Edited by
Michael Pickhardt and Aloys Prinz

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Preface

This volume contributes theoretical and empirical evidence on the shadow economy and on tax evasion. Regarding tax evasion, this volume adds to the literature by evaluating strategies to fight tax evasion and by examining motivations for tax evasion. With respect to the shadow economy, it focuses on the impact of the shadow economy and estimates of its size in Europe. Two additional chapters link the main issues, tax evasion and the shadow economy.

The contributions originate from the international conference 'The Shadow Economy, Tax Evasion and Social Norms', held at the University of Münster, Germany, 23–26 July 2009. This conference brought researchers from 18 nations together to discuss the most recent topics in shadow economy and tax evasion research. Eight papers were chosen to best demonstrate the nature and scope of the volume. They include a chapter from the keynote speaker, Professor James Alm, of Tulane University, USA. The other chapters are written by authors from various European countries, resulting in a truly international volume.

We hope this collection of chapters will stimulate further debate on the issue and in doing so will help to broaden the exchange of ideas. We gratefully acknowledge financial support from the University of Münster and the Münster School of Business and Economics. A special word of thanks must go to our referees for their comments and support, and their ability to meet our deadlines. We are grateful to the anonymous referees of Edward Elgar and to Tina Althoff, Magdalena Mai and Jan Rümenapp for their editorial support.

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PART I

Overview

1. The nature of tax evasion and the shadow economy

Michael Pickhardt and Aloys Prinz

1.1 INTRODUCTION

Issues such as analysing tax evasion and estimating the size and scope of the shadow economy have received increasing interest among politicians, economists and other social scientists during the last three decades. Yet, despite various methodological advances and a growing amount of empirical evidence, even today there are still large areas of interest that have not been touched at all or where scientific research efforts are just in their infancy (see, e.g., Ahumada et al., 2007, 2008; Breusch, 2005a, 2005b; Feld and Larsen, 2005; Hokamp and Pickhardt, 2010). This volume addresses such issues with a view to contributing to a better understanding of the extent and scope of tax evasion, the shadow economy and their interaction.

1.2 TAX EVASION AND THE SHADOW ECONOMY: COMMON ELEMENTS AND DIFFERENCES

The option to earn a higher income seems to be the fundamental motivation for any individual who gets involved in tax evasion or shadow economy activities. The interesting aspect, however, is that this motivational force seems to be independent of the level of income an individual actually earns or may earn without any engagement in either tax evasion or the shadow economy. Therefore we might observe the poor committing social benefit fraud and/or seeking low-skill jobs in the shadow economy and we might observe the rich getting involved in tax evasion or seeking top-level jobs in organized crime or other shadow economy activities. Prominent examples regarding the rich include the Madoff case (USA, organized fraud, 2009) and the Zumwinkel case (Germany, tax evasion, 2008). In this volume, Jürgen G. Backhaus (Chapter 8) offers a detailed analysis of the Madoff case, which allows for a number of interesting insights. This notwithstanding, in general the specific motivational forces that induce agents to get involved in tax evasion or shadow economy activities have not been fully explored (see Kirchler, 2007), so that future research efforts devoted to this area may be particularly rewarding.

A striking difference between tax evasion and shadow economy involvement is the actual or perceived extent of criminal activities. Tax evasion is often regarded as petty crime that may to some extent even be socially acceptable. This is also reflected in the observation that tax evasion is often punished with monetary fines rather than actual imprisonment. In contrast, an engagement in the shadow economy may include profound criminal activities. In fact, with respect to criminal intensity, shadow economy activities may be classified into three different levels. The first is the non-crime level and petty crime level, which includes activities such as neighbourhood support with respect to manual or technical jobs or occasional copyright violations. At this level exchanges are often of a barter type and, therefore, particularly difficult to trace with monetary methods to estimate the size of the shadow economy.

The second level is the criminal level, which includes predominantly black labour activities. Examples may include the local craftsman who offers some of his work without an official bill or the client asking whether prices might be lower without an official bill, part-time jobbers doing some work without being officially registered etc. Most of these activities are handled in cash to avoid being tracked by the authorities and because the amount involved per period is comparatively low at the individual level. Typically, jobs that do not represent people's main occupation fall into this category, so that the people involved are only occasionally or part-time active in the shadow economy. In this volume Bogdan Mróz (Chapter 6) addresses this type of shadow economy activities in Poland.

Finally, the third level is the organized crime level, which may include illegal arms trading, drug dealing, human trafficking, forced prostitution, illegal gambling, blackmailing etc. Black labour also falls into this category, but only if it is due to organized crime activities. Essentially the same is true for organized tax fraud, for example organized VAT evasion via carousel deals. In most of these cases (drug dealing, illegal prostitution etc.), the relevant goods or services are sold in cash at the retail level and since turnovers are usually large and permanent, a money laundering industry is also required (Unger, 2007). This notwithstanding, some of these branches are intrinsically restricted to official bank accounts because these businesses initially appear legal (e.g. organized VAT fraud or Madoff's Ponzi scheme).

Moreover, most of these branches are based on international trade because the goods and services under consideration are usually produced much more cheaply in countries others than those where the bulk of consumption takes place. This international dimension in turn requires a wholesale and retail structure of the business and typically various vertically integrated 'firms' or 'network organizations' would compete for business. Prinz (2005) has analysed the network structure of illegal firms by using network theory of the physics type. He finds that the level of hierarchy of illicit firms is endogenously determined as equilibrium between required profitability and stability, where the latter depends on the strategy of police attacks. Another characteristic of the organized crime level is that most jobs are full time for both the low-skill and the management domain and that these jobs often represent the main occupation for these people.

Of course, this classification is just a rough one with blurred edges, but it is helpful for clarifying the difference from tax evasion. While tax evasion may occur without any involvement in the shadow economy, an engagement in the shadow economy at the crime level or organized crime level almost always leads to tax evasion, including social security evasion, although tax evasion is usually not the primary purpose of the organized criminal activity (except for organized tax evasion). Moreover, activities at the organized crime level often include violent actions and may impose a heavy burden on their victims, whereas tax evasion and activities at the other two crime levels of the shadow economy are typically non-violent.

This notwithstanding, the first two levels may also be used for distinguishing tax evasion. At the non-crime and petty crime level of tax evasion we would typically find actions that are designed to bend the tax law, but not to break it, although the authorities may later declare the scheme unlawful. In addition, occasional underreporting of income or over-reporting of costs belongs to this level. In contrast, at the crime level of tax evasion we would typically find deliberate and permanent activities to evade taxes, although these activities are pursued by individuals and not by organized entities.

The classification is also useful for assessing which of the relevant levels is covered by the available methods for estimating the extent of tax evasion or the size of the shadow economy. For example, currency demand methods are bound to cover only the second and third levels of the shadow economy, but not the first level due to the dominance of barter exchanges at this level. Thus currency demand methods are bound to underestimate the true size of the shadow economy. In contrast, questionnaire survey methods are bound to cover the first and second levels of the shadow economy (or tax evasion), but may not fully cover the third level. Again, this could result in an underestimation of the size of the shadow economy, but the underestimation may differ from the one produced by currency demand methods. Hence, for the same country and period of time, differences in the estimated sizes of the shadow economy should be expected if different methods are employed.

Finally, it is worth noting that the use of the term 'shadow economy' is not universally accepted. Rather, as Kazemier (2006) has noted, there is a variety of terms, such as the underground economy, the black economy, the hidden economy etc. that are used instead of the term shadow economy although all these alternative terms essentially refer to the same phenomenon. Yet, according to Pickhardt and Sardà (2011), the diversity of terms initially emerged because the phenomenon was known under different labels in different languages, so that the different terms simply reflected direct translations into English rather than fundamental differences in definitions. Hence, initially these terms were used in an interchangeable way and alternative definitions emerged only later (e.g. see Schneider and Enste, 2000).

1.3 OVERVIEW OF CHAPTERS

In the following we offer a brief overview concerning the content and major findings of each contribution in this volume.

Part II Tax Evasion

Part II begins with a contribution by James Alm (Chapter 2) on designing alternative strategies to reduce tax evasion. As a leading scholar in the field, Alm provides a comprehensive survey of the most recent results of theoretical, empirical, experimental and agent-based research on tax evasion and tax compliance. Moreover, based on the results of his analysis, he considers three paradigms for tax administration: the traditional 'enforcement paradigm', where the emphasis is on the illegal and criminal aspect of tax evasion and which, therefore, suggests frequent audits and stiff penalties for combating tax evasion; the 'service paradigm', where the role of tax enforcement is recognized, but some emphasis is put on the role of tax administration as a provider of services to taxpayer–citizens; and finally the 'trust paradigm', where the role of ethics in tax compliance behaviour is emphasized. Based on these paradigms Alm suggests a large set of alternative strategies to reduce tax evasion. Note that these three paradigms are firmly linked to the crime level classification we have introduced above. For example, while the 'enforcement paradigm' is strictly necessary to combat tax evasion at the organized crime level, the 'service paradigm' is more appropriate at the crime level and the 'trust paradigm' could play an important role in fighting tax evasion at the petty crime level.

Gloria Alarcón García, Arielle Beyaert and Laura de Pablos, in their contribution on fiscal awareness (Chapter 4), consider a study of female versus male attitudes toward tax evasion in Spain. The authors empirically investigate the impact of gender, culture and knowledge of the tax code on tax evasion. Among other things, they find that societal attitudes have a strong impact on individual decisions, although female decisions are less influenced that way. In addition, the authors find that education and knowledge of the tax code reduce tax evasion and, therefore, they propose appropriate fiscal education campaigns. Besides, it is worth noting that the survey method they use for generating their original data typically covers the first two levels of tax evasion (petty crime level and crime level), but not the third level, where tax evasion is due to organized crime either directly or indirectly.

M. Rosaria Marino and Roberta Zizza (Chapter 3) consider personal income tax evasion in Italy with a particular view on taxpayer type, which is differentiated with respect to gender, age, geographical area and income. Among other things, the authors find that on average about 13.5 per cent of net income is evaded in Italy. Moreover, the authors claim that the highest evasion rates are found for self-employed and entrepreneurs, rentiers and self-employed with a secondary income source from dependent work or pensions.

Part III The Shadow Economy

Philippe Adair (Chapter 5) devotes his contribution to the extent of the shadow economy in various European Union countries (EU-15). In particular, he presents a comprehensive overview and classification of the diverse forms of shadow economy activities that is compatible with the crime level classification proposed above. In addition, he introduces and discusses the different direct and indirect methods employed to measure the size and scope of the shadow economy. The author also performs a number of plausibility tests, for example, by checking whether or not correlations between the estimated size of the shadow economy and other variables such as the tax burden or the extent of self-employment exist among the EU-15. As a result of his findings, Adair proposes a new research agenda and calls for improvements in the methods used for measuring the size and scope of the shadow economy.

Bogdan Mróz (Chapter 6) analyses the petty crime and crime level of the shadow economy in a transition country by considering the case of Poland. He presents an empirical analysis based on survey data that offers some unique insights with respect to the scope of the shadow economy in Poland. For example, he finds that the bulk of employment in the Polish shadow economy takes place in just three branches (Repair 25 per cent, Gardening 25 per cent and Neighbourly services 13 per cent), and that insufficient income is the most important incentive for Polish people to get involved in black labour activities. Moreover, the author explicitly links the shadow economy with the resulting tax evasion and considers economic policy options to fight the shadow economy and tax evasion. To this extent Mróz's contribution is also related to the one by James Alm.

Miroslava Kostova Karaboytcheva and Luis Rubio Andrada (Chapter 7) investigate whether the size of a country's shadow economy has an impact on the country risk indices issued by the large rating agencies. Due to the current financial crisis in some European countries, the work of Kostova Karaboytcheva and Rubio Andrada is of particular interest. The authors use Standard and Poor's index and investigate 28 transition and developing countries and 26 developed countries. Among other things, they find empirical evidence for a relation between the size of the shadow economy and the country risk index for the groups of developing and developed countries. Interestingly, the impact of the shadow economy differs with respect to the country type. Regarding developing countries, the country risk increases with the size of their shadow economy, but for developed countries the impact is reversed: a higher shadow economy seems to improve the country risk index.

Finally, as noted, Jüergen G. Backhaus (Chapter 8) investigates the Madoff case and, therefore, deals with the organized crime level of the shadow economy and indirect tax evasion or tax fraud caused by this organized crime. The author first develops a concept of homogeneity of groups and shows that Madoff's Ponzi scheme essentially relied on these structures to create (undeserved) trust. Backhaus then turns to analysing the law and economics of the Madoff case, which seems to be the biggest organized financial fraud in recorded history. The author comes to the rather surprising result that the Internal Revenue Service (IRS) of the USA was the biggest winner of this fraud. The Madoff case is extraordinary as it consists of a kind of organized fraud that essentially represents some kind of reversed tax fraud. To conceal the fraud involved in his Ponzi scheme, Madoff paid large sums as taxes on profits his scheme never earned.

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