

TAX EVASION AND UNDERGROUND ECONOMY AFFECT CONFIDENCE IN ECONOMY

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*The economy can be regarded as
the provision daughter, temperance sister and
the mother of freedom.*

Samuel Smiles,
(Scottish author and
Government reformer, 1812 – 1904)

Abstract

The article highlights a major problem existing in both transition economies and developed economies respectively on tax evasion and the underground economy; the problem is that among these phenomena there is a close connection that makes it difficult to counter them. When they are perpetuated over a long period, it can be appreciated that the fight is a complicated one, the control strategies will have to be exchanged more since the phenomenon of tax evasion and the underground economy affects whether the partners' confidence funders or outside investors.

Internally the public confidence in the ability of developing economy lowers, perpetuating the unequal conditions of competition as a source of spread of social inequality in a world where globalization has not only beneficial effects. These are considered the most important features; along with the main sectors affected, their effect on widening inequalities in the constantly changing of Romanian society and the fight against these phenomena should be food for thought both in Romania but also in Europe. The insufficient concern on these issues, by their major significance, reveals that significant budget resources are "lost" from the state attention, and also have serious consequences that may not lead to ensure a decent standard of living and tend to generate a climate of social tension.

The continuous restriction of these phenomena can and should be one of the priorities and the means to redress the financial public balance at European level but especially for Romania.

Keywords: trust, economic crisis, underground economy and tax evasion.

JEL Classification: P35, P0, F0, D0

1. Introduction

Tax evasion is one of the negative economic and social phenomena the states face, may they be developing or developed. This paper identifies and analyzes the main reasons for the existence and evolution of tax evasion and underground economy; the analysis is based on the problems and key issues regarding the means and tools to fight against underground economy and tax evasion as well as the economic and social effects that affect them.

In Romania, tax evasion and underground economy were not caused by tradition; they were rather intensified after 1990, following the manifestation of necessity and option generated by poverty, social disorder, unemployment, weak governance and institutional incapacity, which were all linked to the enhancing presence of shortcomings and strong entropic inconsistencies of public and private management during Romania's process of transition to competitive market mechanisms.

Considering that the eradication of tax evasion is still a goal, states try to find solutions to limit as much as possible the unwanted consequences of this phenomenon which affects even the standard of living.

Tax evasion generates negative effects which directly influence the level of tax revenue; this causes major distortions in the mechanism of competitive market, it also affects the economy's capacity to access funds from international lenders; it even endangers the state's external relations.

Tax evasion in Romania has been growing to such an extent for the last twenty years that it seriously affecting the economic development of the country.

Although this is a complex issue requiring serious attention in its approach, tax evasion is still very difficult to control and quantify, mainly due to the factors favouring an environment favourable to these phenomena; we can enumerate some of these factors: imperfections and particularities of tax laws, low living standards of the majority population, the low level of civilization, culture and civic consciousness, aggressive fiscal policies that the state promotes and not least corruption, which is present in the bodies with responsibilities in combating tax evasion.

A definition of **tax evasion**, covering both the Romanian law and the literature abroad might be summarized as follows: "Tax evasion means the avoidance by any means, in whole or in part, from taxes and other amounts due to the general consolidated budget, by Romanian or foreign individuals or legal persons, generically called taxpayers".

There are many terms in literature that relate to a significant segment of the economic activity, known today under the generic name of "**informal**".

Among the most commonly used terms for this market segment are

the following: unreported, undeclared, unregistered, underground, hidden, illegal, gray, shadow, parallel, black, illegal, informal, unmeasured untaxed, unorganized, unnoticed. The existence of these appellations multitude of tests demonstrates the large number of attempts made by economists and researchers worldwide to explore this relatively unknown area of economic activity. This informal economic activity is known as **underground economy**.

2. The confidence in economy affected by the tolerance of tax evasion

The two phenomena, tax evasion and underground economy, usually co-exist and exert an increased aggressiveness on the public budget and the formal economy, thus creating major difficulties; it acts as an illness, the same way as the flu influences the human body. Unless kept under strict control, these phenomena are likely to dramatically affect the economy; their effects are reflected in the state's inability to provide over vital functions for the population, which may led to increased social tension, a climate of social insecurity and also to loss of confidence in the economy

The global financial and economic crisis has highlighted the adjustment of macroeconomic imbalances accumulated in Romania until the end of 2008. The current account deficit and budget deficit were two major structural imbalances that created a high vulnerability for the economy; it explains the extent of the economic contraction in Romania between 2009 and 2010.

The difficult period we are experiencing is not just a feature of countries that changed the economic system in 1990, from centralized to market economy; it is also found in developed countries such as Germany, France, Spain, Italy, which are all countries with consolidated economies. Eventually the economic and financial crisis revealed that we are rather facing a crisis of confidence, as scientists try to demonstrate. At a scientific level, researchers determined a ZEW indicator, which is published by the Zentrum für Europäische Wirtschaftsforschung (Centre for European Economic Research)

The indicator expresses the institutional investors` sentiment at the institutional level. The participants are asked whether they feel optimistic or pessimistic regarding the status of the investments and the economic situation for the next six months. The indicator compares the percentage of investors who feel optimistic about the economy to those who feel pessimistic and then to those who do not expect any change. If 40% of investors feel optimistic about the economy, 30% are pessimistic, and 30% expect no change, the indicator will be +10. Investors` feelings - especially

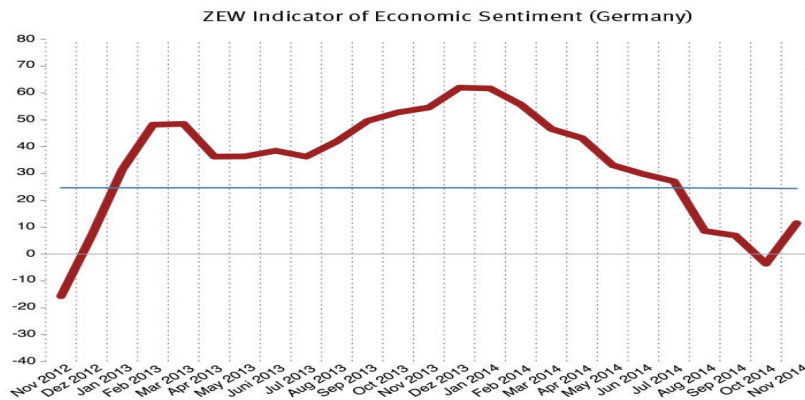
institutional investors - may affect the general economic sense, so that a positive trend in this indicator has a positive influence on the economy and the currency in that region.

This indicator shows that confidence in economy was seriously affected during 2014 even in Germany, which is economically competitive; in November 2014 there was a slight improvement which can be seen in Fig. No. 1.

The ZEW Indicator of Economic Sentiment for Germany gains 15.1 points in November 2014. Now standing at 11.5 points (long-term average: 24.4 points), the index has returned to positive territory after the previous month's slip into negative territory.

"ZEW's Indicator of Economic Sentiment for Germany has increased for the first time in 2014. The recent growth figures for the euro area suggest that the economy is stabilising, which contributed to the indicator's increase. However, the economic environment remains fragile, not least due to ongoing geopolitical tensions," says ZEW President Professor Clemens Fuest [1]. The assessment of the current economic situation in Germany is largely unchanged. Increasing by 0.1 points, the index now stands at 3.3 points. ZEW's Indicator of Economic Sentiment for the Eurozone has increased by 6.9 points in November to a reading of 11.0 points. The indicator for the current economic situation in the euro area has decreased by 2.9 points to a value of minus 59.7 points.

Figure No. 1
ZEW Indicator of Economic Sentiment for November 2014



3. Underground economy and tax evasion in Romania

Underground economy, which is also known as informal economy, is present in all countries of the world regardless of the level of development; it is a remarkable ample phenomenon, threatening the economic development and the social progress, as it creates a sense of social insecurity. This phenomenon is alarming since the average value for 31 representative European countries reached 19.3% of the official gross domestic product (GDP) in 2011 as resulting from researchers' estimates assumed at European level. In **Romania, the weight of underground economy in GDP is about 30%**, which is a worrying fact. At the same time, we can notice a slight decrease its size in the recent years.

Estimating underground economy is a difficult issue due to factors such as insufficient data sources, reluctance to provide information given the borderline of illegal activities in this area. Therefore in practice researchers use several methods with different results, sometimes at a very large extent.

Underground economy is a hot topic and there controversial opinions among specialists and researchers regarding the definition of the activities that fall under this assessment, the methods to estimate its size and the use of economic analysis in order to estimate; the MIMIC model (multiple indicators - multiple causes), the DYMIMIC model (dynamic multiple indicators - multiple causes), the methodology of the National Institute of Statistics (NIS) are the most used methods.

The difficulty of using the MIMIC method arises from identifying the causes and indicators of the underground economy. It is obvious that taking effective policy measures to make it less attractive so that more formal economy becomes attractive is a great challenge for the Romanian government. The successful implementation of such policies would lead to a reduction of the underground economy.

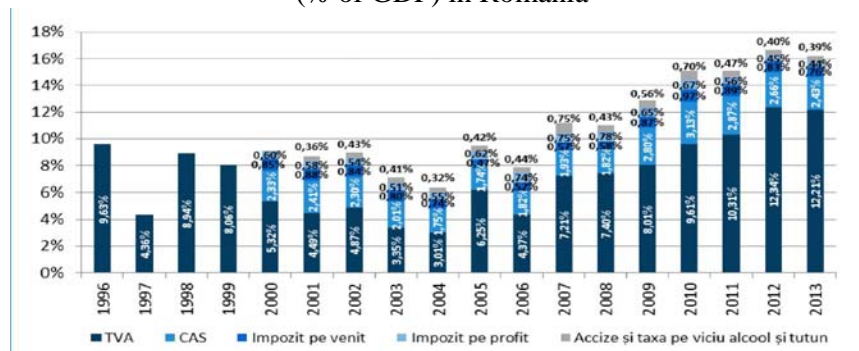
A significant impact on the underground economy is taxation; if too high, it creates a migration tendency towards tax evasion and consequently it has a negative influence. Informal economy and tax evasion are complementary phenomena and are facilitated by institutionalized corruption.

According to the calculations of The National Institute of Statistics (NIS), **tax evasion** is very high in Romania, **representing 16.2% of GDP in 2013** [2]. Should Romania collect taxes to a maximum level, its budgetary income as a percentage of GDP would be above the European average, considering that the legal level of the main taxes in Romania is higher than the European average (at European level, Romania has the 3rd highest standard rate of VAT and the 7th highest tax burden on labour -

generated especially by health insurance; at the same time, Romania has one of the lowest corporate tax and personal income tax rates in the EU, but they represent a low percentage in budget revenues). A thorough reform of the taxes administration in Romania targeted towards increasing tax collection is essential; so as to create the fiscal environment needed to reduce the tax burden on employment, which is a very high level today.

As the researches show, about 75% of tax evasion is generated by the value added tax - VAT (Chart No. 1), which reached a maximum of 12.34% of GDP in 2012; in 2013 there was a slight drop to 12.21% of GDP. In 2010, when the legal VAT rate was increased from 19% to 24% in the second half of the year, tax evasion increased from 8% of GDP in 2009 to 9.6% of GDP in 2010, maintaining the upward trend in the coming years.

Chart No. 1 Evolution of tax evasion concerning the main taxes (% of GDP) in Romania



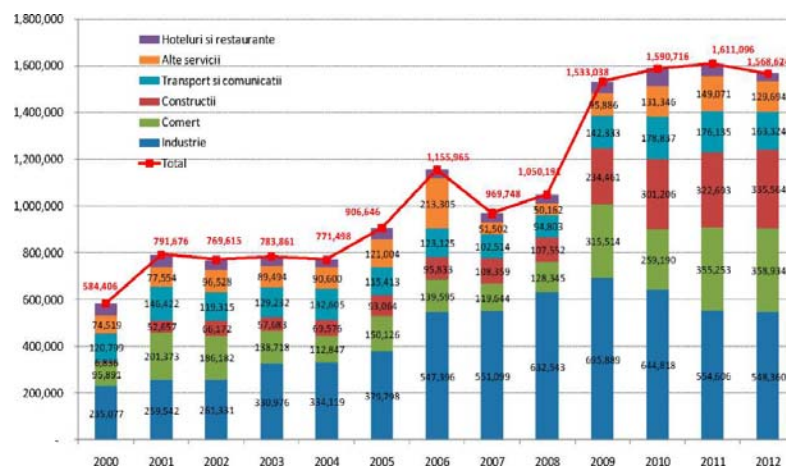
Source: Calculation of the Council tax in Romania based on The National Institute of Statistics

In terms of informal employment (undeclared work), it has been having an upward trend since 2009 (Chart No. 2); its highest weight was recorded in economic sectors such as industry, commerce and construction, which are all areas where the state controls are superficial, often difficult to perform. It is also important to notice that the evolution of the labour market has shifted from formal (legal) to informal labour at the same time as the financial and economic crisis started at the end of 2007. The existence and expansion of illegal work is largely linked to the institutional aspects of the economy, which vary in each Member State of the European Union; mainly they consist of:

- *tax burden - taxes and social contributions* – they certainly influence the level of undeclared labour;

- *bureaucracy and administrative duties* - excessive bureaucracy and difficult administrative procedures contribute to the deterrence of declared work;
- *faulty laws, inadequate provisions regarding the labour market* – the law that does not cover all situations and activities in economy (e.g. work from home is hard to identify, especially in IT), which enables new types of work schedule.

Chart No. 2 Evolution of undeclared work [3] and of unregistered entrepreneurs [4] (number of persons)



Source: Calculation of the Council tax in Romania based on
The National Institute of Statistics

Conclusions

The dominance of short-term political considerations, without paying much attention to the consequences on the sustainability of public finances in the medium and long term, made Romania increase the level of tax evasion and underground economy.

Effort with a view to fiscal consolidation as well as deep structural reforms to create favourable conditions for healthy economic growth so as to allow the fair re-distribution of economy are required in order to restore fiscal sustainability. In this context, government policies should cover the restructuring of public expenditure and release of fiscal space for investment. The government policies also have to intensify their role in strengthening fiscal discipline; they have to contribute as well to improving

the medium-term budgetary programming. A number of fiscal rules have to lead to the prioritization of spending and a prudent fiscal policy in times of economic ascent, which is to preserve the necessary fiscal space to stimulate economy in times of recession.

Budget revisions can trigger the transparency mechanism of fiscal policy if they are limited to two or three during the budget year. In this context, the role of the Fiscal Council should be increased as an independent authority, which will have to support the Government and the Parliament in the process of development and ongoing fiscal policies and to promote transparency and sustainability of public finances.

The major objective of the Fiscal Council should be to help create and strengthen a culture of fiscal and budgetary responsibility in Romania; one of the ways to achieve this includes increasing the public awareness of the consequences of fiscal and budget policy decisions on the medium and long term sustainability.

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[3] Employees and employers with institutional sector Non financial entities

[4] From the institutional sector Households.

Note: The number of people working illegally (employees and employers) in the underground economy is calculated as the difference between the number of people based on the labour survey (AMIGO)¹ and the number of people in the Annual structural survey in enterprises (ASA), excepting the public sector, at the level of homogeneous branch and in full-time equivalents. All industries are covered in AMIGO, except for agriculture and public administration. The Structural Business Survey does not include the public sector (public administration, health, education) and part of the services. Turned whole time equivalent = includes both people who worked full time 40 hours per week (according to law) and those who

¹ Sample surveys

worked part time and turned into full time equivalent. Transformed into homogeneous branch = National Accounts operate.

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