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Shahid Chamran
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Institutional Quality and Tax Evasion in Iran

Mahdieh Rezagholizadeh *, Amirhossein Alami**

** Associate Professor of Economics, Faculty of Economics and Administrative Sciences, University of Mazandaran, Babolsar, Iran. (Corresponding Author).*
Email: *m.gholizadeh@umz.ac.ir*
0000-0003-1172-4824
Postal address: *Faculty of Economics and Administrative Sciences, University of Mazandaran, Babolsar, Iran*
*** Master of Economics, Faculty of Economics and Administrative Sciences, University of Mazandaran, Babolsar, Iran.*
Email: *amirhosseinalami@yahoo.com*

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EXTENDED ABSTRACT

INTRODUCTION

Tax evasion is a major component of underground activities or the irregular sector of the economy, and economists are increasingly seeking to analyze this phenomenon. Given that the tax structure is highly dependent on the governance structure and improvements in governance and corruption control structures lead to public confidence in the government and can reduce the underground economy and tax evasion, examining the relationship between the quality of institutions and good governance with Tax evasion are also important. This study tries to answer this question by examining this relationship during the period 1978-2018, whether improving the quality of institutions in Iran can reduce tax evasion and the underground economy in the country or not? In order to achieve this goal, after identifying the factors causing tax evasion, in the first stage using the method of Multiple Indicators - Multiple Causes (MIMIC) to estimate the time series of relative and absolute size of tax evasion in Iran and investigate the causes and effects using Amos software and with maximum likelihood method. Then, in the second stage, after calculating the time series of the hidden variable of tax evasion, in order to study and empirically analyze the long-term and short-term impact of institutional quality and other related variables (inflation and GDP) on tax evasion in the Iranian economy in Time series, ARDL Bounding test method was used.

METHODOLOGY

As previously mentioned, in the first stage, the method of Multiple Indicators - Multiple Causes (MIMIC) method is employed to estimate the time series of relative and absolute tax evasion in Iran, and to investigate its causes and effects using the AMOS software package and the Maximum Likelihood method. After calculating the time series of tax evasion, the model concerning the relationship between institutional quality and tax evasion in Iran during the study period is formulated as follows:

LTE = f (LPR, LGDP, INF) (1)
Where: LTE: Logarithm of Tax Evasion (obtained in the first stage)
LPR: Logarithm of Institutional Quality
LGDP: Logarithm of Gross Domestic Product
INF: Inflation Rate

FINDINGS

After comparing the fit criteria and estimated results of the estimated models, a model was selected as the final model and basis for tax evasion calculations in which energy consumption growth, money demand growth and GDP growth as effects and inflation, unemployment rate, export-to-GDP ratio, official exchange rate, per capita income, capital asset acquisition ratio (construction cost) to GDP, and import tax ratio to total imports are considered as causes of tax evasion. This model is in a better position than other estimated models in terms of significance of coefficients of factors and effects of tax evasion. In this model, inflation, tax burden, per capita income and official exchange rate have a positive and significant effect on tax evasion, and economic openness index, government size and unemployment rate have a negative effect on tax evasion. It should be noted that in the selected model, the greatest effect of tax evasion is on the growth of money demand. Also, among the variables of causes, the most impact is related to per capita income. The results of estimating the second-stage model also indicate that the impact of institutional quality is significantly negative both in the short run and in the long run.

CONCLUSION

The results of calculating the relative size of tax evasion show that although the trend of tax evasion fluctuates in the desired period, but in general it has had an increasing trend over a period of 38 years, so that from 6.12% of official GDP in In 1978, it increased to its highest amount in 2000 (24.46% of GDP) and finally in 2016, it reached 11.33%. Also, the results of calculating the absolute size of tax evasion show that its amount increased from 63664 billion rials in 1978 to its highest amount in 2000 (290250 billion rials) and in 2018 equal to 89095 billion rials.

Based on the results, the sign of the coefficient for the institutional quality variable is negative and significant in both the short run and the long run. This indicates that improvements in institutional quality in Iran during the study period decrease growth of underground economy and tax evasion. Specifically, a one percent improvement in institutional quality in the long run leads to a 0.62 percent reduction in tax evasion.

Furthermore, the findings indicate that an increase in inflation in the long run increase tax evasion in the country. Conversely, an increase in gross domestic product (GDP) serves as a factor in preventing further growth of the underground economy and tax evasion.

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