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# BREAKING THE VICIOUS CIRCLE: TAX EVASION, CORRUPTION AND THE POWER OF INSTITUTIONAL TRUST IN THE EU

## INTRODUCTION

This thesis explores the two-way relationship between tax evasion and corruption in the European Union, analyzing how these practices reinforce each other and decrease public revenues. Inspired by Ray Dalio's framework on the rise and fall of nations, it investigates whether fiscal mismanagement can trigger a vicious cycle of evasion, mistrust, and weakened governance.

## OBJECTIVES

- To identify the legal, economic, cultural, and technological drivers of tax evasion and avoidance in the EU.
- To assess how institutional trust, tax pressure, and inequality influence fiscal behavior.
- To examine the role of the EU and OECD policies in improving tax compliance.
- To evaluate whether a vicious cycle exists between evasion and corruption.
- To contribute to the academic debate by integrating economic theory with empirical evidence on governance and taxation.



## METHODOLOGY

### GRANGER CAUSALITY ANALYSIS

$$\text{VATGap}_{i,t} = \alpha_i + \sum_{k=1}^4 \beta_k \text{VATGap}_{i,t-k} + \sum_{k=1}^4 \lambda_k^{\text{CPI}} (100 - \text{CPI}_{i,t-k}) + \sum_{k=1}^4 \gamma_k^{\text{GINI}} \text{GINI}_{i,t-k} + \sum_{k=1}^4 \gamma_k^{\text{Trust}} \text{Trust}_{i,t-k} + \sum_{k=1}^4 \gamma_k^{\text{Fiscal}} \text{Fiscal}_{i,t-k} + \varepsilon_{i,t}$$

$$(100 - \text{CPI}_{i,t}) = \alpha_i + \sum_{k=1}^4 \beta_k (100 - \text{CPI}_{i,t-k}) + \sum_{k=1}^4 \lambda_k^{\text{VAT}} \text{VATGap}_{i,t-k} + \sum_{k=1}^4 \gamma_k^{\text{GINI}} \text{GINI}_{i,t-k} + \sum_{k=1}^4 \gamma_k^{\text{Trust}} \text{Trust}_{i,t-k} + \sum_{k=1}^4 \gamma_k^{\text{Fiscal}} \text{Fiscal}_{i,t-k} + \varepsilon_{i,t}$$

This study uses **panel data (2012–2022)** for all 27 EU countries to test the bidirectional causality between tax evasion and corruption through fixed-effects regressions. A panel **GRANGER CAUSALITY** approach with **four-year lags** and Wald tests assesses whether one variable predicts the other over time.

## RESULTS

Causal path (Causal variable – affected variable)	F-Statistic	P-Value	Significance
CPI - VAT Gap	2.9936	0.0208	* (p < 0.05)
VAT Gap - CPI	2.6449	0.0360	* (p < 0.05)
Trust - VAT Gap	4.5775	0.00166	** (p < 0.01)
GINI - VAT Gap	0.1104	0.9787	Not significant
Fiscal - VAT Gap	1.6527	0.1644	Not significant
GINI - CPI	0.4105	0.8008	Not significant
Trust - CPI	0.9591	0.4320	Not significant
Fiscal - CPI	0.5817	0.6764	Not significant

Granger tests confirm a bidirectional causality: past corruption predicts higher tax evasion (p = 0.0208), and past evasion increases future perceived corruption (p = 0.0360). Institutional trust also reduces future evasion (p = 0.0017), while inequality and fiscal pressure show no significant effects.

## CONCLUSIONS & LIMITATIONS

The findings support the **existence of a vicious circle between corruption and tax evasion** in EU countries.

However, this is a complex phenomenon that requires deeper investigation over longer time periods and broader samples to better understand its dynamics.

