus sends a signal that taxpayers are seen as responsible persons. Furthermore, direct democratic rules signalise that citizens are not ignorant or uncomprehending voters, which might create or maintain a certain social capital stock. The government signalises thus that taxpayers' preferences are taken into account in the political process. Taxpayers are treated as "citizens" with extensive rights *and* obligations (Frey 2003). They are in the position to better monitor and control politicians via referenda. Furthermore, they can set rules via initiative and are thus able to renegotiate the tax contract with the government influencing, e.g., the tax laws and the tax rates, which enhances civic virtue. Thus, the possibility for taxpayers to vote on fiscal issues positively influences tax morale. Being involved in the political decision process enhances taxpayers' sense of civic duty (Feld and Frey 2002a) and thus affects tax morale and the size of the shadow economy. The instrument of direct democracy helps spend taxes according to their preferences, the motivation to contribute paying their taxes and remain in the official sector increases. Rules attained through an active involvement of people enhance rule obedience and the willingness to cooperate and to act in line with the decided rules. A lack of participation may lead to lower level of satisfaction with the system and a feeling of powerlessness, which may lower tax compliance (Alm, Jackson and McKee 1993). The more people are involved in establishing rules, the stronger is their sense of obligation (Kidder and McEwen 1989; Cialdini 1989; McEwen and Maiman 1986; Lempert 1972). Tyler (1997) argues that understanding what people want in a legal procedure helps to explain public dissatisfaction with the law and points towards directions for building public support for the law in the future.

2. Tax Rate and Income

The effects of the tax rate and the income on tax evasion are difficult to assess theoretically. It depends on the individual's risk preference and the progression of the income tax schedule (see Andreoni, Erard and Feinstein 1998). A higher marginal tax rate makes tax evasion marginally more profitable, but a contrary effect works depending on the risk aversion of taxpayers. The results are influenced by the tax schedule (proportional, progressive, regressive) (see Frey and Feld 2002). Furthermore, the relationship between tax evasion and tax rate depends also on the penalty structure. In case the penalties are proportional to the amount of evaded income and taking into consideration a decreasing absolute risk aversion and constant tax rates than the sign is ambiguous (Allingham and Sandmo 1972). On the other hand, an increase in the tax rate will encourage individuals to declare more income, if fines are proportional to the amount of evaded taxes (Yitzhaki 1974).

3. Institutional Trust

In a general way, it can be argued that positive actions by the state are intended to increase taxpayers' positive attitudes and commitment to the tax system and tax-payment and thus compliant behaviour (e.g., Smith 1992; Smith and Stalans 1991). If the state acts trustworthily, taxpayers might be more willing to comply with the taxes. On the other hand, perceived unfairness increases the incentive to act against the tax law as psychological costs are reduced. With data from Switzerland (Zurich), Kucher and Götte (1998) found that trust, measured as the ratio of concurrence between the city government's recommendation for an issue put to a vote and the actual outcome at the ballot, significantly raised the ratio of submitted tax declarations between 1964 and 1996.

The relationship between taxpayers and state can be seen as a relational or psychological contract, which involves strong emotional ties and loyalties. Such a

psychological tax contract can be maintained by positive actions. Thus, one of the most important social psychological reasons for expecting co-operation is reciprocity (see Gouldner 1960; Axelrod 1984; Cialdini 1984; Regan 1971). Trust especially plays an important role where detection and punishment are stamped by high cost. Tax authority can not achieve total compliance; they would have to place a tax administrator under every bed. This might indicate that trust is an important institution which influences citizen's incentive to commit themselves to obedience. And this trust can only be created if government's commitment acts in line with citizens' needs and desires (see Hardin 1998). Not only trust in the government but also trust in the court and the legal system and thus the way how the relationship between the state and its citizens is established might have an effect on tax morale. The cost of tax raising and government running is lower if taxpayers are more willing to pay their taxes voluntarily (Slemrod 2003). In this light we predict a positive correlation between institutional trust and tax morale.

One may criticize that cantons with more local autonomy and direct democracy have better governments and therefore people are more willing to pay their taxes in a state work better. This would, for example, suggest that an improvement in tax morale is independent of whether a particular citizen has the possibility to vote. Thus, to isolate the relationship between institutions and tax morale it is important to control for institutional trust. Alternatively, one could also try to include a dummy for foreigner, as they are not involved in the voting process. Unfortunately, this information is not provided by the ISSP data set.

4. Deterrence

It is difficult to predict the effects of deterrence factors on *tax morale*. We are therefore including this variable sequentially in the specification. Deterrence imposed by the tax authority might crowd out taxpayers' intrinsic motivation to pay their taxes and thus crowd out tax morale. On the other hand, deterrence factors might prevent taxpayers with a low tax

morale exploiting the more honest taxpayers. Tax morale is therefore not expected to be crowded out if the honest taxpayers perceive the stricter policy to be directed against dishonest taxpayers. Regulations which prevent free riding by others, reducing the possibility to escape from their tax payments may help preserve tax morale (see Frey 1997).

The economics-of-crime approach may be more reliable when focusing on the shadow economy. The model would predict that the extent of the *shadow economy* depends negatively on the probability of being caught and the size of punishment in case of being caught. Some empirical findings indicate that a higher probability of being caught discourages evasion (see, e.g., Crane and Nourzad 1987; Witte and Woodbury 1985; Dubin and Wilde 1988; Joulfaian and Rider 1996). In experiments there is also the tendency that a higher audit rate leads to more compliance (see, e.g., Friedland et al. 1978; Beck et al. 1991; Alm, Jackson and McKee 1992a, 1992b; Alm, Cronshaw, and McKee 1993; for a survey see Torgler 2002). However, the pooled cross section time series estimation for Swiss cantons over the years 1970, 1978, 1985, 1990, and 1995 done by Frey and Feld (2002) using tax evasion as dependent variable indicates that the probability of detection has a theoretically unexpected positive sign being not statistically significant, while the size of the fine is statistically significant at the 5 percent level. Beron, Tauchen and Witte (1992) found with tax return data from 1969 a weak deterrent effect from audits on tax compliance. Pommerehne and Weck-Hannemann (1996) found that the coefficients of the probability of detection and the penalty tax rate have a negative sign, but none of them was statistically significant. Slemrod, Blumenthal and Christian (2001) used a controlled field experiment in Minnesota to analyse taxpayer response to an increased probability of audit. While low and middle income taxpayers increased their reported tax between 1993 and 1994 relative to the control group, the reported income of high income taxpayers fell sharply in relation to the control group.

5. Further Control Variables

Regarding the control variables it might be worthwhile to point out that older people can be expected to have a higher tax morale than the younger (Torgler 2007). Over the years they have acquired greater social stakes, as material goods, statuses, a stronger dependency on the reactions from others (Tittle 1980), as they mostly have lived for a certain time in the same place and thus are more attached to the community (see Pommerehne and Weck-Hannemann 1996). Torgler and Valev (2006) provide strong support that the age affects tax morale in a positive manner, controlling also a cohort effect in a panel investigation.

In the tax compliance literature evidence concerning the variable gender indicates the tendency that men are less compliant than women (see, e.g., Vogel 1974; Tittle 1980; Spicer and Becker 1980). Looking at the marital status it can be argued that married people might be more constrained by their social network and thus more compliant, but on the other hand in Switzerland they are taxed in a higher bracket than two separate incomes which might have a negative impact on tax morale. Better educated taxpayers are supposed to know more about tax law and fiscal connections and thus would be in a better position to assess the degree of compliance, being better aware of the benefits and services the state provides for the citizens from the revenues (see Lewis 1982). On the other hand, they may be less compliant because they better understand the opportunities for evasion and avoidance and might be more critical about and better aware of how the state uses tax revenues. Self-employed persons do not per se have lower tax morale than other taxpayers, but they have better possibilities to evade taxes. Most empirical results, which indicate that self-employed have lower tax compliance, are from other countries than Switzerland, where labour income earners pay taxes at source.

Religiosity might influence people's habits, and might make individuals reluctant to engage in tax evasion. As the religious variable, we use the variable frequency of CHURCH ATTENDANCE, which measures how much time individuals devote to religion. These results are consistent with those of Torgler (2006), who find that a higher religiosity is correlated with a higher tax morale.

3.2. Results

We present weighted ordered probit models. Some groups might be over-sampled. A weighted variable helps to correct the samples and thus to reflect national distribution. The weighted ordered probit models help analyse the ranking information of the scaled dependent variable tax morale. As in the ordered probit estimation, the equation has a non-linear form; only the sign of the coefficient can be directly interpreted and not its size. Calculating the marginal effects is therefore a method to find the quantitative effect a variable has on tax morale. The marginal effect indicates the change in the share of taxpayers (or the probability of) belonging to a specific tax morale level, when the independent variable increases by one unit. In the weighted ordered probit estimation, only the marginal effects for the highest value “seriously wrong not to report all the income” (ISSP 1999) are shown⁷.

We report clustering-robust standard errors (or t-statistics) for all tax morale regressions as we combine data on tax morale at the individual level with institutional data at the cantonal level. If the random errors are correlated at the cantonal level, the standard errors of the coefficient on the institutional variables are underestimated. Moulton (1990) has shown that failing to take this correlation into account would lead to a serious downward bias in the estimated errors, resulting therefore in inflated t-statistics and perhaps spurious finding of statistical significance for the institutional variable.

The results of 12 regressions are presented in Table 1 to 3. First we explore in Table 1 only LOCAL AUTONOMY (LA) as an institutional variable, including in (2) T (tax rate), and in (3) TR (institutional trust). In a second step, we add in Table 2 DD (direct democracy) (4) and D, the two deterrence factors (5). In equation (6) we also test the robustness of model using an OLS instead of an ordered probit model. In this case we report *beta* or *standardized* regression coefficients to explore the relative importance of local autonomy. Moreover, to

obtain robust standard errors in these estimations, we use the Huber/White/Sandwich estimators of standard errors. In Table 3 we conduct a further robustness test. We control for culture differences using a language dummy LATIN (French and Italian speaking individuals) while running all the previous specifications. Torgler and Schneider (2007a) have shown the importance of controlling for culture differences within a country.

As can be seen, there is a strong and positive correlation between LA and TM (tax morale). The coefficient is always statistically significant and the marginal effects indicate that an increase in the LA by one point raises the share of persons indicating the highest TM value by more than 3 percentage points. Thus, the results show that we cannot reject our main hypothesis. Specification (6) also shows the relative importance of LA. An increase of one standard deviation in LA leads to a 0.116 standard deviations increase in TM. Table 2 indicates that the LA has one of the largest standardized coefficients.

Looking at the other variable we also observe that DD matters. The coefficient is statistically significant with marginal effects close to 2 percentage points. Frey and Stutzer (2000) argue that direct democracy and local autonomy are interdependent. Direct democracy and federal structures foster each other because individuals are interested in a strong federalism. They are bearing the costs and benefits of governments' activities, which help taxpayers get a better identification. In general, Feld and Kirchgässner (2001) point out that: "The more important regional and local jurisdictions are in the internal organization of a nation-state, the more important is the question of the proper decision-making procedures at the different government levels. The assignment of competencies to different government levels is linked to decision-making procedures" (p. 333)⁸. However, to investigate whether the positive correlation between institutions and tax morale are largely driven by a higher institutional trust (TR), we add the variable in specifications (3) to (6) and (9) to (12) together

⁷ The obtained results remain also robust when run estimations with standard errors adjusted to clustering on cantons.

into the same equations. The results also indicate that TR is relevant. An increase in the TR scale by one unit increases the share of subjects indicating the highest TM scale by around 3 percentage points. In advance we may have expected that adding the trust variable in the specification would lead to a decrease of the institutional variable in case institutional trust acts as a mediator variable. However, as specification (3) shows we don't observe a decrease in the marginal effect of LA once we include trust.

The results also show that there is a positive correlation between CHURCH ATTENDANCE and TM. To the author's knowledge only a limited amount of studies examine the correlation between religiosity and tax cheating (Tittle 1980; Grasmick et al. 1991; Torgler 2006). All three studies indicate that religiosity is negatively correlated with the degree of rule breaking or in other words is positively related to tax compliance and tax morale. Our findings are therefore in line with these results. Looking at the variables FINE RATE, AUDIT PROBABILITY and T (INDIVIDUAL TAX RATE) we find that the basic tax evasion model does not perform in a satisfactory way when focusing on tax morale. Deterrence shows a negative relationship with the coefficients that are not statistically significant. Similarly, we observe a negative and insignificant relationship between the individual tax rate and tax morale and the same for the income variable. The negative sign is consistent with many empirical papers analysing the correlation between tax rates and tax evasion (see, e.g., Clotfelter 1983; Crane and Nourzad 1992)⁹. Finally, looking at Table 3 we also observe that culture matters. French and Italian speaking individuals report a lower level of tax morale than German speaking individuals. Such a result is consistent with Alm and Torgler (2006) who report that Romanic countries have a higher tax immorality than most other northern European countries.

⁹ The two variables are significantly correlated at the 0.01 level ($r = 0.574$). Thus, it is difficult to separate the effects of the two variables in one model.

4 Empirical results on the shadow economy

The previous results provide strong support that local autonomy matters. In a next step we will see whether this relationship remain robust when focusing on the shadow economy with macro (cantonal) data. We therefore take the opportunity to extend the investigation from the attitudinal level to a behavioural one. This is especially important since it allows a further robustness check and provides the chance to control for additional variables at the cantonal level.

The shadow economy includes all market-based legal production of goods and services that are deliberately concealed from public authorities for the following reasons (Schneider 2005b):

- (1) to avoid payment of income, value added or other taxes,
- (2) to avoid payment of social security contributions,
- (3) to avoid having to meet certain legal labor market standards, such as minimum wages, maximum working hours, safety standards, etc., and
- (4) to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.

Hence, in this paper, we will not deal with typical underground economic activities, which are all illegal actions with the characteristics of classical crimes like burglary, robbery, drug dealing, etc. We also do not include the informal household economy which consists of all household services and production. To measure the size of the shadow economy as a percentage of the official GDP proceed in two steps: First, we use the MIMIC-method to estimate the parameters for determining the relative size of the shadow economy. Second with the help of the Currency Demand Method we calibrate the estimated coefficients of the MIMIC procedure into absolute ones. We build a panel with values for the years 1990, 1995,

⁹ It should also be noticed that Feinstein (1991) does not find a positive correlation between tax rates and non-compliance, trying to better separate the effects of marginal tax rates from those of income.

and 2000.¹⁰ The fundament of the methodology of these two estimation procedures has been discussed in previous studies and is therefore not further discussed in this paper (see Schneider and Enste 2002, and Schneider 2005a,b)¹¹.

4.1 Model

To explore the relationship between local autonomy and the level of shadow economy, we propose the following baseline equation:

:

$$SHADOW_{it} = \alpha + \beta_1 CTL_{it} + \beta_2 C_{it} + \beta_3 DD_{it} + REGION_i + \varepsilon_{it} \quad (2)$$

where i indexes the canton in the sample, $SHADOW_{it}$ denotes cantons' size of the shadow economy as a percentage of the official GDP over the periods 1990, 1995 and 2000. C_{it} and DD_{it} are our proxies for centralization and direct democracy. We use the previous index and calculate values for these three years. The previously used proxy for local autonomy cannot be used as it has only been collected once. Thus, we take an alternative proxy that measures cantonal degree of centralization, namely the share of cantonal public spending on cantonal and local spending. The regressions also contain several control variables, CTL_i , including factors that we will discuss in the next sub-section. To control for cantonal invariant factors, we include cantonal fixed effects, CD_i . ε_{it} denotes the error term

4.2. Key Independent Variables

¹⁰ The values for the shadow economy of the Swiss Cantons are taken from Schneider, Torgler and Schaltegger (2008).

¹¹ As has been extensively discussed both estimation methods have their weaknesses. The MIMIC procedure requires a clear differentiation between causes and indicators, which is not easy to achieve; the estimates are quite often not stable and if time series are used for the cause and indicator variables, they should be stationary. The currency demand approach requires domestic locals currency it excludes barter transactions, also the assumption of the same velocity of the money in the official and underground economy can be criticised, as well as missing variables (like tax morale, or other influences) as driving forces for the shadow economy. To summarize, all known estimation procedures for the size of the shadow economy have severe weaknesses; hence

In order to fulfill the *ceteris paribus* conditions, we have to control for a number of other important factors, what will be discussed in turn:

1. GDP

GDP is a proxy for the level of development and prosperity of a region. A higher level of development goes together with a greater capacity to pay and collect taxes, as well as a higher relative demand for income elastic public goods and services (Chelliah 1971; Bahl 1971). In general, we would expect a negative relation between the GDP and the level of the shadow economy.

2. Demographic and Labor Characteristics

Demographic and labor characteristics such as population size or the labor force may also affect the shadow economy. The *labor force* variable measures the potential pool that has the best preconditions to work in the shadow economy. On the other hand, individuals with an occupation have less leisure time at their disposal. Thus, time acts as a restriction to being active in the shadow economy. *Unemployed people* have an incentive not to report their additional work hours as otherwise they would lose their financial support. If the wage of illicit work and the financial aid together yield more income than regular and overtime work, taking also into account the costs of detection and punishment and assuming risk neutrality, full-time illicit work as an unemployed person yields *ceteris paribus* a higher utility. In such a situation, the danger that a person remains in the shadow economy and turns down job offers increases (Schneider and Enste 2002). Moreover, a higher level of *urbanization* may further anonymity and thus reduce loyalty towards the state; this may lead to a higher level of shadow economy. As many sectors are city-based, it is expected that there the incentives to act in the

underground economy are higher, especially when government activities and services are below individuals' expectations and preferences. Moreover, in line with micro estimation we control for the demographic structure within a society (share of elderly and the share of pupils).

3. Fiscal Burden

The fiscal burden is expected to influence the shadow economy positively. It can be argued that a higher burden increases the attractiveness of behaving illegally. We expect a positive correlation between the fiscal burden and the size of shadow economy. However, using such a proxy has some limitations. It can be argued that it is not so much the statutory tax rates that are relevant in the decision to behave illegally, but rather their application, offering tax exceptions or concessions that affect individual decisions (Friedman et al. 2000). The authors couldn't find evidence that higher direct or indirect tax rates are associated with a larger unofficial economy. On the contrary, they find some evidence that higher direct tax rates are associated with a smaller shadow economy. Such results are also supported by Dreher and Schneider (2006).

4. Further Variables

In line with previously we also control for deterrence and education. As a proxy for education we use cantonal expenditures in education. This variable covers all publicly provided education spending for basic education, high-schools, professional formation and cantonal universities in Switzerland which accounts for approximately $\frac{1}{4}$ of all cantonal spendings. We also consider the share of REGISTERED CANTONAL HOUSE PROPRIETORS on the cantonal population¹². The commitment made by house proprietors to their jurisdiction by

economy.

¹² For summary statistics see Appendix.

voluntarily increasing their opportunity costs for the exit option to migrate to another jurisdiction may support the willingness to remain honest. On the other hand, house proprietors have a strong demand for those economic sectors that have the highest rates of illicit work. Schneider and Enste (2002) report that building, renovating, repairing provide the largest share of illicit work (44% of the total illicit work) in Germany. Such results are also applicable to Switzerland. Thus, home proprietors may have a stronger incentive to take advantage of such services which increases the shadow economy. Finally, we also control for transfer payments (TRANSFERS) between the federal level and the cantons according to the federal fiscal equalization scheme. The financial equalization scheme between the cantons and the federal level has the aim to provide equal opportunities and fair positions among the cantons with respect to the production of public goods and services. However, cantons receiving extensive transfer payments are possibly subject to the “flypaper effect” with incentives for increased government spending and thus in consequence are less financially healthy and independent. This may be an indicator of institutional weakness that may affect compliance, too. Remarkably, these imperfections were also reason why the financial equalization system had been under pressure due to the lack of transparency and adverse incentives that promoted centralization. Moreover, the lack of incentives of cantons to fulfil their responsibilities on their own has also been criticized (Schaltegger and Frey, 2003)

4.3 Empirical Results

Table 4 presents the results reporting five regressions. We report *beta* or *standardized* regression coefficients to reveal the relative importance of the variables used. To obtain robust standard errors in these estimations, we use the Huber/White/Sandwich estimators of standard errors. First, we explore the impact of C (centralization) independently of further control variables (except cantonal dummies). Table 4 shows that the coefficient for C is

statistically significant at the 1 % level. A higher level of centralization is correlated with a the dependent variable SHADOW. Such a result supports our previous finding. In a next step we add direct democracy (DD). As can be seen, the coefficient for centralization is still statistically significant at the 1% level. An increase of one standard deviation in C produces an increase of 1.444 standard deviations in SHADOW. Similarly, in line with previous results the coefficient DD is also statistically significant with a negative sign reporting similar quantitative effects (reduction of 1.238 standard deviations in SHADOW). In specification (8) we add a large amount of control variables. Table 4 shows that the impact of both institutional variables decrease below 1, but the correlation is still quite substantial and the coefficients are statistically significant. In the following two specifications we add the cantonal TAX BURDEN and DETERRENCE¹³ into the specification. Also the remaining two regressions show that previous results are valid. Centralization and direct democracy also matter at the macro level focusing on the shadow economy and not tax morale. Thus, we find that institutional conditions are connected to individuals' attitudes and their behavior.

Looking at the control variables we find as expected a negative correlation between GDP and SHADOW. We also observe that SHARE OF REGISTERED HOUSE PROPRIETORS is positively correlated with SHADOW. The coefficient is statistically significant in the regressions. We also observe the tendency that URBANIZATION is positively correlated with SHADOW. However, the coefficient is not statistically significant. On the other hand, LABOR FORCE is negatively correlated with SHADOW. It seems that time acts as a restriction of being active in the shadow economy. Such a result is also supported when looking at the correlation between POPULATION>65 and SHADOW. On the other hand, the UNEMPLOYMENT RATE does not matter at all. Surprisingly, the results also show a positive correlation between EDUCATION EXPENDITURES and SHADOW.

¹³ We only consider the audit probability as fine rate is directly related to tax evasion and not the shadow economy.

As an interpretation, this may reflect the fact that with a rising government size, opportunities in the shadow economy are also rising, independent of the specific government task. The positive relationship between TRANSFERS and SHADOW points in the same direction. However, we were not able to find a positive correlation between the fiscal burden and the size of shadow economy. Admittedly, using the tax burden has some limitations. It can be argued that it is not so much the statutory tax rates that are relevant in the decision to behave illegally, but rather their application (Friedman et al., 2000). The authors couldn't find evidence that higher direct or indirect tax rates are associated with a larger unofficial economy. On the contrary, they find some evidence that higher direct tax rates are associated with a smaller shadow economy. Such results are also supported by Dreher and Schneider (2006) and Torgler and Schneider (2007b).

What about the causality between local autonomy and tax morale or the shadow economy? In Switzerland people cannot only vote on aspects of the tax structure, but also on the institutional structure. It can be stated that values and attitudes, which may partly differ across cantons, determine the extent of institutional structure in the long run. Thus, the effect of the institutions may partly reflect values. Or in other words, do taxpayers with a higher tax morale choose stronger a local autonomy or direct democratic institutions? Moreover, a substantial increase of the shadow economy can lead to a significant decrease in tax revenues and therefore to a lower quantity and quality of public goods and services. In line with Frey (2001); and Frey and Stutzer (2000) it could be argued that institutions such local autonomy and direct democracy have a long tradition in Switzerland and are quite stable over time, which suggests that the causality runs from institutions to tax morale or the size of the shadow economy and not the other way round. Two figures in the Appendix A5 and A6 report the changes of these institutions over time. In addition, the decentralization variables often exhibit a pseudo-variation which is caused by the fact that the tax base of sub-national governments

is affected differently by the business cycle than the tax base of the national government.¹⁴ However, based on this analysis it is not possible to fully rule out the causality problem.

5 Conclusions

In the last two decades the number of studies investigating the underground economy or tax compliance have strongly increased. Generating statistics and empirical results are insofar important as it allows having effective and efficient resource allocation decisions. A similar tendency is observable in other areas that investigate illegal activities (Schneider and Enste 2000, 2002; and Schneider 2005a). Although there are more and more studies that investigate the causes of shadow economic activities, societies often attempt to control these activities through measures such as punishment, prosecution, economic growth or education (Schneider and Enste 2002). However, there are further instruments that merit more attention. In this aspect, it is highly relevant to investigate other variables such as local autonomy. Thus, the basic intention of this paper was to analyse the effects of a bottom-up approach to fight the shadow economy and to increase tax morale. Specifically, we evaluate the impact of federalism on tax morale and the size of the shadow economy, a factor that the literature has strongly neglected so far. We therefore provide evidence using Swiss data at the micro and macro (cantonal) level. The results indicate that local autonomy is highly relevant to understand why people cooperate with societies' rules. Institutions that respect the preferences of the citizens will have more support by the people than a state that acts as a Leviathan, and thus a responsive government will enhance tax morale. Both instruments help spend taxes according to the citizens' preferences, which increases the motivation to pay the taxes. A high level of local autonomy allows expressing one's own preferences and enhances identification with a state's institutions; this counteracts the inclination to be active in the

¹⁴ We are grateful to the referee for providing us with the argument.

shadow economy and increase the willingness to pay taxes. Identification reduce therefore free-rider problems. If citizens and authorities interact with a sense of collective responsibility thanks to the institutional structures, the system may be better governed and the policies more effective, as accountability promotes effectiveness through its impact on government behaviour.

Acknowledgment For advice and suggestions thanks are due to two anonymous referees. Moreover, financial support from the Swiss National Science Foundation is gratefully acknowledged.

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Table 1: Tax Morale and Local Autonomy

<i>ISSP 1999</i> <i>weighted ordered probit</i> <i>Dependent variable: tax morale</i>									
	(1)			(2)			(3)		
<i>Independent Variables</i>	<i>Coeff.</i>	<i>z-</i> <i>Stat.</i>	<i>Marg.</i>	<i>Coeff.</i>	<i>z-</i> <i>Stat.</i>	<i>Marg.</i>	<i>Coeff.</i>	<i>z-</i> <i>Stat.</i>	<i>Marg.</i>
a) Institutions									
LOCAL AUTONOMY (LA)	0.193***	2.79	0.056	0.187***	2.70	0.054	0.196***	2.74	0.057
b) Tax Rate									
INDIVIDUAL INC. TAX RATE (T)				-0.006	-0.24	-0.002	-0.005	-0.21	-0.001
c) Demographic Factors (CTL)									
AGE 30-49	-0.013	-0.12	-0.004	-0.014	-0.12	-0.004	0.065	0.51	0.019
AGE 50-64	-0.004	-0.03	-0.001	-0.006	-0.05	-0.002	0.063	0.40	0.018
AGE 65+	-0.029	-0.22	-0.008	-0.032	-0.24	-0.009	0.038	0.24	0.011
WOMAN	0.078	0.89	0.023	0.078	0.89	0.022	0.077	0.79	0.022
EDUCATION	0.036	1.58	0.010	0.037	1.58	0.011	0.034	1.49	0.010
d) Marital Status (CTL)									
MARRIED/LIVING TOGETHER	-0.042	-0.44	-0.012	-0.044	-0.45	-0.013	-0.066	-0.68	-0.019
DIVORCED	-0.276	-1.45	-0.071	-0.278	-1.45	-0.072	-0.299	-1.52	-0.077
SEPARATED	0.181	0.74	0.056	0.181	0.74	0.056	0.141	0.57	0.043
WIDOWED	-0.101	-0.56	-0.028	-0.102	-0.57	-0.028	-0.092	-0.50	-0.026
e) Economic Variables (Y)									
INCOME	0.1e-04	0.87	0.3e-05	0.000	0.44	0.1e-04	0.2e-04	0.38	0.4e-04
f) Employment Status (CTL)									
PART TIME EMPLOYED	-0.167	-1.22	-0.046	-0.173	-1.22	-0.047	-0.155	-1.06	-0.043
LESS THAN PART TIME	0.040	0.19	0.012	0.026	0.12	0.007	0.014	0.06	0.004
UNEMPLOYED	-0.054	-0.16	-0.015	-0.068	-0.21	-0.019	0.011	0.03	0.003
STUDENT	0.362**	2.16	0.116	0.342*	1.89	0.109	0.395**	2.53	0.128
RETIRED	0.332***	2.61	0.104	0.317**	2.15	0.099	0.319**	2.20	0.100
AT HOME	0.160	1.04	0.048	0.144	0.89	0.043	0.146	0.82	0.044
SICK	0.254	1.24	0.080	0.240	1.39	0.075	0.196	1.27	0.061
g) Religiosity									
CHURCH ATTENDANCE (CTL)	0.090***	4.52	0.026	0.090***	4.43	0.026	0.082***	3.89	0.024
h) Trust									
TRUST IN COURT AND LEGAL SYSTEM (TR)							0.096***	3.27	0.028
Observations	1114			1114			1068		
Prob > chi2	0.000			0.000			0.000		
Pseudo R2	0.027			0.027			0.030		

Notes: Dependent variable: tax morale on a four point scale. In the reference group are AGE 16-29, MAN, SINGLE, FULL TIME EMPLOYED. Significance levels: * 0.05 < p < 0.10, ** 0.01 < p < 0.05, *** p < 0.01. Marginal effect = highest tax morale score (4). Standard errors adjusted to clustering in 26 cantons.

Table 2: Robustness Tests

ISSP 1999 Dep. V.: tax morale	weighted ordered probit			weighted ordered probit			OLS	
	(4)			(5)			(6)	
Variable	Coeff.	z-Stat.	Marg.	Coeff.	z-Stat.	Marg.	Beta	t-Stat.
a) Institutions								
LOCAL	0.144**	2.05	0.042	0.142**	2.00	0.041	0.116**	2.20
AUTONOMY (LA)								
DIRECT	0.059**	2.02	0.017	0.061*	1.80	0.018	0.055*	1.77
DEMOCRATIC RIGHTS (DD)								
b) Tax Rate								
INDIVIDUAL INC.	-0.002	-0.11	-0.001	-0.002	-0.11	-0.001	-0.002	-0.15
TAX RATE (T)								
e) Demographic Factors (CTL)								
AGE 30-49	0.066	0.52	0.019	0.066	0.52	0.019	0.042	0.42
AGE 50-64	0.062	0.39	0.018	0.061	0.39	0.018	0.048	0.43
AGE 65+	0.024	0.15	0.007	0.024	0.15	0.007	0.045	0.28
WOMAN	0.080	0.83	0.023	0.080	0.83	0.023	0.062	0.87
EDUCATION	0.037	1.60	0.011	0.037	1.59	0.011	0.030	1.64
f) Marital Status (CTL)								
MARRIED/LIVING TOGETHER	-0.066	-0.67	-0.019	-0.065	-0.65	-0.019	-0.059	-0.76
DIVORCED	-0.297	-1.53	-0.076	-0.297	-1.54	-0.076	-0.259*	-1.88
SEPARATED	0.149	0.61	0.045	0.150	0.63	0.046	0.084	0.37
WIDOWED	-0.101	-0.56	-0.028	-0.100	-0.55	-0.028	-0.086	-0.59
g) Economic Variables (Y)								
INCOME	0.1e-04	0.29	0.3e-05	0.1e-04	0.29	0.3e-05	0.1e-04	0.45
h) Employment Status (CTL)								
PART TIME EMPLOYED	-0.151	-1.03	-0.042	-0.151	-1.04	-0.042	-0.111	-1.05
LESS THAN PART TIME	0.018	0.08	0.005	0.017	0.07	0.005	0.027	0.18
UNEMPLOYED	0.023	0.07	0.007	0.023	0.07	0.007	0.054	0.22
STUDENT	0.403***	2.60	0.131	0.404***	2.66	0.131	0.316**	2.09
RETIRED	0.339**	2.27	0.107	0.339**	2.27	0.107	0.272*	1.77
AT HOME	0.158	0.88	0.048	0.158	0.88	0.048	0.138	1.02
SICK	0.228	1.58	0.071	0.227	1.59	0.071	0.220	0.97
i) Religiosity								
CHURCH ATTENDANCE (CTL)	0.083***	3.95	0.024	0.083***	3.95	0.024	0.064***	4.18
d) Trust								
TRUST IN COURT AND LEGAL SYSTEM (TR)	0.093***	3.22	0.027	0.093***	3.23	0.027	0.080**	2.29
a) Deterrence Factors (D)								
AUDIT PROBABILITY				-0.3e-04	-0.04	-0.1e-04	0.1e-04	0.01
FINE RATE				-0.1e-03	-0.10	-0.3e-04	-0.1e-04	-0.01
Observations	1068			1068			1068	
Prob > chi2 or Prob > F	0.000			0.000			0.000	
(Pseudo) R2	0.031			0.031			0.077	

Notes: Dependent variable: tax morale on a four point scale. In the reference group are AGE 16-29, MAN, SINGLE, FULL TIME EMPLOYED. Significance levels: * 0.05 < p < 0.10, ** 0.01 < p < 0.05, *** p < 0.01. Marginal effect = highest tax morale score (4). OLS estimations: robust standard errors and beta coefficients. Standard errors adjusted to clustering in 26 cantons.

Table 3: Tax Morale and Culture

	Ordered Probit					OLS
	1a	2a	3a	4a	5a	6a
LA	0.118 <i>1.72</i> 0.034	0.116 <i>1.73</i> 0.033	0.129 <i>1.79</i> 0.037	0.127 <i>1.88</i> 0.037	0.126 <i>1.85</i> 0.036	0.102 <i>1.91</i>
LANGUAGE (LATIN)	-0.215 <i>-2.13</i> -0.060	-0.199 <i>-1.87</i> -0.056	-0.199 <i>-1.87</i> -0.056	-0.186 <i>-1.05</i> -0.052	-0.192 <i>-1.06</i> -0.053	0.673 <i>1.92</i>
T	NO	YES	YES	YES	YES	YES
TR	NO	NO	YES	YES	YES	YES
DD	NO	NO	NO	YES	YES	YES
D	NO	NO	NO	NO	YES	YES
CTL	YES	YES	YES	YES	YES	YES
Observations	1114	1068	1068	1068	1068	1068
Prob > chi2 or Prob > F	0.000	0.000	0.000	0.000	0.000	0.000
(Pseudo) R2	0.029	0.032	0.032	0.032	0.032	0.079

Notes: Dependent variable: tax morale on a four point scale. In the reference group are AGE 16-29, MAN, SINGLE, FULL TIME EMPLOYED. Significance levels: * $0.05 < p < 0.10$, ** $0.01 < p < 0.05$, *** $p < 0.01$. Marginal effect = highest tax morale score (4). z-statistics and t-statistics in italics, marginal effects in bold. OLS estimations: robust standard errors and beta coefficients. Standard errors adjusted to clustering in 26 cantons.

Table 4 Impact of Centralization on the Size of the Shadow Economy

Dep. variable: shadow economy	<i>Beta</i> (7)	t-stat.	<i>Beta</i> (8)	t-stat.	<i>Beta</i> (9)	t-stat.	<i>Beta</i> (10)	t-stat.	<i>Beta</i> (11)	t-stat.
CENTRALIZATION (C)	1.675***	3.64	1.444***	3.13	0.805**	2.13	0.825***	2.08	0.687*	1.96
DIRECT DEMOCRACY (DD)			-1.248**	-2.30	-1.058**	-2.34	-1.112**	-2.55	-0.985**	-2.28
GDP					-1.100**	-1.98	-1.125**	-2.27	-1.266***	-2.69
TRANSFERS					0.692***	4.48	0.624***	4.17	0.603***	4.28
EDUCATION EXPENDITURES					0.578***	2.67	0.544**	2.45	0.377	1.65
LABOR FORCE					-0.375**	-2.32	-0.346**	-2.34	-0.316**	-2.27
UNEMPLOYMENT RATE					0.058	0.44	0.018	0.13	-0.037	-0.29
URBANIZATION					0.390	0.32	0.760	0.59	0.906	0.64
POPULATION <15					0.364	0.70	0.750	1.52	0.715	1.47
POPULATION >65					0.829**	2.19	0.680*	1.71	0.674*	1.78
SHARE OF REGISTERED HOUSE PROPRIETORS					1.612*	1.82	2.414**	2.31	2.630***	2.68
TAX BURDEN							-0.406*	-1.67	-0.486*	-1.91
DETERRENCE									0.386*	1.76
State (canton) effects	Yes		Yes		Yes		Yes		Yes	
Prob > F	0.000		0.000		0.000		0.000		0.000	
Observations	78		78		78		78		78	
R-squared	0.413		0.448		0.828		0.839		0.852	

Notes: *t*-statistics in parentheses. Significance levels: * 0.05 < *p* < 0.10, ** 0.01 < *p* < 0.05, *** *p* < 0.01.

APPENDIX

Table A1 Derivation of variables ISSP

Variable	Derivation
TAX MORALE (TM, DEPENDENT VARIABLE)	Do you feel it is wrong or not wrong if a taxpayer does not report all of his or her income in order to pay less income taxes? (1. not wrong, 2. a bit wrong, 3. wrong, 4. seriously wrong).
LOCAL AUTONOMY (LA)	Local autonomy is measured at the cantonal level (c) with an index developed by Ladner (1994) based on survey results where chief local administrators in 1865 Swiss municipalities were asked to report how they perceive their local autonomy on a 10 point scale. (1= no autonomy, 10 = very high communal autonomy).
DIRECT DEMOCRACY (DD)	Index of direct democracy, own calculation based on Stutzer (1999).
TRUST IN COURT AND THE LEGAL SYSTEM (TR)	How much confidence do you have in courts and the legal system (5=complete confidence to 1=no confidence at all)
FINE RATE (D)	Standard legal fine (in percent) as a multiple of the evaded tax amount based on questionnaire data of Frey and Feld (2002); and Feld and Frey (2002a, 2002b)
PROBABILITY OF DETECTION (D)	Number of tax auditors per taxpayer (in %) based on questionnaire data of Frey and Feld (2002); and Feld and Frey (2002a, 2002b)
INDIVIDUAL TAX RATE (T)	Own calculations based on the average weighted value (in percentage) working with the income information done by the ISSP. From the tax table (Steuerbelastung in der Schweiz 1999, p. 48) the value closest to the ISSP income values (midpoint) is used. For simplicity, no differentiation between singles and married people has been made, working with the individual tax rate table for singles.
CHURCH ATTENDANCE (CTL)	How often do you take part in the activities or organisations of a church or a place of worship, other than attending services? Never (1), less than once a year, about once or twice a year, several times a year, about once a month, 2-3 times a month, nearly every week, every week, several times a week (9)
INCOME (Y)	Monthly earnings from employment in Swiss francs (midpoints)
EDUCATION (CTL)	What is the highest educational level that you have attained? <ol style="list-style-type: none"> 1. Incomplete primary school 2. Primary school (up to 12 years of age) 3. Incomplete secondary 4. Secondary completed 5. Incomplete + complete semi-higher qualification, incomplete university, others 6. University completed
LATIN	French and Italian speakers.

Source: ISSP (1998)

Table A2 Descriptive statistics for macro analysis

Variable name	Description	Source
SHADOW ECONOMY	Size of the shadow economy as a percentage of the official GDP	Own calculations
GOVERNMENT CENTRALIZATION	Share of cantonal public spending on cantonal and local spending	Swiss Federal Finance Administration
DIRECT DEMOCRACY	Index of direct democracy	Own calculation based on Stutzer (1999)
GDP	Real cantonal GDP (logarithmized in the estimations)	BAK Basel Economics
EDUCATION EXPENDITURES	publicly provided cantonal education spending (logarithmized in the estimations)	Swiss Federal Finance Administration
TRANSFERS	transfer payments between the federal level and the cantons according to the federal fiscal equalization scheme (logarithmized in the estimations)	Swiss Federal Finance Administration
LABOR FORCE	Share of employment on the cantonal population	Swiss Federal Statistical Office
UNEMPLOYMENT RATE	Share of unemployment on the cantonal population	Own calculations on the basis of Swiss Federal Statistical Office
URBANIZATION	Proportion of local communities having more than 10'000 inhabitants.	Swiss Federal Statistical Office
POPULATION <15	Share of cantonal population over age 65 on total cantonal population	Swiss Federal Statistical Office
POPULATION >65	Share of cantonal population under age 15 on total cantonal population	Swiss Federal Statistical Office
SHARE OF REGISTERED HOUSE PROPRIETORS	Share of registered house proprietors	Share of registered cantonal house proprietors on the cantonal population
TAX BURDEN	Cantonal tax burden	Swiss Federal Statistical Office
DETERRENCE	Number of tax auditors per taxpayer (in ‰)	Based on questionnaire data of Frey and Feld (2002); and Feld and Frey (2002a, 2002b)

Table A3 Summary statistics micro

Variables	Obs	Mean	Std. Dev.	Min	Max
TAX MORALE (TM)	1143	1.767	0.917	0	3
LOCAL AUTONOMY (LA)	1204	4.737	0.662	3.2	6.1
DIRECT DEMOCRATIC RIGHTS (DD)	1204	3.599	1.203	1.75	5.69
INDIVIDUAL INC. TAX RATE (T)	1204	5.890	6.234	0	25.14
AGE 30-49	1204	0.450	0.498	0	1
AGE 50-64	1204	0.241	0.428	0	1
AGE 65+	1204	0.123	0.328	0	1
WOMAN	1204	0.534	0.499	0	1
EDUCATION	1201	3.657	1.681	1	7
MARRIED/LIVING TOGETHER	1196	0.535	0.499	0	1
DIVORCED	1196	0.058	0.233	0	1
SEPARATED	1196	0.023	0.151	0	1
WIDOWED	1196	0.053	0.223	0	1
INCOME	1204	2911.296	3445.100	0	22500
PART TIME EMPLOYED	1201	0.143	0.350	0	1
LESS THAN PART TIME	1201	0.068	0.252	0	1
UNEMPLOYED	1201	0.014	0.118	0	1
STUDENT	1201	0.072	0.258	0	1
RETIRED	1201	0.142	0.350	0	1
AT HOME	1201	0.087	0.283	0	1
SICK	1201	0.009	0.095	0	1
CHURCH ATTENDANCE	1188	2.582	1.825	1	9
TRUST IN COURT AND LEGAL SYSTEM (TR)	1146	3.119	0.906	1	5
AUDIT PROBABILITY (D)	1204	53.006	36.141	7.05	188.98
FINE RATE (D)	1204	78.241	33.292	30	200
LATIN	1204	0.375	0.484	0	1

Note: 38% of the individuals stated that they have no own income or no paid work. Excluding this group leads to a mean in the individual tax rate of 9.8 percent.

Table A3 Summary statistics macro

VARIABLES	Obs	Mean	Std. Dev.	Min	Max
SHADOW ECONOMY	78	0.073	0.013	0.051	0.104
GOVERNMENT CENTRALIZATION	78	0.680	0.102	0.526	0.978
DIRECT DEMOCRACY	78	4.256	1.200	1.583	5.833
GDP	78	4.624	0.108	4.446	5.054
EDUCATION EXPENDITURES	78	2.449	0.157	2.169	2.874
TRANSFERS	78	3.176	0.076	3.051	3.458
LABOR FORCE	78	0.502	0.027	0.439	0.564
UNEMPLOYMENT RATE	78	1.879	1.800	0.000	7.000
URBANIZATION	78	0.324	0.250	0.000	0.994
POPULATION <15	78	0.183	0.022	0.116	0.232
POPULATION >65	78	0.148	0.020	0.108	0.209
SHARE OF REGISTERED HOUSE PROPRIETORS	78	0.412	0.111	0.127	0.612
TAX BURDEN	78	102.606	19.264	55.80	154.10
DETERRENCE	78	63.188	41.433	3.139	188.98

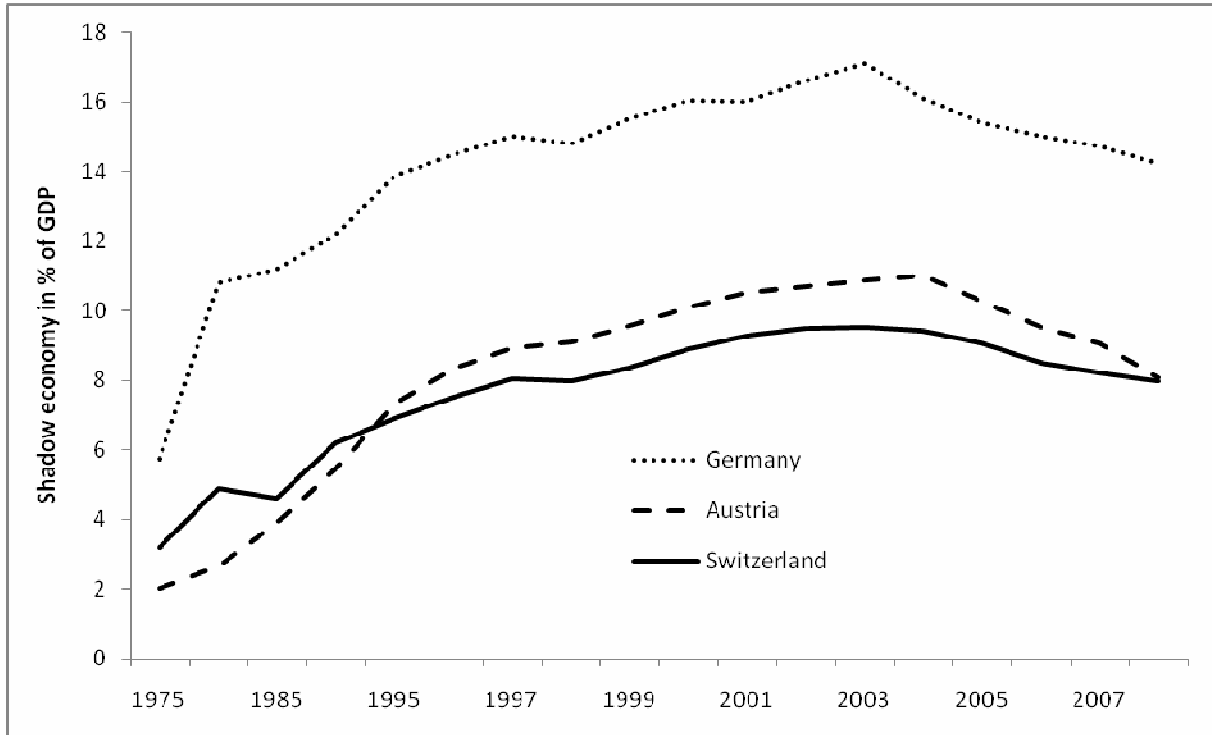
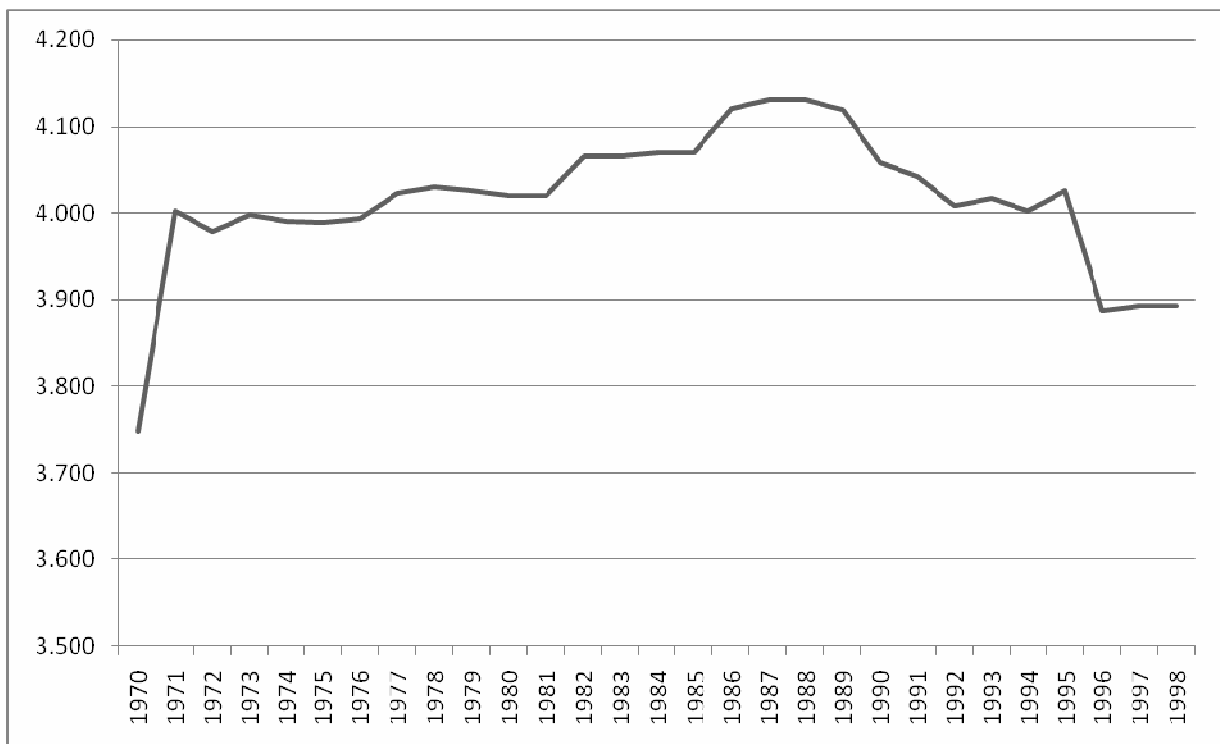
Table A4: Shadow economy over time in Switzerland**Table A5:** Development of direct democracy over time in Switzerland (Frey-Stutzer-Index)

Table A6: Government centralization over time (share of state spendings on state and local spendings) over 26 cantons

