

Tax Evasion or Tax Optimization: is there any Narrow Path between the Two?

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SUMMARY

There are three disadvantages of the taxation system in Hungary: the explicit and implicit taxes on work income, its transparency and the long-term predictability of tax regulation, and the extent of tax evasion. Minimizing tax evasion has always been a significant task in defending a country's budget-based income. Besides the loss of revenue, tax-avoidance also deforms the effects of the tax system's redistribution, simply because it causes an unintended redistribution between those who pay and those who avoid taxes. Discovering the causes and repairing the tax morals are only possible after a thorough 'diagnosis'. In the present phase of the research, the different forms of tax evasion are dealt with.

Keywords: tax evasion, tax wedge, competitiveness, tax regulation, tax reform, tax morals

Journal of Economic Literature (JEL) code: H260

INTRODUCTION

In Hungary, regulations about not letting the moral risks grow could be one – if not the only – solution for breaking out of the long-existing (economic) stagflation. The Department of Economics of the University of Miskolc (DE-MU), in collaboration with the National Tax and Duty Office (NTDO), aims at researching the possible causes and forms of tax evasion, ways of repairing the tax morals, and the formation of the present opinions on the NTDO as an organization. This article summarizes the present state of the research.

Minimizing tax evasion has always been a significant task in defending the budget-based income of a nation. Colloquially, the two concepts mentioned above in the title – tax evasion and tax optimization – are often used interchangeably. Tax evasion clearly means an illegal activity, while tax optimization functions within legal frameworks. Based on an example of an enterprise, hiding and not providing tax declaration of the actually acquired income is tax evasion (or simply tax avoidance¹). However, presenting the same income as capital income (instead of work-income) can be considered tax-optimization² (Scharle et al., 2010).

OPTIMUM TAXATION

Based on tax theories and empirical results, there are three disadvantages of the taxation system in Hungary: the explicit and implicit taxes on work income (especially the different social allowances), the transparency and long-term predictability of tax regulation and the extent of tax avoidance. Merely reconstructing the present tax system is not enough for economic growth, but tax reform can strengthen the positive effects achieved in other areas. The financial crisis puts a burden on such reform ideas, but on the other side it forces/encourages the reconstruction of Hungarian economic regulations (Elek & Scharle, 2008).

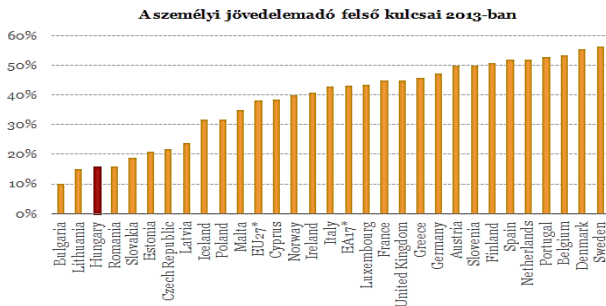
Taxes Imposed on Work

Comparison reports by international organizations state that the taxes imposed on work in Hungary are too high, despite the significant lowering of the income tax rate (Scharle et al., 2010). This is in fact also the most dominant barrier to economic growth. As a result of tax regulations, the proportion of work taxes (within the GDP) dropped; however, from the global investment

¹ *In present study, considering that the two concepts (tax avoidance as part of tax evasion) are the same from a budgetary deficit point of view, they will be used interchangeably.*

² *This is particularly emphasized in tax systems where the two types of income fall under different taxation methods (i.e. capital income has a lower tax proportion than work income).*

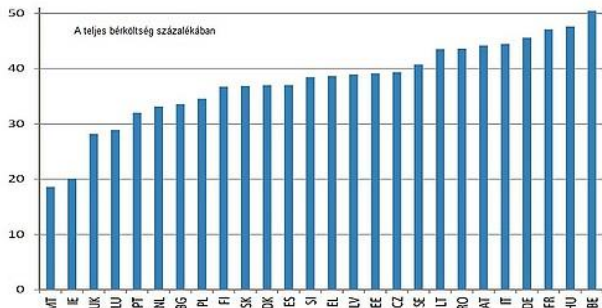
point of view, it remained high in comparison to the regional competitors. The explanation for this ambivalence is that in the last few years (as a result of the global crisis), the European countries also lowered the taxes on work in order to keep up a normal level of purchasing and consumption. The core process is well-presented by the tax wedge: the 55% tax wedge in the years before 2010, due to the 16% flat-rate personal income tax, dropped to 49% by 2013. Despite this 6 % drop, our position has not changed due to strong tax competition. Figure 1 & 2 gives an indication of the situation described above.



Forrás: Eurostat, Portfolio.hu

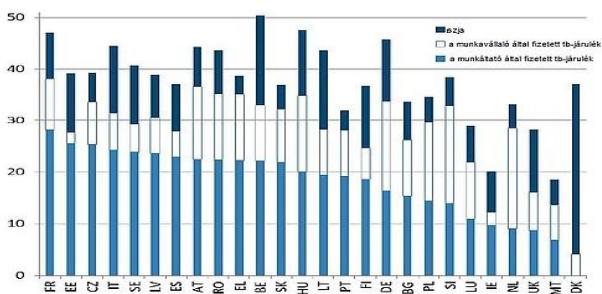
Source: Eurostat, Portfolio.hu

Figure 1. The upper tax bracket of the personal income tax in 2013



Source: Eurostat, Portfolio.hu

Figure 2. Taxes imposed on work in proportion to the full income in %, 2013



Source: Eurostat, Portfolio.hu

Figure 3. Percentage indication of taxes imposed on work (dark blue: personal income tax, white: the social insurance paid by the employee, light blue: social insurance paid by the employer)

Among the EU countries, Hungary occupies the second place after Belgium in the tax wedge proportion list. This position was also typical in the last decade. Therefore, as lowering the tax rate does not seem to help in the country's competitiveness, further lowering proposals should be considered carefully. Figure 3 indicates in which areas potential lowering can occur.

In Hungary, the general tax level per income, in the form of personal income tax and social insurances paid by the employer and employee is higher than the EU average. Consequently, it is a question of political values, economic rationality and fiscal force, by which figure (employer or employee), in which area (tax or contribution), and to what extent taxes imposed on work can be lowered. Obviously, further research is required on which tax types should be enhanced and which investments from the budget should be cut down on in order to counterbalance this process.³

Tax Regulation

Besides the rate of taxes, the lack of the tax system's transparency and predictability poses the largest threat to the country's competitiveness and judgement about its business environment quality. The administrative burdens connected with taxation and the effect of the different legal regulations on the economic figures also belong to this dilemma.

The main characteristic of the Hungarian tax system is its complexity and ever-changing nature (Kátay, 2009). According to theoretical models and empirical research, the unpredictability of the tax system reduces the volume of investment. In general, uncertainty lowers the future value of the income of enterprises. Great uncertainty, nevertheless, postpones the decision about irreversible investments. The most significant source of uncertainty is the (lack of) authenticity of the economic-political steps. The investor should consider in advance whether a given reform is durable enough or not. In case of an economic-political step with questionable authenticity, the waiting time is prolonged, and obviously, investments are postponed. A general feature in decision-making observed in ex-socialist countries is that the stability and predictability of the incentives is far more important than the mere proportion of the incentives (Bélyácz, 2009).

Besides their real function, legal regulations and their changes always have an unintended negative effect on society. The cost of tax administration is an example of this. The main question is: what costs do the tax imposition; its collection and its verification carry in themselves? On the one hand, they usually emerge in the public sphere in the form of direct costs of the tax-collection and verification institutions. On the other hand, they emerge in households and enterprises. In these last two cases, the most notable loss of costs (which can be

³ The research of this essential problem is not part of the present study.

neglected on a social level) is the costs of the actual payment of taxes and the cost of fines (Deloitte, 2009). From a social point of view, further costs on a national level are also significant to mention. One part of them is the costs of investment and education connected to obeying the tax regulations; another part is the costs of registration and the continuous declaration. These emerging costs are not necessarily correlated with the income generated by the present type of tax; they rather show a connection to the frequently changing, complex and often ambiguous legal regulations⁴ (Barr, 2004).

The sustainability of a tax reform largely depends on the reactions of the entrepreneurs. If an economic-political step is not credible and thus the enterprises do not respond, without the intended prosperity (as a self-fulfilling prophecy), the government is forced to withdraw the reform ideas. Another typical example of the effect of taxes is when the various tax- and subsidy elements change the behaviour of the economic figures. For instance, when the tax imposed on work keeps the employee from activities on the labour market; when the enhancement of the work costs lowers the labour demand of enterprises; when the interest tax influences savings; or when the corporate tax cuts down on the investments of enterprises. These examples are of essential value and influence – although to various extents – the income and expenditures of public finance (Brys, 2010). For now, it is sufficient to be able to recognize the phenomenon; later in the article it will be differentially examined.

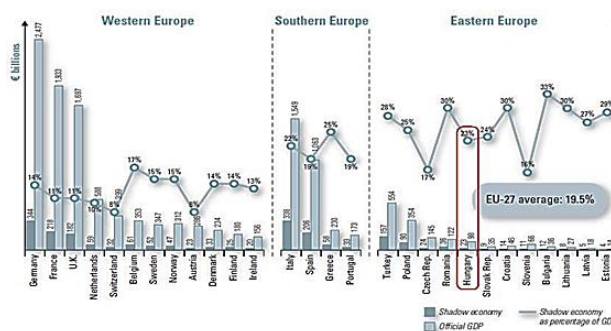
Tax Avoidance

In the present phase of the research the different forms of tax avoidance are dealt with. Discovering the causes and repairing the tax morals are only possible after a thorough ‘diagnosis’. Besides the loss of revenue, tax avoidance also deforms the effects of the tax system’s redistribution, simply because it causes an unintended redistribution between those who pay and those who avoid taxes. It also affects the economy, because nowadays in several industrial branches the avoidance of taxes is leading pricing practices and creating employee expectations. Therefore, those who do pay taxes have to face a vast competitive disadvantage, while tax-avoiding enterprises gain an unrightfully high level of competitive advantage. A further negative consequence is that the tax avoiding possibilities (without the tax avoidance) in fact lead investments towards less profitable activities. Nevertheless, if the tax system makes other economic activities impossible, then from a social welfare point of view tax evasion and the continuation of the present activity could be seen as advantageous. The tools of legal inspection cannot always catch up with the tax avoiding

techniques, so these inspections often reach individuals who do fulfil their taxation responsibilities. As a consequence, the moral tension is growing in taxing processes, which turns even the regularly taxing individual towards tax avoidance (Fortin et al., 2007).

Based on recent estimations of the OECD about the shadow economy, tax avoidance can be seen as a general characteristic in Hungary. The extent of the problem is indicated in Figure 4, showing that the untaxed incomes are equal to 23% of the GDP. The tax effect of this is 2 trillion HUF.

The shadow economy in relation to total GDP



Source: Eurostat, Portfolio.hu

Figure 4. The shadow economy in relation to total GDP 2012

In view of the Hungarian budgetary data, it becomes evident that if by the reparation of the tax morals, structural reform of the tax system and broadening the rate of tax-payers, the role of the grey economy could be lowered to the EU-average of 19.5%, then it would mean a 1 trillion HUF budgetary income growth for the country.⁵

Possible Causes

In studies about the grey- and black economy and corruption, research question about the causes of tax-avoidance often rises. Obviously, various answers can be found among countries with different taxation cultures.⁶ According to the standard economic view, tax avoidance depends on the rate and inspection of taxes. Inspection, however, has two essential aspects: the risk of being caught red-handed and the rate of the fine (Slemrod & Yitzhaki, 2002).

The inspection of the Tax Authority can only be successful if it has adequate remedies against tax-avoidance. This statement from the economic figures’ point of view is as follows: tax avoidance depends on its relative yield; in other words, what is the degree of ‘savings’ by fraud in proportion to tax paying? A risk-neutral tax payer will be lawful if the degree of tax is lower than that of the expected fine.⁷

⁴ In case of certain environmental product prices, the costs can be in proportion to the budget income, generalized by the tax type.

⁵ Such an amount would obviously in itself compensate for the budgetary deficit.

⁶ This could be a particularly interesting comparative analysis, using cross-cultural elements, which would provide useful information for governments and international companies.

⁷ The expected value of the fine is the probability of being revealed multiplied by the combination of the fine and the taxation responsibility.

An effective counter-act to tax evasion is the enhancement of fines and inspection procedures.

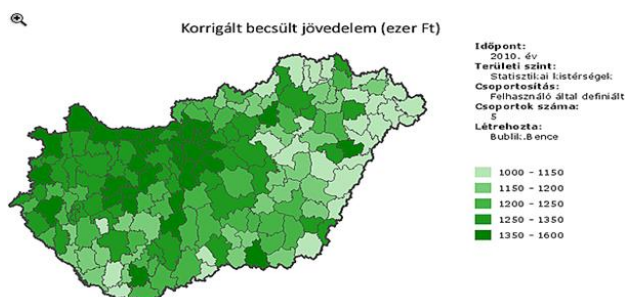
According to applied models, the risk of being unveiled and the degree of the fine is always in inverse ratio to tax avoidance. The degree of the tax, however, does not show correlations with tax avoidance; tax rates can positively or negatively affect tax avoidance, depending on the calculation method of the fine and the speculations about being revealed (Ali et al., 2001). The tendency to pay tax in reality cannot be explained only by the risk of being caught red-handed or by the rate of the fine; as opposed to the forecasts of standard models, more people pay taxes than expected. However, models that take social correlations into consideration make a more accurate estimation. According to these models, social influence can have three resources:

- > The need for conformity, following rules, and belonging to groups
- > The possibility of learning from others
- > The need for justice

Therefore, the following aspects may also influence a tax paying tendency: information about others' tax paying customs, information about tax evasion methods, a well-balanced distribution of tax burden, the quality of governmental policy and the customer-friendly functioning of the tax office (Fortin et al., 2007).

Existing Consequences

The economic split of Hungary is a well-known fact. Numerous studies have dealt with the comparison of the western and eastern regions (e.g. Fazekas et al., 2013). There is no homogeneity on a regional level, but the phenomenon exists, fuelling social and economic problems. Considering it from a tax evasion point of view, there is also a well-defined line between the western and eastern regions; however, having a closer look at the more homogenous micro-regions, interesting patterns can be seen. In Figure 5, the income division of the small regions can be observed. The lighter shades indicate lower average incomes.



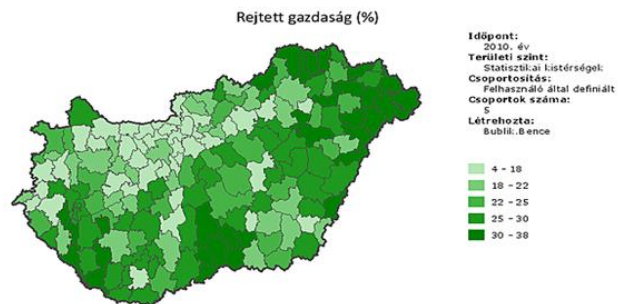
Source: Economic and Regional Studies of the Hungarian Academy of Sciences

Figure 5. Corrected estimated income (in thousand HUF), 2010

⁸ In case of bankruptcy crime it is usually not the NTDO who starts the prosecution, but rather the enterprise itself who initiates the windup.

⁹ In 2012, the financial detectives of the NTDO discovered various economic crimes with a total value of 121 billion HUF. The budgetary fraud (mainly tax fraud) committed at the expense of the Hungarian state was worth 94.86 billion HUF.

North-East Hungary and the Northern Great Plain, along with the southern part of the Great Plain and southern Transdanubian regions, belong to the lower income line. Contrarily, Central Hungary and the northern Transdanubian regions show higher income rates. This not so surprising result for economic experts and laymen alike is worth further analysis, using Figure 6. On this map of the hidden economy, Hungary is also divided into small regions, where the darker areas indicate the presence of hidden or shadow economy.



Source: Economic and Regional Studies of the Hungarian Academy of Sciences

Figure 6. The division of shadow economy by micro regions

This map of Hungary seems to be the reflection of that depicted in Figure 5. Tax avoidance as a response to tax rates thus not only varies among countries or country groups. According to the chart it has become obvious that within a country (belonging to a certain tax culture) the regions can also simultaneously show different tax morals. Discovering the causes of this phenomenon can greatly contribute to the explanation of tax avoidance and the definition of the parameters for enhancing tax morals, which could form the aim of the next phase of the study.

THE MOST FREQUENT ECONOMIC CRIMES

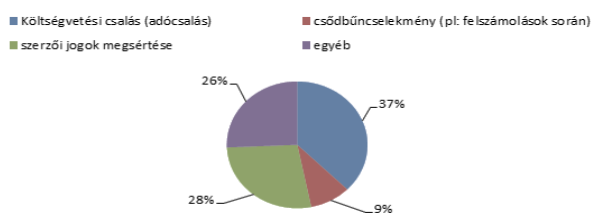
The two most important categories of economic crimes involve budgetary fraud (including tax evasion) and bankruptcy crime in windup processes. Figure 7 gives an indication of the criminal procedures⁸ initiated by the NTDO's Criminal Directory department in the first quarter of 2013.

In total 2756 criminal procedures were initiated for 37.82 billion HUF; blue: budgetary fraud (tax fraud); green: violating copyrights; red: bankruptcy crime (e.g. windup processes); purple: other.

The economic crimes⁹ known up to this point can be broken into 37.4% budgetary fraud, 27.54% violation of copyrights, and 9.4% bankruptcy crime. In all, 77.84% of the 37.82 billion HUF deficit (i.e. 29.44 billion HUF) was caused by crimes belonging to budgetary fraud.

Az Adóhatóság által indított büntetőügyek száma 2013. I. negyedévében

Összesen 2756 indított büntetőeljárás
Összesen 37,82 milliárd Ft. elkövetési érték

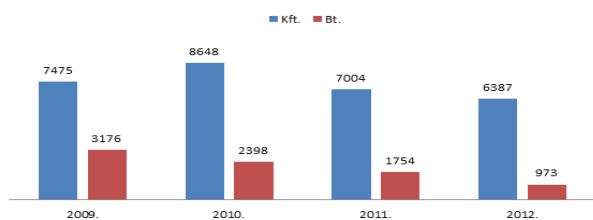


Source: NTDO Criminal Directory

Figure 7. Criminal procedures initiated by the NTDO (1st quarter of 2013)

Budgetary fraud is the most frequent crime in inspection reports. Along with this, the perpetrator is also sued for the falsification of private documents, as the tax declaration is in fact a private document. The most important cause of prosecution within budgetary fraud is connected to the VAT; however, other types of misuse with social insurance and other social allowances cannot be neglected. In windup procedures, the most important cause is indicated as bankruptcy. Figure 8 depicts windup procedures in the last few years.

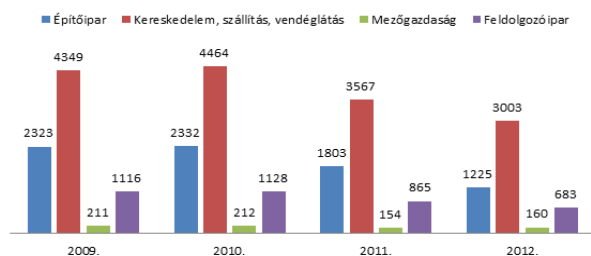
Felszámolási eljárások számának alakulása Magyarországon



Source: NTDO Criminal Directory

Figure 8. Windup procedures in the years 2009-2012. Blue – limited corporations; red – partnerships

Felszámolás alá került cégek főtevékenység szerinti megoszlása



Source: NTDO Criminal Directory

Figure 9. Distribution of main activities of companies undergoing windup procedures, 2009-2012. Light blue – construction; red – trading, hospitality; green – agriculture; purple – processing industry.

As a result of the financial crisis, the tendency for number of companies winding up to continue growing has been disrupted, and, although the numbers are still high, nowadays a reduction can be observed. When researching this tendency of this economic structure, dividing windups into the main activities of these enterprises can be revealing. The results are indicated in Figure 9.

This division according to industrial branches may contribute to the efforts taken to reach the goals of present study.

SUMMARY

In the last period, the fight against tax avoidance has been moving through an essential process, as a result of which a better tax system is about to evolve in Hungary, living up to international standards. It is the foremost task of the NTDO to synchronize, unite and develop the efforts against tax avoidance. Due to professional cooperation, the discovery of tax evasion and other economic crimes is year by year more efficient, contributing to the 'whitening' of the economy. However, it would be an illusion to say that tax avoidance can be completely eradicated. There will always be individuals/enterprises who try to represent income gained from tax fraud as legally obtained. Therefore, emphasis should be put on prevention, based on a tax system and inspection structure that is able to resist tax avoiding intentions. Its realization should occur on an international level as economic crimes know no national bounds. Cooperation with international organizations and living up to the international conventions and protocols are a keystone for effective prevention. Immediately adopting the international practise is especially significant, since tax avoiders have good knowledge of the regulations of different countries. They tend to establish their enterprise in a country where the measures still prove to be weak against their tax-evasive methods. Although the focus of present study lies somewhere else, this could be an interesting research topic.

A tax reform can be considered successful if it enhances economic performance, lowers the administrative burdens around taxation and tax avoidance itself, and if the government's value corresponds with the social justice, as also defined in the tax laws (Sivák, 2012). Namely, the market figures react sensitively to taxation changes. Consequently, the demand and supply of the labour force, the investments, savings and the consumption may also change. In case of unexpected reactions of the economic figures,¹⁰ substantially less or more income from taxes can appear in the revenue. These consequences should not only be the priority of economic politicians who aim at enhancing the competitiveness of the country and keeping up the budgetary balance, but also that of the Hungarian society.

¹⁰ This predictability can be transformed into a highly accurate prognosis with the help of targeted efficiency examinations.

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