REDUCING TAX EVASION BY INTRODUCING CONTROL GUIDES IN ROMANIA

PhD, Matei Adrian Ducu[11]

Taxes are paid in the sweat of every man who labors.
***Franklin D. Roosevelt** (b. 1882, d. 1945)*
The thirty-second president
of the United States of America
(1933–1945)

Abstract

Companies operating on legal basis and which pay their taxes correctly do not cope with the existing competition when tax evasion reaches a high level in economy. However, more effective control by tax authorities is required in a way that gives hope and the certainty that someone really cares. This can be doubled by a more rigorous verification by state control bodies, by using modern ways to eliminate subjectivism and to promote similar solutions to similar issues. Such stratagem can be achieved by means of control guides and handbooks with similar approach for similar issues and focused on types of taxes; it requires designing control tests to be specifically applied to them, as well as the legal basis of test, the controlled documents, a description of possible errors and an enumeration of possible consequences.

***Keywords**: tax evasion, competition, informal economy.*

JEL Classification: H26

Introduction

Solutions are being sought to promote a competitive environment as effective as possible in the market economies which aim to progress, where companies enjoy free initiative, the freedom to decide as efficiently as possible how to combine production factors and the free movement of goods, services and capital, as well as equal treatment. All these mean an equal treatment when considering the special features of tax systems in the jurisdiction where business is conducted. For this purpose, it is necessary to study these tax systems which become more complex and may result in some inequities either by their regulations, or by their implementation, or by the way in which state control bodies accomplish their duties.

For this purpose, it is important to permanently analyze both legislation and regulations, but also the public policies which influence taxation, from an independent perspective. This includes both those which are in force and those which will be adopted by professional assessment, helping to trace those normative acts or regulations as well as public policies specific to the fiscal area and which have a negative influence on the equal treatment between companies and help identify the best solutions. It is important to keep the principles of the great Scottish economist, politician and philosopher Adam Smith (1723 - 1790); in part II On taxes and the principles of taxation of his work ”The Wealth of Nations”, he sets out four extremely important principles. It is very important if the current tax systems still observe these principles.

Before further analyzing various taxes, it is necessary to remember and acknowledge if *taxation correctness or taxation fairness* considers the advantages of some social classes but also if taxpayers in each country support the state, as far as possible, considering their real possibilities, i.e. in relation with one's income, under the protection of the state they may enjoy. It is also important to determine if *tax certainty* considers factors such as payment period, manner of payment, the amount to be paid, which are simple and easy to find out, both for the taxpayer and any other person. At the same time, it is necessary to analyse if taxpayers' interest (i.e. those with the most significant role in the state politics, social life and economics) is relevant in terms of *easiness of determining taxes* with respect to determining tax form and deadline. At the same time it is also significant to analyse *tax efficiency* which mainly refers to the fact that any tax must be determined and then collected from the taxpayer's account as amounts as little as

[11] *Adrian Ducu Matei, PhD, “Costin C.Kirițescu” National Institute for Economic Research, email: ducumatei@yahoo.com*

possible, maybe a little more than the taxpayer can pay to the public budget; thus phenomena like fraud, tax evasion and unsupervised transactions may occur.

The precision and accuracy of complying with the aforementioned principles, as well as the ability to fulfill a number of requirements, demanded more or less vigilance from all nations. In general, many nations have endeavored, as far as they could, to levy correctly determined taxes, with a high degree of certainty, as favorable as possible for the taxpayers, judging by the maturity date, but also considering the manner of payment, and - in conjunction with the income generated to the state - with costs as low as possible for the taxpayers or population.

These principles may be affected to different degrees in those countries where tax evasion is at high rates, and the authorities' intervention is the way to restore the balance. Fraud and tax evasion create inequities between taxpayers and the most honest of them are most affected, especially when the level of these negative phenomena is very high. Therefore it is important that the state takes a firm, constant stand when fighting with these negative phenomena and endeavors to reduce their scale.

1. Tax evasion and informal economy

After a series of studies and assessments done by international rating agencies, such as Fitch Rating, expansionist fiscal policies will enhance macroeconomic imbalances and will contribute to the emergence of increased vulnerability in public finances.

The expansionism of the fiscal policy started in 2016 in Romania and was also present in 2017; the increase of production recorded led however to a higher degree of sensitivity in public finances.

This can only mean a proper environment favorable for business and competition, effective for combining factors of production. In the context of sensitized public finance, tax evasion and informal economy usually increase and not taking firm measures to diminish them leads to a no longer balanced and equal treatment of taxpayers.

Tax effectiveness plays an important role in assessing a system of taxation; this evaluation is carried out periodically by assessments and research; very useful conclusions for the business environment are drawn, only based on a series of indicators such as: Ease of paying taxes (EPT), the number of annual tax payments (NATP), the number of hours per year for tax payment (NHPYFTP), total tax rate (TTR).

A thorough research on the relation between tax evasion, underground economy and the effectiveness of tax system will emphasize the need for a stronger approach of the negative phenomenon of non-payment of taxes to the public budgets.

Tax evasion may occur in economy either by the way in which fiscal laws and regulations are drafted and adopted and not only, but also as a result using some ways to reduce or conceal the tax basis.

It can be inferred from here that the actors influencing the two ways in which tax evasion spreads may be in the first case those who legislate and regulate as well as some concerned taxpayers; in the second case there are also two categories of participants, i.e. those which carry out controls on how the taxes are determined and collected and those who either run a business or own goods or means which will be taxed.

It is necessary to limit the ability to operate incorrectly; in the first case it is necessary to research, study and analyze laws and regulations, as well as public policies both in force and to be adopted, in order to block the negative influence. In the second case a greater strictness is necessary in checking, by drafting guides and manuals on types of taxes in order to indicate the determination of each type of tax in a uniform manner, by logical diagrams. This should be done based on control tests which should be applied specifically, the legal basis of the control test, the records checked, the description of any deviations, an indication of the possible consequences which may result from failure to comply with the legislation or regulations.

These guides and manuals may be drawn up and disclosed by independent bodies or by the inspection bodies of the State or by the fiscal authority to the public and taxpayers as a proof of transparency in the treatment of taxpayers. This approach can even contribute to limiting possible abuses of the fiscal authority concerning the selection of contributors which are subject to control. Thus, the selection should be based on the assessment of risks and vulnerabilities to tax evasion and informal economy.

In order to assess the main risks for each type of tax, the main vulnerabilities arising from the applicable legislation or regulation and from improper controls and possible consequences of the most significant taxes must be identified by research, studies and investigations on several levels and then their applicability should be extended for all existing categories.

It is necessary to make an inventory of taxes owed to the public budgets (national, regional, local) to start drafting and adopting guides and manuals, followed by research, studies and analyzes and then by estimates and measurements of tax evasion, fiscal fraud and the informal economy to see which of them have the largest share in tax evasion.

Thus, it is very useful to use research, studies, international and reliable national investigation, recognized international and national data bases.

The size of informal economy depends on different elements. The literature highlights specific causes and indicators of the informal economy. Main causes:

Tax burden and the quality of governing: It is widely accepted by the literature that tax burden is one of the most important causes that lead to the proliferation of informality; tax burden is measured by an index of fiscal freedom which includes the individual and corporate income tax, as well as the share of tax burden on GDP. In addition, the paper also includes the government consumption expenditure as a share in the GDP, as it can be expected that the poor quality of the government and a higher tax burden encourage more economic activity to move into the informal sector.

At an institutional level: The World Bank produces a series of governance indicators, in particular: (a) rule of law, (b) control of corruption and (c) government stability. Businesses will understand the cost of operating in formal economy, in countries where the state of law is observed and corruption is reduced, whereas non-observance of law or a high level of corruption would encourage informal economic activity.

Open trade: Trade share in GDP indicates the size of the market and how open the country is to the world. Along with the increase in the economy, it is likely that moving economic activity from the formal sector to the informal one is more difficult to achieve. In addition, as international trade grows, it would be hard to conceal trade from the competent authorities;

Monetary indicators: The persons involved in informal economy usually carry out cash activities. Most of the small economic activities are therefore reflected in the excessive use of cash payments. This indicator is reflected in the monetary aggregate corresponding to the currency outside banks.

Labor force participation rate: After the economic activity and workers move to the informal economy, such workers should no longer appear as part of the labor force in national sampling.

Economic growth: An increased informal economy would be associated with an increased economic activity which will move from the formal economy and would indicate a decline in economic growth.

2. Assessment of tax evasion and informal economy in Romania

Extensive research is carried out at international level in connection with the recent developments concerning the existing methods of estimating informal economy.

When discussing tax evasion and informal economy, the main methodologies used for the measurement of the informal economy are considered, considering their advantages and disadvantages. These approaches can be divided into direct or indirect approaches. The most common direct approaches for the measurement of informal economy are based on studies and samples based on voluntary answers or on fiscal audits and other methods to verify compliance. Indirect approaches have primarily a macro-economic nature. These are partly based on: the discrepancy between national statistics regarding expenditure and revenue; the discrepancy between the official labor force and the real one; the approach of the "consumption of electricity" as discussed by Kauffman and Kaliberda (1996); Feige's approach on "monetary transactions"(1979); and Cagan's "currency demand" approach (1958) or others; and "Multiple Indicators, Multiple Causes" (MIMIC)

Since there is a large amount of literature on the various methods available for the measurement of the underground economy, no detailed presentation thereof is discussed here, nor the issues using these methods (including the MIMIC method). For a more detailed study see the literature, among which the important contributions of Schneider (2010), Schneider, Buehn and Montenegru (2010), Schneider (2010, 2015), Schneider and Williams (2013), Williams and Schneider (2016).

The main methodologies used in general for the evaluation of the underground economy are used for the assessment of the informal economy, emphasizing their advantages and disadvantages. These approaches can be divided into direct or indirect approaches (including those based on models). It is a complex issue and a precise definition of the underground economy is quite difficult to provide, as it constantly develops, adjusting to taxation and regulations changes.

Measuring the size of informal economy is not a simple process. Reality shows that the persons involved in underground activities do everything they can to avoid identification and liability. However, business decision makers and governmental administrators need information, namely the size of the informal economy and tax evasion and about how many people are active in the underground economy, how often activities are carried out and the size of these activities, so that they can take appropriate decisions on the allocation of resources.

Researchers focused on samples consisting of several countries, using a variety of estimation methods to predict and quantify the size of the informal economy. The results show that, for all countries investigated, the added value in the underground economy has reached remarkable large amounts.

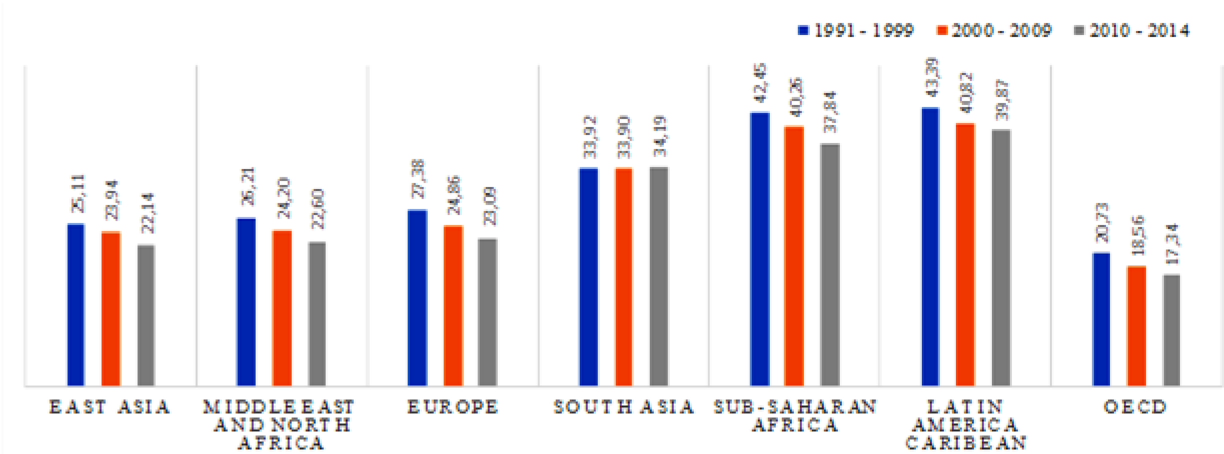
Among the main causes of the existence of underground economy can be listed as follows: legislative, institutional, conjectural and psycho-social causes. They mainly derive from the poor fiscal administration, the inability to penalize non-compliance with regulations, some causes regarding institutional transparency. The high level of taxation, tax regulations may be considered along with them, as they have become too complicated and difficult to interpret. There are mainly five main causes in OECD countries (out of which the first two are the most important): increased taxation, the difficulty of the tax system, rejection of institutions and regulations, the reduction of labor time, the reduction of the level of education.

Not taking measures to reduce informal economy and tax evasion may have serious consequences such as: using resources with other destination than the one officially established, the emergence of an additional offerings of goods and services, the increase of the budget deficit and fewer public investment opportunities, endangering public authority and power of the state, negatively affecting the social system, increase of social insecurity.

In some international assessments (Medina, Schneider, 2017), informal economies continuously decreased from 1991 to 2014, as can be observed in a grouping by region (the average, as a percentage of GDP) divided into three relevant periods, namely 1991-1999, 2000-2009 and 2010-2014, as shown in Figure no. 1 Informal economy on regions, 1991 - 2014.

The smallest underground economy has been noticed in OECD countries, followed by European countries and Eastern Asia, then the Middle East, and North Africa and South Africa countries, and the largest in Sub-Saharan Africa and Latin America and the Caribbean. These results show that informal economy decreased from 1990 until 2015 by 3-4 percentage points.

Figure 1 Informal economy by regions, 1991 – 2014 (average, % GDP



Source: Medina, Schneider 2017

New research on informal economy are published by the International Monetary Fund (IMF)[12] for 158 countries around the world and the period between 1991 - 2015 is an ample one. In this study the strengths and weaknesses of the research methods are highlighted but it also shows a comparison and a critical evaluation of the methods. The average size of the informal economy or underground economy from 158 countries during 1991-2015 is 32,3%. The largest are Zimbabwe with 60.6%, and Bolivia with 62,3% of GDP. The smallest are Austria with 9.9 percent, USA with 9.4% and 9.0% in Switzerland. New methods, in particular the new macro method, the method of Currency Demand Approach (CDA) and the model examined multiple relations consisting mainly in multiples indicators and multiple causes (MIMIC[13]) in an estimate based on the hybrid model are structured, promising approaches from the point of view of econometric, along with some assessments to new micro level. These estimates come close enough to each other to be used for the statistical offices or based on the opinion polls. We have selected several 10 countries which highlight the position occupied by each of them in table no. 1: The effectiveness of the system of taxes and duties, Romania being ranked 122nd of 158 countries. It is ranked after countries such as Bulgaria, The Czech Republic, Estonia, Hungary, Poland and above countries such as Slovakia and Slovenia. The data reveals a high level of tax evasion and underground economy in Romania, which causes difficulties in carrying out business and a lower competitive level.

Table 1: The effectiveness of the system of taxes

No.	Country	ISO	Average	Stand. Dev.	Median	Minimum	Maximum
22	Bulgaria	BGR	30.8	5.5	32.3	22.4	37.7
41	Czech Republic	CZE	17.1	2.7	18.1	12.8	20.7
49	Estonia	EST	28.8	4.3	29.6	22.5	35.5
67	Hungary	HUN	25.2	4.2	24.1	20.4	33.7
84	Latvia	LVA	26.0	4.2	25.9	19.7	32.4
89	Lithuania	LTU	27.7	4.8	26.9	20.2	35.1
119	Poland	POL	26.5	4.6	27.5	19.1	34.5
122	Romania	ROM	30.1	4.2	31.1	22.4	36.0
129	Slovak Republic	SVK	16.6	2.8	17.9	12.5	20.8
130	Slovenia	SVN	26.0	3.2	26.3	19.5	31.4

Source: Source: Medina, Schneider 2017

As a result of research and international studies, the Paying Taxes Report 2017[14] shows that for Romania in 2015 as compared to 2014, the number of hours needed for paying taxes has increased to 161 (from 159), the number of annual payments which must be done by a taxpayer for tax payment were ranked at the same level, i.e. 14 payments, and the share of taxes in the total profit decreased significantly, from 42,0% to 38.4% (with 3.6 pp on account of reducing social contributions paid by the employer from 20,8% to 15,8 %). Thus, a medium-scale company in Romania made 14 tax payments during a year (it is ranked above the European average of 11.8 annual payments, but far below the average at the global level of 25,0 annual payments) and allocated and used 161 hours of specific intellectual effort for the calculation, filling in and submitting tax statements (under the European average of 164 hours, respectively, the average of 251 hours at global level). As for the size of the total taxation rate (the share of taxes and social contributions for the benefit of a medium-sized company), Romania ranked better in 2015 at a level of 38.4%, under the European average of 40,3%, respectively under the average of 40.6% at global level. I have selected for the analysis the same 10 countries from the data presented in the report, as well as in the previous study published by the International Monetary Fund (abbreviated names of the countries are as follows: Estonia = EST; Latvia = LVA; Slovenia = SVN; Lithuania = LTU; Bulgaria = BGR; Slovak Republic = SVK; Poland = POL, Czech Republic = CZE , Hungary= HUN; Romania = ROM) as there is a relation between tax evasion, the underground economy and the effectiveness of the system of taxes to be examined more closely.

---

[12] *The material may be read at the address https://www.imf.org/en/Publications/WP/Issues/2018/01/25/Shadow-Economies-Around-the-World-What-Did-We-Learn-Over-the-Last-20-Years-45583*

[13] *The concept of the MIMIC model is to examine the relationships between a latent variable "size of shadow economy" and observable variables in terms of the relationships among several observable variables by using their information of covariance*

[14] *The report for 2017 is carried out with the last updated data on July 1, 2016 and will relate to the fiscal year 2015 (data relating to the taxation of companies are available after the consolidation of financial statements).*

Table 2: The effectiveness of the system of taxes

	EST	LVA	SVN	LTU	BGR	SVK	POL	CZE	HUN	ROM
	Ease of tax payment (position)									
2012	32	49	54	56	81	102	113	122	124	134
2013	28	40	42	20	89	100	87	119	88	52
2014	30	27	35	49	88	73	58	122	95	55
2015	21(32)	15(26)	39(67)	27 (50)	83(99)	56(72)	47(62)	53(80)	77(89)	50 (43)
	Number of tax payments per year									
2012	7	7	11	11	13	20	18	8	12	39
2013	7	7	11	11	13	20	18	8	11	14
2014	8	7	10	11	14	10	7	8	11	14
2015	8	7	10	11	14	8	7	8	11	14
	The number of hours per year for tax payment									
2012	81	264	286	175	454	207	286	413	277	200
2013	81	193	260	175	454	207	286	413	277	159
2014	81	193	245	171	423	188	271	405	277	159
2015	84	161	245	171	453	192	271	234	277	161
	Total rate of taxation									
2012	49.4	35.9	32.5	43.1	27.7	47.2	41.6	48.1	49.7	42.9
2013	49.3	35.0	32.0	42.6	27.0	48.6	38.7	48.5	48.0	43.2
2014	49.4	35.9	31.0	42.6	27.0	51.2	40.3	50.4	48.4	42.0
2015	48.7	35.9	31.0	42.7	27.0	51.6	40.4	50.0	46.5	38.4

Source: The World Bank

From the perspective of the easiness with which a company may start business processes relating to the reimbursement of VAT, respectively the control necessary for the correction of errors in the income tax return, *Romania is among the countries whose procedures are considered to be carried out with greater difficulty*, but, compared with other Member States of the European Union, it is positioned better than Italy, Bulgaria and Hungary. As a whole, in 2015, Romania has made *some progress on turning the payment of taxes more effective*, being middle ranked among Central and Eastern Europe countries, before the Czech Republic (globally ranked the 53rd), Slovakia(the 56th), Hungary (the 77th), Bulgaria (the 83rd), but behind Latvia (the 15th), Estonia (the 21st), Lithuania (the 27th), Slovenia (the 39th) and Poland (the 47th). In Table no. 2: The effectiveness of the tax system, above, for comparability with the classification for 2012 - 2015 on the ease of tax payment, carried out in accordance with the previous methodology (as per Paying Taxes reports, 2014, 2015 and 2016 editions), the positions for 2015 were determined without taking into account the new sub-index between brackets. A *slight deterioration of Romania's position* within NSM10 in 2015 can be noticed, as compared to 2014, as a result of methodology changes.

Number of tax payments per year is an indicator showing the total number of paid taxes and contributions, the method of payment, the frequency of payments, the frequency of filling in tax statements and the number of the agencies involved in the collection of taxes in the case of companies in their second year of activity. A single payment only is recorded when payment is made electronically, regardless of the frequency of payments.

The number of hours per year for tax payment is an indicator which shows the time required for the preparation, filing in documents and payment of the main taxes: income tax, social security and labor taxes and other charges.

Total tax rate is an indicator which shows the share of the amounts related to taxes and social securities and compulsory social contributions paid by a company, starting with its second year of activity, in the commercial profit.

However, a greater difficulty of procedures is an increase of bureaucracy, which makes the companies and taxpayers choose on a lot of occasions not to waste extra time with statements and in some cases even not to declare a part of their activities, which helps increase tax evasion and underground economy. These difficulties are often quantified in additional costs. For this purpose, it is necessary to permanently analyze laws and regulations, as well as public policies which contribute to the growth of tax evasion and underground economy. The analysis must be carried out on types of taxes and following these investigations to establish guides on types of taxes, which shall detail well enough the steps that must be followed in order to achieve correct and effective taxation in terms of a lower number of payments, in the number of hours per year for the payment of taxes. Ways for reducing tax payment in time, for periods of minimum 5 years based on estimates and projections, of total tax rate, must also be indicated for each tax.

Conclusions and suggestions

In conclusion, drafting guides and textbooks on types of taxes and publishing on the internet pages of the central, regional, local tax authority represents an important step in order both to improve transparency in carrying out audits and to educate the taxpayers. I also suggest certain measures which include some useful implications for decision makers, which may contribute to the reduction of tax evasion and underground economy:

- One should keep in mind that major reductions in rates of taxation will not reduce substantially the underground economy, but might be able to stabilize it;

- The marginal rates of taxation are more relevant for the work decisions of human economy than for the average rates of taxation and replacing direct taxes with the indirect taxes is unlikely to contribute to the improvement of the tax system efficiency;

- More frequent fiscal audits based on guides and control manuals and more severe penalties for tax evasion can reduce the size of the informal economy;

- Governmental decision makers should focus on the legalization of certain underground economic activities, for example by liberalization of labor market;

- Regulations liberalizing reforms and making the economy more competitive reduce incentives for corruption and encourage firms to move from the underground economy to the official one. The governmental decision makers should focus on the rule of law and on the strict application of a minimum set of needed rules, instead on the increase of the number of regulations.

Bibliography

Abdih, Y. and Medina, L. (2013), Measuring the Informal Economy in the Caucasus and Central Asia, International Monetary Fund, WP/13/137.

Breusch, V. (2016), Estimating the Underground Economy using MIMIC models, Journal of Tax Administration, Vol. 2, No. 1.

Boeschoten, W.C. and M.M.G. Fase (1984), The Volume of Payments and the Informal Economy in the Netherlands 1965–1982. M. Nijhoff, Dordrecht.

Cagan, P. (1958), The demand for currency relative to the total money supply, Journal of Political Economy, 66, pp. 302–328.

Feige, E. (1979), How Big is the Irregular Economy?, Challenge, 22(1).

Kaufmann, D. and A. Kaliberda (1996), Integrating the unofficial economy into the dynamics of post socialist economies: a framework of analyses and evidence, in: Kaminski, B. (ed.), Economic Transition in Russia and the New States of Eurasia. M.E. Sharpe, London, pp. 81– 120.

Medina, L. and F. Schneider, 2017, „Shadow Economies Around the World: New Results for 143 Countries Over 1996–2014", Discussion Paper, Department of Economics, University of Linz, Linz, Austria.

Medina, L., Schneider F., 2018, „Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?" Materialul se poate consulta la adresa https://www.imf.org/en/Publications/WP/Issues/2018/01/25/Shadow-Economies-Around-the-World-What-Did-We-Learn-Over-the-Last-20-Years-45583

Schneider, F., Buehn, A., & Montenegro, C. E. (2010). New Estimates for the Shadow Economies all over the World. International Economic Journal, 24(4), 443–461.

Schneider, F. and C.C. Willams (2013), The Shadow Economy, IEA, London.

Schneider, F. (2015), Schattenwirtschaft und Schattenarbeitsmarkt: Die Entwicklungen der vergangenen 20 Jahre, Perspektiven der Wirtschaftspolitik, 16/1, pp. 3–25.

Williams, C. C. and Schneider, F. (2016). Measuring the Global Shadow Economy The Prevalence of Informal Work and Labour. Edward Elgar Publishing, UK.