

# THE UNDERGROUND ECONOMY, THE CORRUPTION . A WAY OF MANIFESTING THE FISCAL EVASION

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*Fiscal evasion is mainly found within the underground economy, came to the specialists' attention within the 1960s, moment in which it took a great extent. The main cause which leads to activities within the underground economy is represented by the increase of direct taxes, which has the largest influence, followed by the intensity of the regulations and the complexity of the fiscal system. The imposed taxes determine more and more countries to act within the underground economy, as long as there is not a proper offer of public goods and infrastructure. In his study, Vito Tanzi indicated as the main cause of the underground economy the level of taxes. (Tanzi, 1983:11-15) He adds the instability of the legislative framework, legislative restrictions imposed within certain states, corruption and bureaucracy. Corruption and the activities specific to the underground economy are realities all the states confront with. Gathering information about the dimensions of corruption and the connection with the underground economy proves to be a task which is impossible to achieve, because all the people involved within these mechanisms prefer not to be identified. Even if the underground economy and corruption are considered as being twins, the questions which appear are: who needs them and who fights against them? Theoretically speaking, corruption and the underground economy can be complementary or substitutable. The anticorruption efforts have to focus on a real reform of the administrative system, whereas the citizen's perception on corruption is mainly based on his personal experiences in direct connection with the state institutions. Both the public sector as well as the private sector should become more responsible, so that the public institutions to be able to carry out their obligations under integrity conditions and without external pressure or implication. Corruption attracts the economic agents to the underground economy, which leads to a reduction of taxes collected by the state, finally materialized in the increase of the fiscal burden for a less and less number of tax payers.*

**Key words:** fiscal evasion, underground economy, corruption, taxes, fraud .

**J.E.L. classification:** G0, G15, G33, H26, H3

## 1. Introduction

The difficulty to define the underground economy, generated by the diversity of the activities it combines, the fact that it varies according to the particularities in space and time, specific to this type of economy, determined a multitude of definitions within the speciality literature. According to the definition adopted by the countries within the European Union, **the activities** which refer to the underground economy's field of activity are classified into:

**-undeclared legal productive activities** (black economy), including activities which are not recorded at the state's level through the national accounting system (domestic activities, voluntary work, activities for the community's benefit etc.) and those which are not declared within the financial administration (fraud and fiscal evasion, illicit work etc.);

**-undeclared illicit (illegal) productive activities** which produce goods and services (drugs production and trade, traffic in firearms etc.).

Lippert and Walker make another classification of the activities assimilated to the concept of underground economy, based on the monetary criterion and the legality of the respective activities. Within the developed countries, the undeclared legal activities, in order to avoid payment of fiscal obligations, represent the most important part of the underground economy, whilst within the developing countries, due to the fact that auto-consumption is very powerful and the possibilities to statistically record all the activities are reduced, the production which is

not recorded conventionally is very important, often exceeding the official economy. Among the *possible causes* of the underground economy there are:

***- fiscal pressure exercised by the direct and indirect taxes;***

The empiric results of the influence of tax growth on the underground economy are emphasized in Schneider(Schneider1994:137-152) and Johnson(Johnson,Kaufmann 1998:387-392), Kaufmann and Zoido-Lobaton (Schneider 1986:643-668)]researches, who have found an evident statistic connection with regard to this matter. This strong influence of direct and indirect taxes on the underground economy is proven in the case of Austria and Scandinavian Countries. Similar results were discovered by Schneider in 1986 for the Scandinavian Countries (Denmark, Norway and Sweden).(Jonson,Kaufmann,1998)

***- intensity of the regulations;***

Intensity of the regulations is another important factor which reduces the freedom to choose of the individuals involved within the official economy. We may include regulations regarding labour market, commercial barriers and restrictions within labour work for foreigner. Johnson, Kaufmann and Zoido-Lobaton have empirically proven the influence of the regulations within the labour market on the underground economy, their impact being analysed in the case of Germany. Generally, regulations lead to substantial increase of the work force costs within the official economy. But, when most of these costs are transferred to the employees, an orientation towards the underground economy takes place, where they may be avoided. The analysis carried out in order to support Johnson, Kaufmann and Shleifer's model - which stipulated that the countries with a higher intensity of the regulations tend to have a higher weight of the underground economy in the GDP - is found in their empiric studies.(J,K.,S.,1997)The conclusion is that the intensity of the regulations is the key factor which influences negatively the companies and the population, and not the general legislative framework. In this context, the governments have to focus on the improvement of the laws and not on the increase of their number.

***-public services.***

The increase of the underground economy's dimensions may lead to the reduction of the budgetary incomes, which in its turn leads to the decrease of the goods and public services' quality and quantity. It may also lead to an increase of the tax rate for the economic agents and the population within the official sector, which combined with a deterioration of the public goods' quality (for example the public infrastructure)and administration's quality, determines a strong orientation towards the underground economy. Johnson, Kaufmann and Zoido-Lobaton (Johnson,,Zoido,1998)present a model of these relationships.The study shows that the underground economies of small dimensions appear within the countries with incomes from higher taxes, if these are obtained by smaller tax rates, regulations and reduced restrictions.The countries with a more restrictive legislative framework, which are financed by incomes from taxes, also have small dimension underground economies. Transition countries have higher levels of regulation, taxes from large official activities and a wide legislative framework and, consequently,a higher level of the underground economy.

## **2.The underground economy and the level of taxation**

It is found that the 20-25 percents which represent the increase of taxation in the European states within the last decades were annihilated by the 12 percents of the GDP in the same countries, representing the percentage of the underground economy within the states member of OECD at the end of the last century. The increase of the taxes imposes, even if not proportionally in all the cases, the increase of prices. This affects everybody, especially the final consumers. This way, the underground economy registers supplementary profits because:

*-it offers cheaper products of lower quality, because by avoiding the taxes, the clandestine producer can ask prices which fraudulently compete with the prices within the real economy;*

*-it attracts new activities to its domain because many tax payers overwhelmed with supplementary taxes, choose the underground economy as an exist option;*

*-it creates the possibility of illegal work, of obtaining different non-taxable incomes.*

Numerous specialists have studied the impact of taxation increase on the level of the underground economy, stipulating different increase figures, as a consequence of increasing the taxation by a percent. For example, the results of a study carried out based on the data regarding the underground economy in the USA show that for the increase by a percent of the marginal rate of the income tax the increase of the underground economy is of 1.4 percents. (Cebula,1997) In another study it is shown that the value of the undeclared incomes increases by 0.05% only, for each increasing percent of the value of the incomes from taxes, drawing up the conclusion that, it is questionable whether the increase of incomes achieved by reducing evasion could be high enough in order to cover the loss generated by tax reduction.( Clotefelter ,1983) With regard to the relationship existing between the level of the pressure of taxation and the one of the underground economy, Norman Loayza, a well-known analyst of the underground economy phenomenon, demonstrates in a recent study for countries within Latin America that in the economies where the pressure of taxation is higher than the optimum one, and the application of regulations has a low level, the increase of the relative dimension of the unofficial sector leads to a reduction of the economic growth.(Dinu,2003) His results indicate the following: for an increase of the underground economy by a percent of the GDP a reduction of GDP by 1.22%.

### **3. Conclusion**

The general conclusion is that the developed countries member of OECD and different Eastern European states maintain a stable balance between the relatively low level of taxes and regulations, adequate mobility of the incomes, corruption control and generally they have a low level of the underground economy. At the opposite pole, there are countries within Latin America and former Soviet Union, which have characteristics which place them in an instable balance: high level of taxes, inadequate regulations, a great weight of activities in the unofficial economy. The decision to choose the underground economy is based on cost-benefit analysis in which the illicit work and fiscal evasion are a lot more attractive because of the slight possibility of being caught.(Iceg Ec,2006) One of the main ***negative effects of the underground economy*** is represented by the way in which the underground economy may affect the fiscal health of a state. There are theories which state that, if the governments were able to control the forms of the underground economy, many of the fiscal issues of the public sector might be reduced.

On the other hand, the underground economy absorbs a part of the labour force dismissed from the official sector and it may compensate the lack of products on the market, thus acting in the direction of balancing the labour market, goods and services market etc. There is an opinion according to which, with the existent taxation and legislation, it is better to carry out a part of the economic activity outside the official market and so get rid of the constraints.(Craiu,2003) There are situations in which the underground economy turns into official economy; they are separated by a fine, artificial, line, formed of regulations and interdictions(Hoanta,2000) Cancelling different restrictions may determine the passage of different illegal activities into the official sector. Poor countries suffer the most due to corruption. The low IPC scores indicate the fact that the public institutions are severely compromised. The government should focus on improving transparency within the financial management, from tax collection to public expenses, as well as on improving the monitoring and control mechanisms. The high scores of the rich countries and territories, mainly from Europe, Eastern Asia and North America, reflect the existence of relatively clean public sectors, based on political stability, solid regulations with regard to conflict of interests and free access to information of public interest, as well as a civil society free to exercise monitoring activities. Despite all these, corruption at high level within the poor countries has an international dimension, which involves the countries situated on the first places

in IPC. In most of the cases the money for bribe comes from the multinational companies within the rich countries of the world. The position of these countries is unacceptable; they consider bribe on the export markets as a legal business strategy. Moreover, the world financial centres have an important role, creating the possibility for the corrupt officials to transfer, hide or invest fortunes illegally obtained. Off-shore financing, for example, played a central role in the misuse of enormous amounts of money from developing countries, such as Nigeria and Philippines; they facilitated violation of the law by the corrupt leaders and poverty of the population. In many cases, pursuit and recovery of the stolen goods are difficult to be carried out due to money laundering by means of different off-shore banks, situated within jurisdictions where the bank secret still represents a general rule. According to the stipulations of the UN Convention against Corruption, the following objectives should be priorities: improvement of the international cooperation and mutual juridical assistance, acceleration of the actions to recover goods and development of the legislative and technical expertise within those countries which request return of the stolen goods. For many states, funds repatriation will mean long and complex processes.

Being a global issue, *the fight against corruption* requires a large range of *measures*.

-Developing countries should use the funds received from donators in order to reinforce the public institutions and thus, to increase the quality of the govern, by using diagnosis studies and development strategies elaborated at the internal level; these countries should include improvement of public integrity and corruption prevention into the poverty reduction programmes.

-Public independency, integrity and liability within the juridical system have to be improved in order to increase its credibility within the poor countries. In order for the justice to operate properly, the juridical procedures should be protected by the influence of the politics. A clean and capable justice is essential in order for the developing countries to be able to process requests of mutual juridical assistance in connection with the recovery of stolen goods

-According to the stipulations of the UN Convention against Corruption, the governments have to introduce measures against money laundering to determine disappearance of those places where the stolen goods are stored. The large bank centres should focus on development of certain rapid procedures to identify, freeze and repatriate the funds and goods obtained from corruption activities. It is essential to have clear stipulations regarding the custody exercised by the third parties on funds involved in disputes.

-Rich countries have to proceed to a stricter regulation of their own financial centres. Some of the important measures these countries can take with regard to corruption facilitators are: a greater attention given to the role of the trusts, better knowledge of the real beneficiaries and intensification of the provisions regarding money laundering.

Corruption Perception Index launched by Transparency International uses a scale from zero to ten, where zero indicates a high level of corruption, and ten indicates a low level of corruption. With regard to Romania, Corruption Perception Index was of **6.7 points** in 2011, increasing by 0.6 points compared to the previous year. The perception of the public regarding the corruption within the business environment, mass-media and civil society is also worrying, the three elements registering high values. Despite all these, Romania continues to be perceived as the country with the highest level of corruption within the European Union.

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