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TAX AVOIDANCE, TAX EVASION, AND THE SHADOW ECONOMY

Shadow economy ("underground economy" or "hidden economy"), in the broadest sense, refers to economic activities that take place outside the official economy and are not declared for tax purposes. Some of the vast areas of shadow economy are "black" labor and tax evasion as well as do-it-yourself activities and neighborly help. The term shadow economy refers to both legal and illegal activities.

The assignment of economic activities to shadow economy varies in the literature. Feige (1990) distinguishes between (1) illegal economy (production of prohibited substances), (2) unreported economy (tax evasion), (3) unrecorded economy (household productions), and (4) informal economy (black labor). Schneider (2000, p. 79) proposes a fourfold table, differentiating between legal and illegal activities as well as monetary and nonmonetary transactions.

The extent and growth of shadow economy can be measured with direct (audits, surveys) and indirect (indicators, simulation models) methods. As shadow economy is hardly directly measured, indicators are often used to estimate shadow activities (Schneider 2011; Schneider and Enste 2000):

- Currency Demand Approach: Changes in cash flow can act as an indicator, as it is assumed that cash payment is common in shadow economy in order to leave no traces.
- Labor market indicators (labor force participation rate or growth rate of the total labor force): If total labor force participation rate is assumed to be constant, a change can act as an indicator of shadow economic activities.
- Discrepancy between national expenditure and income statistics: The gap between income measure of GDP (Gross Domestic Product) and expenditure measure of GDP can be used as an indicator of shadow economic activities.
- Physical inputs (electricity consumption): The growth of shadow economy is calculated as the difference between the growth of electricity consumption and the growth of official GDP (Gross Domestic Product).
- Transaction Approach: It is assumed that there is a constant relation between the volume of transaction and official GDP over time. The GDP in the shadow economy is calculated as the difference between the official GDP and the nominal GDP (which is based on the value of total known transactions in the national economy).

Another method to calculate the growth and extent of the shadow economy is the simulation approach, which explicitly considers multiple causes and multiple effects of shadow economy. Here structural equation models are used to estimate unobservable variables (Kirchler 2007, 16).

The main cause of shadow economy is the rise of the burden of tax liability and social security contributions. It is assumed that a higher tax burden leads to an increase in underground economic activities. Further, unemployment, increasing regulation in the official economy and bureaucratic burden, forced reduction of weekly working hours, earlier retirement, and declining tax morale have to be mentioned as important influential factors (Schneider 2000, 82).

Tax evasion is one of the best investigated areas of shadow economy. Tax evasion refers to the process whereby individuals or companies evade taxes by breaking the law, that is, they illegally pay less tax than the law mandates. Tax evasion can involve acts of omission or commission (failing to report certain assets or deliberately issued false reports) but excludes inadvertent noncompliance resulting from lack of knowledge, memory lapses, or calculation errors.

In contrast, the term tax avoidance describes the process to reduce the amount of tax burden using options within the law. Tax avoidance is not illegal although it is against the spirit of the law. Reduction of tax liability occurs by taking advantages of loopholes in the law.

Erich Kirchler and Barbara Hartl

See also: Fairness; Financial Literacy; Law and Economics, and Social Norms; Norms; Tax Compliance

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TAX COMPLIANCE

Behavioral economics offers a considerable contribution to the understanding of tax compliance and noncompliance. Standard economic analysis suggests that straightforward monetary considerations influence decisions regarding tax compliance. However, many taxpayers comply with their tax obligations even when there is little chance of tax evasion being detected or substantial penalties imposed. Factors that affect taxpayer compliance include a willingness to contribute to the general good, attitudes towards the state and the tax authorities, perceptions of fairness, the roles of individuals in society and accepted norms of behavior, as well as a range of background factors such as age, culture, education, gender, and occupation. While there is no doubt that auditing and penalties are essential, compliance policy may be more effective when it also follows a more behavioral approach.

Tax authorities have long used behavioral techniques to promote compliance. For example, the technique of withholding tax at source, which dates back to the sixteenth century in England, exploits behavioral phenomena now known as the "endowment effect," "*status quo* bias," and "loss aversion." Individuals feel the loss of tax payments less if they are taken before they actually receive their money rather than afterwards. More recently, tax authorities have set out specifically to take advantage of insights generated by behavioral economics. For instance, one initiative led to improvements in the behavior of some taxpayers after they received letters explaining that most people in their area had already paid their taxes. More generally, compliance can be improved by more public education and developing a sense of responsibility towards taxation. More specific communications with individuals can improve their understanding of the tax system and how to meet their obligations. Other particular insights include personalizing language on official documents received by the public so that people realize more easily that taxation is relevant to them, highlighting key messages and prompting taxpayers at key points in the completion of tax forms.

It is also useful to consider what is meant by "compliance." Sometimes the definition is cast in terms of the extent to which taxpayers formally comply with the tax law. It has then been claimed that the degree of noncompliance can be measured by the "tax gap"—the difference between actual revenue and that which would be received if there were 100 percent compliance. However, if taxpayers go to inordinate lengths to reduce their tax liability, it is difficult to see this as "compliance" even if their activities are technically lawful. A further complication is that, as well as raising revenue, taxation is used as an instrument of economic and social policy when the purpose of taxation is often to influence behavior. It may actually be the aim of some taxes that they are avoided. For example, it has been argued that higher taxes on alcoholic drinks and tobacco would reduce the consumption of those products and lead to improvements in the health of the population. Any such changes in behavior would constitute tax avoidance according to narrow definitions, but that would have been the intention. A better definition of compliance would therefore be for taxpayers to behave in accordance with the spirit as well as the letter of the law, and this is best achieved with a behavioral approach to tax compliance.

Simon James

See also: Honesty; Tax Avoidance, Tax Evasion, and the Shadow Economy; Trust

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MORRIS ALTMAN, EDITOR

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