

## **TAX EVASION - BETWEEN LEGAL AND ILLEGAL. MECHANISMS OF THE UNDERGROUND ECONOMY**

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### **Abstract:**

*Tax evasion, special component of the underground economy is an economic and social phenomenon whose size has grown in all countries.*

*Tax evasion and has appeared with the state and tax laws. Its cover area is extended to all taxes. It actually aims to minimize taxation through the use of inventive, accessible and real alternatives.*

*The effects of tax evasion are reflected directly on fiscal revenues and expenditures, competition, generating social dissatisfaction, inequity and tensions.*

**Key words:** tax evasion, corruption, underground economy, tax burden

**JEL Classification:** E26, H26, O17

### **1. Definition of tax evasion**

*Tax evasion is considered a special component of the underground economy because of at least three reasons:*

1. Tax evasion is a crime committed against a special economic agent - the state;
2. Involves a fragile connection of information between those involved in the activities of the underground economy (tax dodgers, investigators and government);
3. There is a special relationship between tax evasion and other important events for the study of public economies.

Although the issue is extensively approached, the specific literature failed to formulate a clear and comprehensive definition of this concept, most of the ideas issued highlighting the tax evasion's particularity - avoiding the tax payment to the state -, but not the scope.

It should be noted that “unreported income tax” is not synonymous with “tax evasion”. The latter includes as well the oversizing of tax deductions. In this way deemed necessary to clarify the concept of “fiscal income”. This is defined by the tax law being all sources of income in the national taxation base. Potential taxation

base (including total economic income and capital gains) includes several components (in Romania taxable income, non-taxable income and tax-exempt income), depending on the tax laws of each country. *Taxable income* includes both cash income and equivalent income in kind, minus the amount of deductions allowed by law. *Non-taxable incomes* are not subject to income taxation because of certain social considerations. *Exempt from tax revenues* are actually taxable income but exempted from taxation. Moreover, the concept of “unreported income” is totally different from that of “unregistered” income, which implies an underestimate taxable income, which reduces the total economic income.

*The manner in which it resorts to tax evasion* regards:

- The law that provides by itself tax evasion, being favorable;
- Abstention of the taxpayer to perform activities subject to taxes;
- Use of tax system loopholes.

Hoanță Nicolae<sup>1</sup> introduced the concept of *tax evasion a priori*, which refers to a *tax evasion due to a legal vacuum*.

During the interwar period, the notion of tax evasion was included in the fraud. Contemporary economists, however, defines the two terms, considering that *tax evasion represents all events aimed at avoidance of taxes, having two major components: licit tax evasion and fiscal fraud* (illegal tax evasion). From economical point of view, the judicial distinction is irrelevant as long as both of them lower budgetary tax revenues available to the state.

Specific activities of fraudulent tax evasion are based on *decision taken under uncertainty* (risk of being discovered and forced to pay taxes and penalties, possibly involving criminal liability). Instead, licit tax avoidance involves decisions within an exact environment, the taxpayer being safe because of a refuge or a favorable interpretation of tax legislation, based on skillful use of the possibilities and alternatives offered by the law. In practice, it is very difficult to distinguish lawful from the unlawful tax evasion, they are not strictly separated, and there is a dividing each relative. Frequently, the shift from one form to another is gradual and imperceptible, individuals moving from abstention to break the law, to qualified fraud.

Since the economy involves the production of goods and services both legal and illegal, it is clear that tax evasion will be associated with legal or illegal activities, as appropriate.

*Pure tax evasion* consists of failure to report or partial reporting of profits or taxable income, which does not involve labor or way that operates the economic entity related to the economy. Some activities are carried out at the limit of law regulations, others are conventionally-legal, but do not report income or exaggerate

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<sup>1</sup> Hoanță Nicolae, (1997), *Evaziunea fiscală*, Editura Tribuna Economică, București, 1997, pag. 216

their expenses. There are situations that occur in various forms of income transfers between family members to reduce the taxable supply or conceal the type, source and upon receipt of such income.

As regards *the tax evasion*, this implies *a violation of tax laws, a conscious and deliberate infringement of the rules regarding the payment of fiscal obligations*. The concept of tax fraud unites “all unlawful practices that allow not paying, in part or all mandatory taxes”. These practices are likely to be punished by administrative penalties, even criminal. *Most European countries treat tax fraud in terms of its illegal nature, its various manifestations being punishable in different ways*. At EU level, tax evasion is addressed by regulations and Guidelines that outline the *acquis communautaire* in the field of tax evasion. It defines methods to collect integrated evasion equity resulting from VAT and import taxes linked to production.

So, while tax fraud designates a crime, tax evasion requires skillful use of gaps and leaks of the law. But regardless of how we define the phenomenon of tax evasion, it is clear that it is a manifestation condemned around the world, which persists despite any sanctions imposed by the state.

## **2. Causes of tax evasion and its implications**

The implications of tax evasion are both economic - adversely affect the tax revenues and competition - and social, leading to increased tax liability incurred by the rest of taxpayers, inequalities and social tensions.

Recourse to escapist practices is related to the taxpayer's system of values, beliefs and morality, but also social conduct and economic environment in which it belongs. Circumvention possibilities vary from a social category to another, depending on the nature or origin of property subject to taxation, the manner of material taxes, etc. control the organization. Another factor is the perception of the taxpayer on the tax system that allows them to maintain that compliance standard of living and satisfaction of individual needs into account remaining after paying income tax obligations incumbent. Finally, it should be noted both legislative and administrative system, how their state apparatus applies tax laws and penalties arising from conformation to the law.

However, *the propensity to tax evasion* is more pronounced in some countries than others, *depending on the promoted fiscal policy, economic, social and political climate, being usually inversely proportional to the degree of economic and social development of communities*. In this sense, “the theory of tax evasion persistence” requires dissociation between the individual interest and the community one.

As regards economic and financial aspect of motivation to evade taxation, the fiscal rate must be analyzed and reported to the level of taxable income.

*Tax burden is one of the reasons of inevitable conflict between the state and taxpayers. On the one hand, the state seeks to increase tax revenues at the expense of funding to meet increasing public spending and therefore generates a growing tax burden and on the other hand, taxpayers want to reduce the tax burden to increase individual revenues.*

Regarding the taxpayers, *social inequities* appear between those who pay taxes and those who avoid them. Therefore, discontent will deepen and social unrest will occur. An honest taxpayer will realize that the situation is precarious compared to the neighbor, who does not pay tax liabilities and tax authority is unable to punish him, or if it does, this happens very late. He may conclude that it is economically more profitable to practice also tax evasion. This reasoning lies in the frustration that honest taxpayer feels to tax dodger and its high standard of living. Respect for honest work is injured this way, and the concepts of fairness, justice and the rule of law as well.

*Excessive tax burden generates evasion and tax avoidance, propensity to invest and save reduction, unwillingness to work legally, tax revolts and social unrest.* It is however influenced by economic performance objective of a state at a time, the low efficiency of public spending financed through taxes, the mentality of the people related to budgetary needs and government policy.

*Legal vacuum, very slow updating of legislation, duplication and ambiguity of legislative provisions enable the propagation phenomenon of tax evasion in all areas of economic life.* The legislative framework is the base of the tax system. If it has flaws, is confusing or too thick, tax evasion and fraud event find fertile ground.

Also, techniques for setting and collection of taxes, reduction and deduction mechanisms, and granting tax breaks too easily and without rational foundation is the premise of tax evasion. Moreover, they affect revenues and stimulate indiscipline in fulfillment of tax obligations.

*Lack of skilled, dedicated and responsible staff, inadequate salaries, lack of equipment in the field of computer systems and performance of the administrative apparatus, chaotic and inefficient organization, do not give possibility to control and prevent tax evasion.*

The political class in power, besides having no longer the financial resources they relied on, cannot ensure the stability of “the social contract” cannot meet the political program of government and loses credibility and votes of those who elected them.

In conclusion, *the temptation to tax evasion is amplified by the lack of information and knowledge about tax system, the tax burden and gaps in the legal system and state administration.*

### 3. Mechanisms Of Underground Economy

#### 3.1. Work „black”

Work "black" is a profitable activity, *but performed outside the legal regulation, services supplied in clandestine conditions and the true value not reported, respectively*. As a result, work “black” is not recorded, reported, taxed, insured, and socially protected, putting the worker totally at the disposal of that for which he works. So, it appears an alteration of the balance of the labor market because there is a disruption of supply and demand and thus a parallel, underground labor market is created.

According to dual labor market theory, it can be divided into four major categories: primary, secondary/shadow, informal and illegal. These categories reflect actually the contemporary social stratification.

Corruption is a complex, multidimensional and multidisciplinary phenomenon, whose causes and effects in different contexts generate serious economic problems.

Corruption can be defined in many ways but the most popular and simplest definition which is circulated is as an *“abuse of public power for personal interests”*.

Specialized economic literature provides taxonomy of the main types of corruption having as the main element tax reporting:

- Bureaucratic corruption;
- Political - administrative corruption;
- Political - legislative corruption;
- Legal corruption.

*Bureaucratic corruption* usually involves officials at the "front desk", which deals directly with the public. It may occur in two forms: either as a unique opportunity, or as part of an ongoing relationship between an officer and a potential contributor. In the first case, the official tax administration can find a quantity of goods delivered, but not declared for taxation, in which the taxpayer will try to bribe officials in order not to be punished. In the second case it is a “premium” regularly paid to the officer, in order to obtain its protection.

*Political - administrative corruption* is considering situations where the taxpayer, making use of political influence, shall provide special tax treatment. The ability of politicians to “provide” protection depends on the political dependence of the legislative and administrative levels. The higher independence of the two levels, the more difficult for politicians to intervene in the tax administration.

*Political - legislative corruption* refers to cases where taxpayers try to ensure “greater legitimacy” with the political process in order to find more generous tax treatment. The general purpose is to groups of interest.

*Legal corruption* occurs when there is a legal system dependent on the government in power, and the financially motivation is insufficient, so accepting of

bribes is an alternate solution. Put in the position of arbitrator between taxpayers and tax administration, such a system tolerates behaviors in another context the law amended.

Still remaining in the fiscal sphere and pointing out *similarities and differences between tax evasion and corruption phenomena* a parallel can be traced between the two social-economic maladies, on the following considerations:

- Tax evasion may be a unilateral act, while corruption requires mandatorily at least a bilateral act;
- Tax evasion does not mean, automatically, subsequent use of corruption, while corruption acts and funding is provided, particularly on account of financial resources stolen from taxes;
- Tax evasion is a component of the underground economy, particularly manifested in the area, while corruption has its followers in the real, formal economy, although this does not exclude that the intention and corrupters individuals come from the underground economy;
- While tax evasion is to protect earnings against taxes levied by the state, corruption concerns access to the levers of state to obtain gains.

However, it should be noted that in most cases, tax evasion and corruption go "*hand in hand*". Tax evasion does not rule out corruption, and vice-versa.

Another type of phenomenon can be identified if it is to their vulnerability to corruption of various social structures as follows: economic corruption, social corruption, administrative or bureaucratic corruption, political corruption. Causes of corruption are many and very different: poverty, inequity in terms of income, low civil service salaries, inadequate and inefficient public management, excessive bureaucracy, and lack of transparency in decision-making, etc. Thus, factors involved in the development of this phenomenon are from an economic, political and institutional origin.

*Economic corruption* involves illegal actions committed by individuals or legal entities, embodied in different offenses: false banking and accounting, counterfeit goods, fraud, embezzlement, fraudulent bankruptcy, abuse of power, etc. Generally speaking, the foundation of economic corruption acts is the exchange of money or material goods. If, however, it proceeds to a "social exchange", which implies client-sympathy, favoritism, or ethnic sympathy, we can speak of *social corruption*.

#### **4. Fiscal paradise and dirty money laundering**

Economic globalization has led to the internationalization of crime, including within the economic field. In this context it was necessary to conceal the origin of fraudulent financial resources and their subsequent integration into the formal economy as investment resources, a procedure known as "money

laundering". The ultimate objective of the operations of this nature is the availability to gain access to money, without any suspicion about their origin.

*Dirty money laundering, as an expression of the cross-border economic crime, is the attribute of high corruptive potential criminal groups, which show great skill, ingenuity and professionalism, and high capacity to adapt to market requirements, taking advantage of the authority crisis of the state institutions.*

Regarding the money laundering process, a definition is that it is *"a complex process through which revenues that are believed to arise from criminal activity are transported, transferred, converted or mixed with legitimate funds, in order to hide or distort the true nature, source, disposition, movement or ownership of those profits"*.

In Community law, money laundering operations relate to:

- Conversion or transfer of property (or assistance for this purpose), if it is known that such property is derived from criminal activities;
- Concealing or disguising the true nature of goods (origin, location, movement, property rights), if it is known that such property come from criminal activities or participation in such activities;
- Acquisition, retention or use of goods, if on the delivery it is known that they come from criminal activities or participation in such activities.

"Efficiency of the black money laundering phenomenon is measured through the ability of mafia groups to recycle results of crimes carried out (such as tax evasion, drug trafficking, trafficking in stolen cars, etc. - generally called predicate offenses), usually using the financial system".

Money laundering process is based on three phases:

- *Placement* - involves the collection, handling and transport of illegal profits (cash) out of space that they might be detected and confiscated through banks, financial and insurance systems to parallel remittance, casinos, stock agencies, retail, external transfer, mixing with legal funds, "ghost" companies without real income, but with deposits from recyclers, etc.;

- *Stratification* - aims to design complex financial transactions (activities and transactions are added as a step in continuing to make another extremely difficult, if not impossible to detect illegal profits) designed to separate the illicit income from their source: purchase of travel checks, payment orders, bonds, stocks, electronic transfers are made, the resell value of goods purchased during the placement of cash, etc., transactions giving rise to the possibility of making further domestic and external transactions;

- *Integration* - ends black money circuit by providing an apparently legitimate image on assets acquired with illicit financial resources.

*Fiscal paradises are in fact "the umbrella" under which money laundering come from illegal drug trafficking, weapons smuggling, etc.*

Although, in general, fiscal paradises offer the same facilities, there are some differences between them that make them more attractive to certain categories of investors. Thus, upon their basic characteristics, they can be grouped into seven types of countries:

1. Countries which *do not apply any taxation on income and capital gains* ("pure Heavens"): Aruba, Bahamas, Bermuda, Cayman Islands, Dominica, Grenada, Madeira, Mauritius, Saint Vincent, Samoa, etc.;
2. Countries where *income or benefit tax is reduced*: Cyprus, Liechtenstein, Malta, Oman, Jersey, etc.;
3. Countries where *the tax is established on a territorial basis*, and taxpayers receive tax exoneration for benefits obtained in operations conducted outside: Costa Rica, Hong Kong, Malaysia, Panama, Philippines, etc.;
4. Countries that offer *special treatments for offshore and holding companies*: Luxemburg, Netherlands Antilles, Singapore, Thailand etc.;
5. Countries where *companies producing for export are exempted of taxes*: Ireland and Madeira;
6. Countries where *tax benefits are offered to international business companies*, companies that qualify as privileged offshore financial companies: Antigua, Bahamas, Barbados, Bermuda, Dominica, Grenada, Montserrat, St.Vincent, St. Lucia, etc.;
7. Countries that offer *tax advantages to specific bank companies or to other financial institutions with offshore activities*: Hong Kong, Madeira, Malaysia, Philippines, Singapore, Thailand and Vanuatu.

Advantages offered by fiscal paradises are not only no taxation or it is smaller size, but also non-fiscal advantages: promotional advertising, modern and efficient communications network, political and economic stability, protection, precision and discipline, etc. This allows creation of complex networks through which capital, dirty money, financial fraud, criminal profits are transited and as well legal capital of large companies, on search of affordable financial and tax treatments.

Most serious consequence of this phenomenon is that recyclers have the pleasure of fraudulent income and may not be held liable for the infringing activities of their generators. With enormous profits, untaxed and not subject to applicable legal standards developed businesses in the formal economy, they carry much higher costs than firms investing legally in the real economy. As a result, these companies are unfair competition.

Money laundering contributes to the development of a financial, legal and political corruption: the representatives of financial institutions, the judicial and political authority fall prey to huge circulating amounts of money.

Together with the great expansion of global economic activity, and increasing of foreign direct investment worldwide respectively, the demand for

operations performed by offshore companies has significantly increased as well, especially in countries considered fiscal paradises, in order to avoid / reduce taxes. Being geographically small countries, with limited natural resources, which cannot support the development of some industries, they turned onto tourism and services and the "rental tax sovereignty." Rapid growth of this sector took place amid pressure from developed countries' tax authorities, and their restrictive and protectionist regulations, and as a result of taxpayer discontent.

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