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The theoretical remarks about the shadow economy

Part II

PARTICIPANTS OF THE SHADOW ECONOMIC ACTIVITY

Outline

- 1. The participants of Shadow activity
- 2. The factors of Shadow Economy
- 3. Tax Evasion in Greece – A Case Study
- 4. The structure of the Shadow Economy

Goal of this lecture:

- Defining the participants of Shadow activity
- Analyzing the causes of Shadow economy
- Analyzing the causes of illegal activity in Greece and its consequences
- Considering the parameters that determine the level of tax evasion in an economy
- Considering the solutions of reduction Shadow activity

The shadow economy includes all market-based legal production of goods and services that are deliberately concealed from public authorities for any of the following reasons:

(1) to avoid payment of income, value added or other taxes,

(2) to avoid payment of social security contributions,

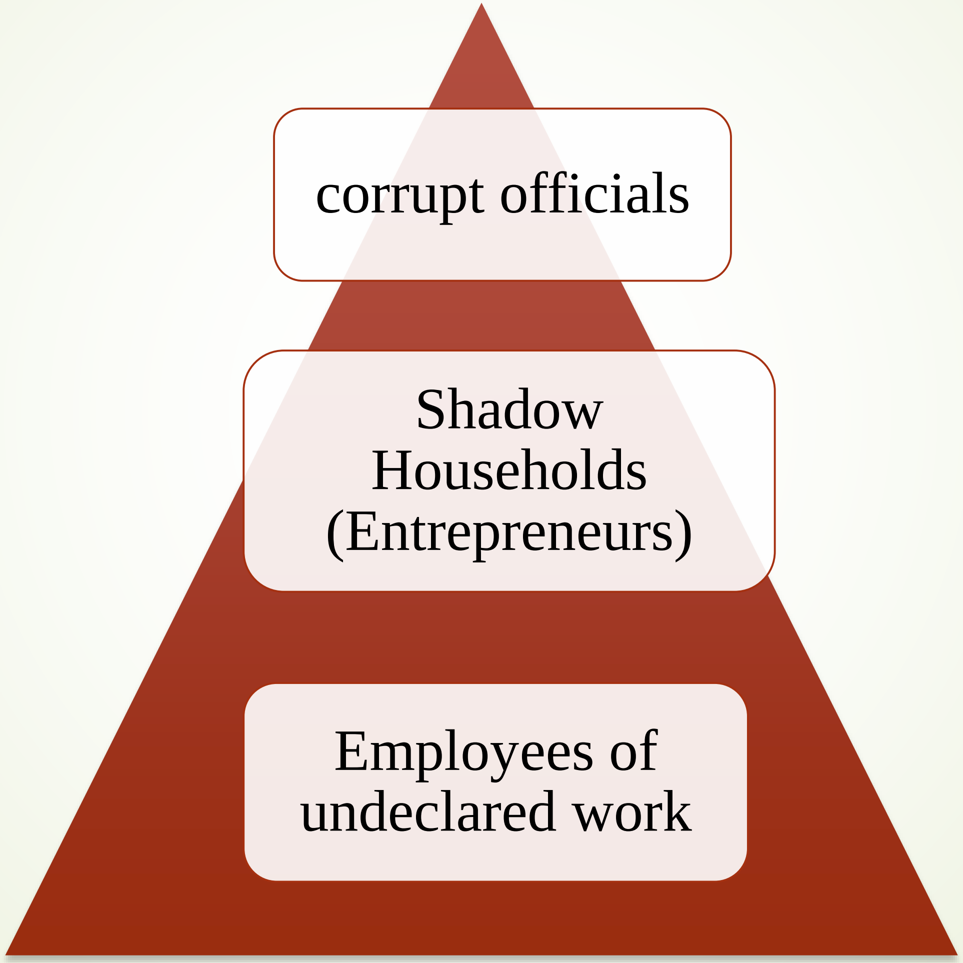
(3) to avoid having to meet certain legal labour market standards, such as minimum wages, maximum working hours, safety standards, etc., and,

(4) to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.

1. The participants of Shadow activity

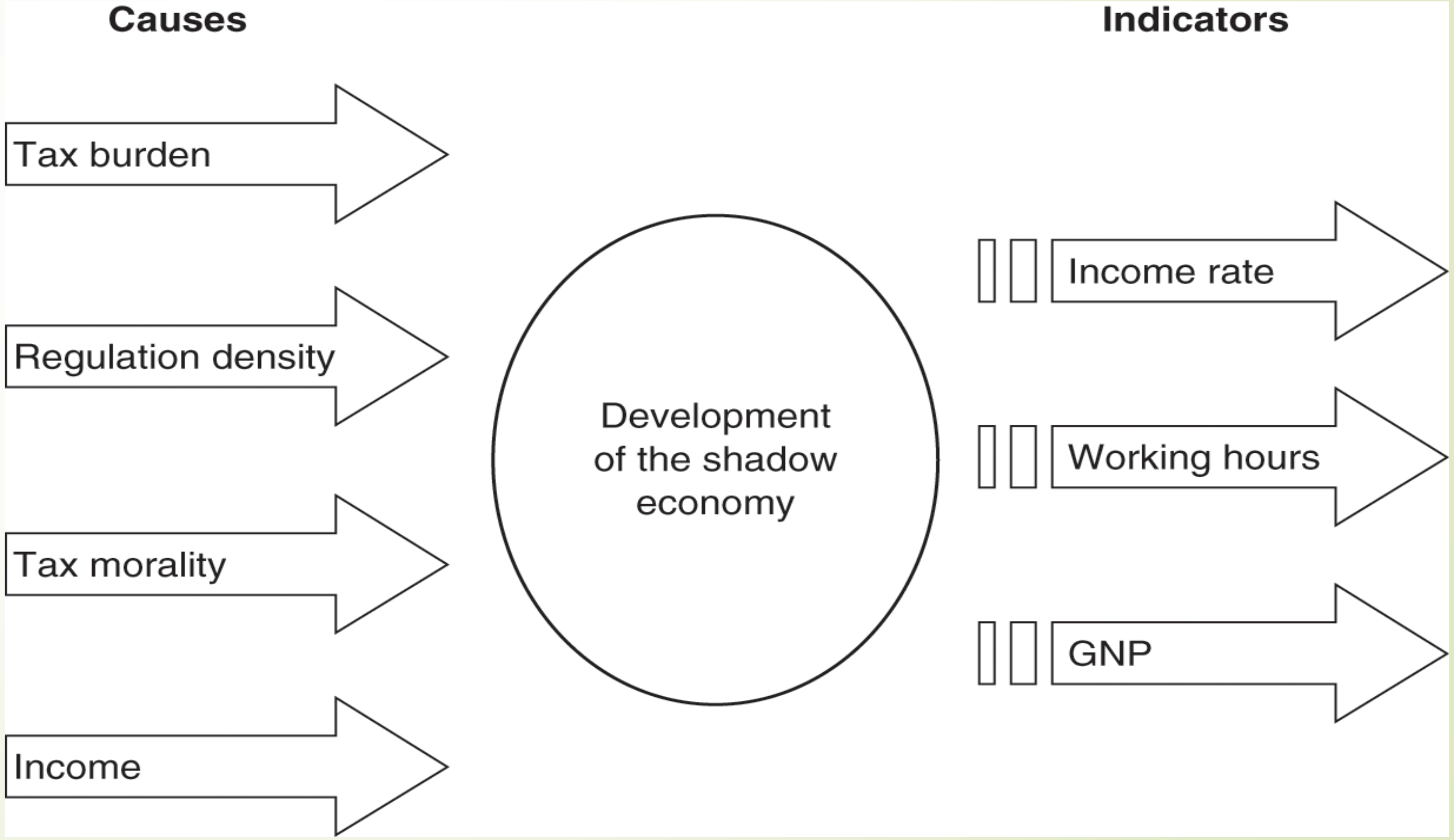
The shadow economy is organized according to the pyramid principle. The shape of the pyramid explains: first, it maintains verticality (the dependence of "below located" on "above-located") interaction of subjects of the shadow economy. Secondly, with a certain percentage of assumptions clearly demonstrates the number of participants in each horizontal segment.

The participants of the shadow economy



Causes of Shadow Economy

- Taxes;
- Regulations;
- Prohibitions;
- Corruption.



1. Taxes

- Income taxes
- Value added taxes
- Excises
- Social security taxes
- Foreign trade taxes
- Taxes on capital transfers

- Tax characteristics:

  Rates

  Administrative aspects:

  (a) efficiency of tax administration

  (b) penalties for tax evasion

  (c) exemptions levels

  (d) cost of compliance

Other aspects:

(a) corrupt tax inspectors

(b) taxpayers morality

(c) quality of public spending

2. REGULATIONS and their effects:
   (a) labor markets
   (b) goods and services markets
   (c) domestic financial markets
   (d) foreign exchange markets

3. PROHIBITIONS and their effects

(a) illegal drugs

(b) illegal gambling

(c) usury lending

(d) production and sale of dangerous

substances and services

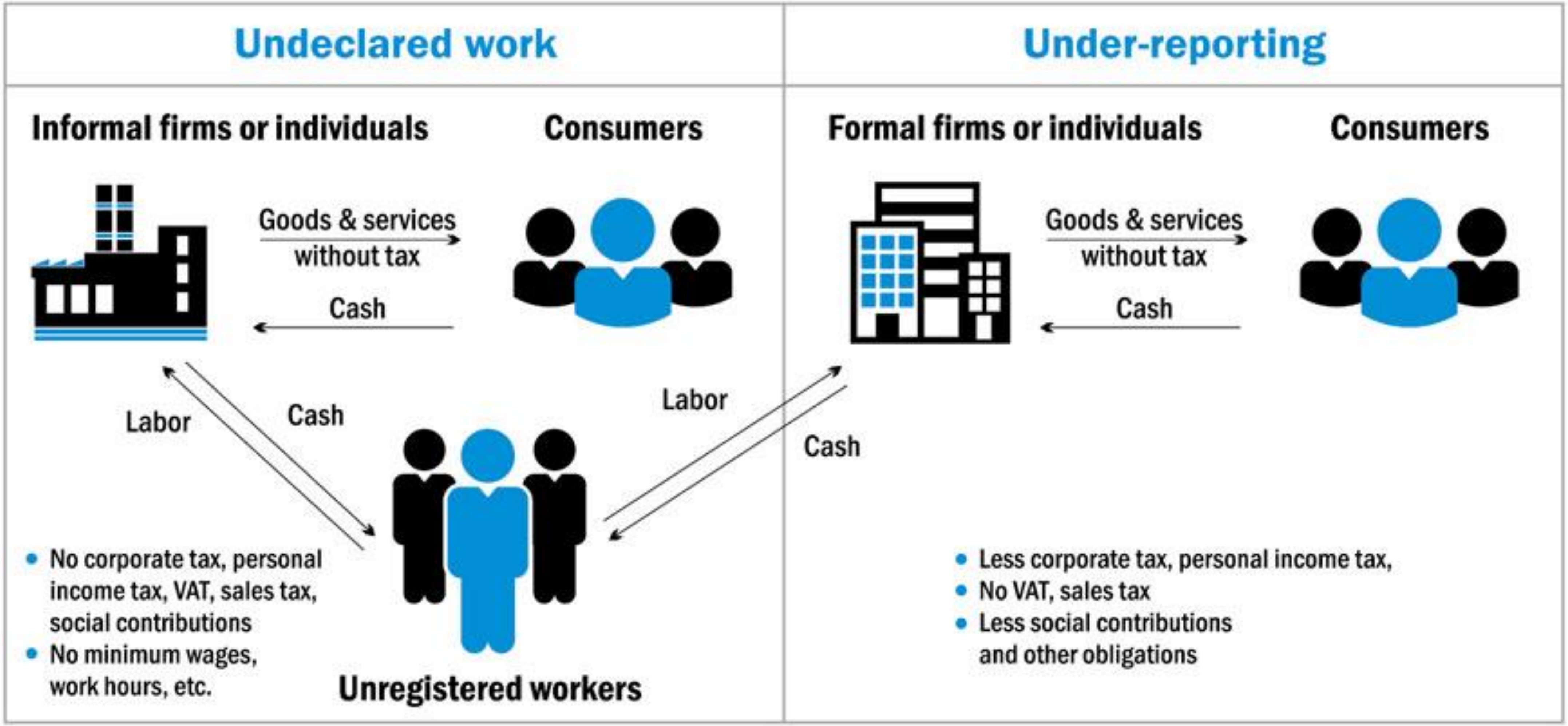
(e) criminal activities

Prohibition and criminal activities raise important question for the definition (and the measurement of the shadow economy). Should incomes obtained from illegal activities (prostitution, sale of illegal drugs and weapons, proceeds from gambling or extortion) be considered parts of shadow economy? They can be very large.

Political corruption

- Political corruption is the use of powers by government officials for illegitimate private gain. An illegal act by an officeholder constitutes political corruption only if the act is directly related to their official duties, is done under of law or involves trading in influence.
- Forms of corruption vary but include bribery, extortion, cronyism, nepotism, parochialism, patronage, influence peddling, graft, and embezzlement. Corruption may facilitate criminal enterprise such as drug trafficking, money laundering, and human trafficking, though is not restricted to these activities. Misuse of government power for other purposes, such as repression of political opponents and general police brutality, is also considered political corruption.
- The activities that constitute illegal corruption differ depending on the country or jurisdiction. For instance, some political funding practices that are legal in one place may be illegal in another. In some cases, government officials have broad or ill-defined powers, which make it difficult to distinguish between legal and illegal actions. Worldwide, bribery alone is estimated to involve over 1 trillion US dollars annually. A state of unrestrained political corruption is known as a kleptocracy, literally meaning "rule by thieves".
- Some forms of corruption – now called "institutional corruption"– are distinguished from bribery and other kinds of obvious personal gain. A similar problem of corruption arises in any institution that depends on financial support from people who have interests that may conflict with the primary purpose of the institution.

Two types of shadow economy and their structures



Source: 'Can Tax Incentives for Electronic Payments Reduce the Shadow Economy?' Myung Jae Sung, Rajul Awasthi and Hyung Chul Lee, World Bank Group, January 2017

2. The factors of Shadow Economy. Tax Evasion

Shadow economy is not only for tax avoidance

- While tax avoidance can be a powerful motivator for keeping economic activity off the books, it is not the only one. For example, farming-related activities are not taxable. However, farmers prefer cash over banking transactions. Cash dealings are simple and ubiquitous. The fact that some services come cheaper if you do not insist on a receipt and pay in cash is a huge added benefit. Where tax avoidance is the motive, shadow economy can arise out of both – unreported work or under-declared income.
- In off-the-book transactions, both the buyer and the seller benefit – the first from lower prices and the latter from lower costs. Untraceable cash transactions are a key to shadow economies.

There are three parameters that determine the level of tax evasion in an economy:

- The level of tax rates.
- The likelihood of detection and punishment.
- The level of fines imposed.

Traceability of transactions

Tax-administration officials would ideally like a complete trail of every transaction that happens in the economy. Unfortunately, without adequate incentives, it is of no interest to almost any other economic player.

GST (goods-and-services tax) is designed to allow linkages to be drawn between buyers and sellers and build an auditable trail of the entire transaction chain. Several loop holes remain. These are as follows:

- A transaction chain that remains completely off the books will continue to remain so and will provide cheaper products to end users – an economic advantage that is hard to beat.
- In B2B transactions (business to business), both the buyer and the seller are required to participate in the audit trail. At least there is a possibility that this would make off-the-book transactions more difficult. In B2C transactions (business to consumer), this is not the case. Here, since the buyer does not disclose his identity, especially for cash transactions, it is easy to suppress the 'value add' component.
- Inputs that are imported can easily be under-invoiced – much as they are currently. This will continue to lead to tax evasion to a large extent.

Reducing shadow economy appears to be a problem of the use of cash (and therefore untraceable) transactions.

Who evades taxes?

- There is a truth that is more or less valid throughout the world: the self-employed and small businesses avoid paying their taxes. From the United States to Germany, and from Italy to Bulgaria, there are small businesses and many freelancers that fail to accurately declare their true income to authorities. Unlike salaried workers or large businesses, they are able to hide their income because the likelihood of detection is very low and the incentive to issue invoices and to declare every cent they make is smaller. This phenomenon has a relatively small impact on tax revenues in most developed countries for one simple reason: The number of very small businesses in those economies is lower, and the self-employed represent a smaller percentage of the workforce. According to studies, the self-employed **hide around 57-58.6% of their income**, while salaried workers are only able to hide about **0.5-1%**.

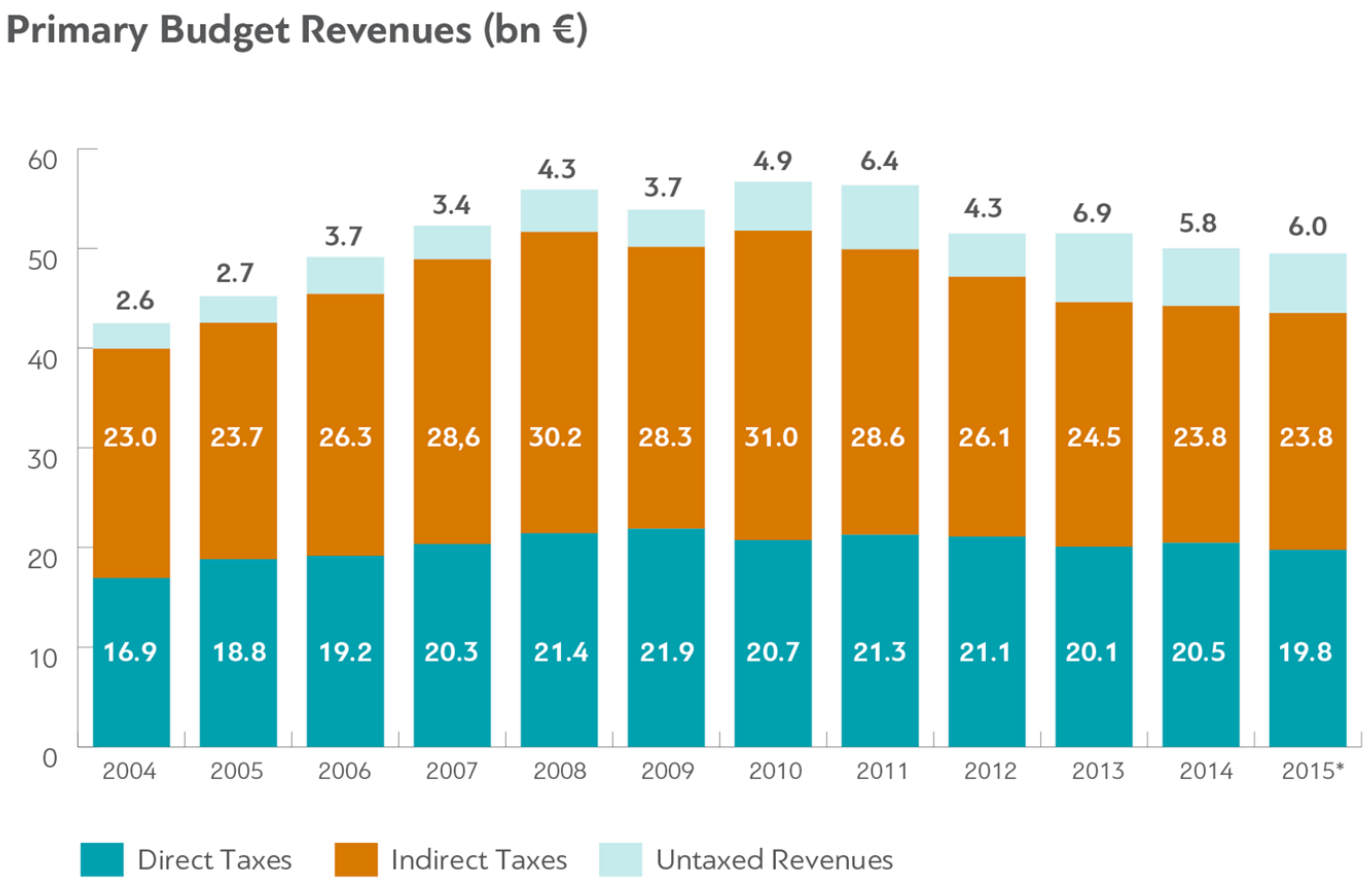
3. Tax Evasion in Greece – A Case Study

- The legendary Supreme Court Justice Oliver Wendell Holmes famously said that taxes "are the price we pay for a civilized society". In a recent diaNEOsis opinion poll, respondents seemed to agree: 85,5% stated that they consider tax evasion to be equivalent to theft. At the same time, however, 35,1% acknowledge that they would readily evade their taxes if the opportunity arose, because 'everyone does it.'
- Tax evasion is one of the most important problems facing any democratic state. It appears to be even more acute in Greece; according to several studies, tax evasion in this country is substantially higher than in other developed countries.

How much tax evasion is really going on?

- The exact scale of tax evasion in Greece is obviously unknown. We can only rely on estimates that calculate its scale based on indicative data but, by definition there is no available information to measure its exact size. We gathered estimates that have been published on all different types of tax fraud, and we arrived at a range that may appear arbitrary to a certain extent, but which does present the closest estimate one can get from data that is available. According to the studies:
- Revenue lost due to **personal income tax evasion** ranges from **1.9% to 4.7%** of annual GDP.
- **An additional 3.5% of GDP** is estimated to be lost due to **Value-Added Tax (VAT) fraud**.
- Losses from **alcohol, tobacco and fuel smuggling** amount to about **0.5% of GDP**.
- For legal entities, revenue lost from tax evasion and tax avoidance is estimated at **around 0.15% of GDP**.
- Consequently, the scale of tax evasion in Greece can be relatively safely estimated at somewhere between **6%** and **9%** of GDP, which amounts to something between **€11**and **€16** billion a year.

Who pays taxes in Greece?

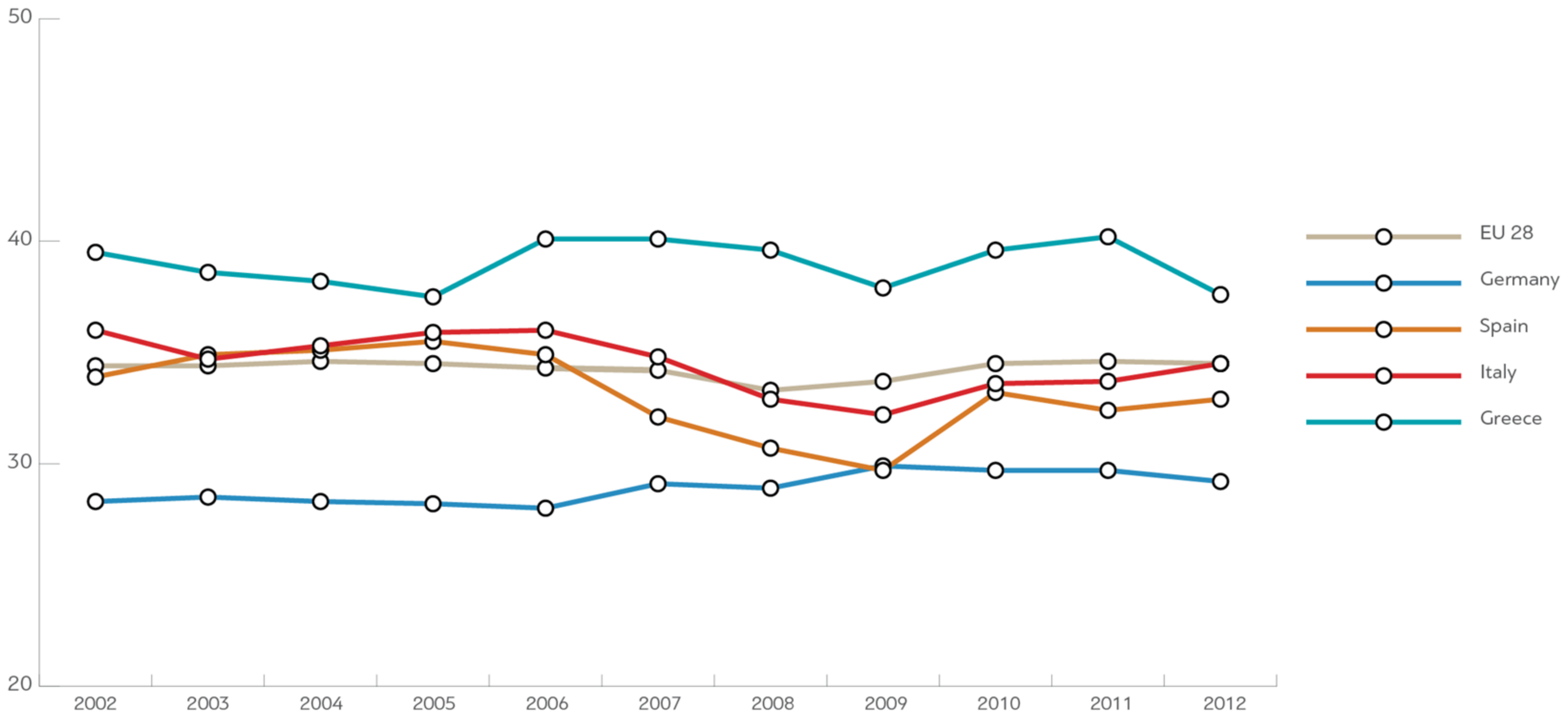


Source: Bank of Greece, Governor's Report

The Greek state's annual revenue hovers around **€50 billion**. This is income that, along with social security payments, insurance revenues, and loans from the European Union together must cover all state expenses. These expenses include the government's operating costs, repayment of the country's loans (around €12 billion a year), pension payments (€28 billion a year), salaries of public employees (around €15 billion a year) and, according to the memoranda that have been signed with Greece’s creditors, significant annual primary surpluses.

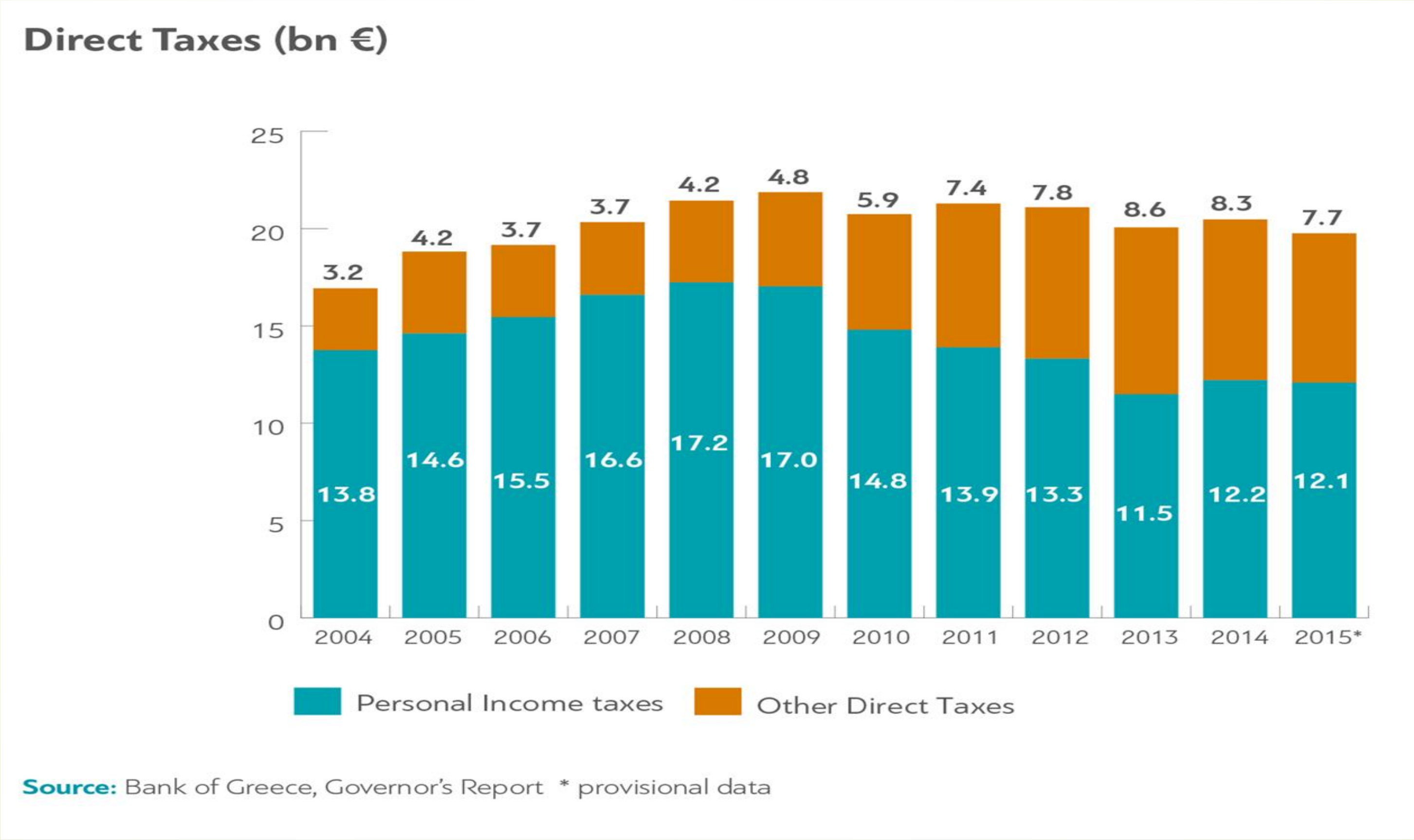
According to the statistic data from 2015, **88% of the state’s revenue** (not including insurance revenue collected by the social security funds) comes **from taxation**. Direct taxes bring in around **€20 billion**, while indirect taxes (VAT, fuel tax, tobacco tax, etc.) bring in around **€24 billion**. This is important. Indirect taxes are considered more ‘unjust’ because they affect the rich and the poor equally. The tax systems of most developed countries rely more on direct taxes for that reason. It is mostly developing or third world countries that rely more on indirect taxes.

Indirect Taxes as a Percentage of Total Taxes



Source: OECD, EU DG Taxation and Customs Union, Eurostat

The country's revenues have been more or less steadily decreasing since 2010, with the largest decrease occurring in indirect tax revenues. There was a rapid decline in income tax collected (from 17.2 billion in 2008 to 12.1 billion in 2015) – which is to be expected, since citizens' incomes have decreased dramatically. At the same time, however, during the crisis, direct tax rates increased, and new direct taxes were also introduced (solidarity tax, Single Property Tax-ENFIA), which softened the state's losses but increased the tax burden for everyone -primarily for the poor.



- But who *is* paying taxes? It appears that, up until the first few years of the crisis, it was generally the rich who were bearing the county's tax burden.
- In Greece in 2011 – the last year for which analytical official data from the GSPW are available – 5.7 million tax returns were filed, a number that has remained more or less constant for the past ten years. Nearly half of them (49%) featured declared incomes below €12,000.**64% of the self-employed declared income below the tax-free limit of €12,000** (they declared a mean income of just €4,300). These taxpayers combined paid **less than 1%** of the total tax revenue. In other words, 2.8 million citizens paid a total of 60 million euros in taxes –€21.4 each. On the other hand, the 8% of taxpayers who declared income above €42,000 -around 400,000 citizens in total- paid **69% of the total personal income taxes**.

		2006	2007	2008	2009	2010	2011
individuals with income <€12,000	Number of Tax Statements (millions)	3.1	3.0	2.9	2.8	2.8	2.8
	% of total	57%	54%	51%	49%	49%	49%
	Income (millions €)	18.404	18.047	17.398	16.479	15.841	15.294
	% of total	23%	21%	19%	17%	16%	16%
	Total tax (millions €)	33	33	23	23	24	60
	% of total	0.5%	0.4%	0.3%	0.3%	0.3%	0.8%
individuals with income from €12,000 to €42,000	Number of Tax Statements (millions)	2.1	2.2	2.4	2.4	2.4	2.4
	% of total	38%	40%	42%	43%	43%	43%
	Income (millions €)	44.084	46.924	50.512	52.568	53.188	53.421
	% of total	55%	55%	54%	54%	53%	55%
	Total tax (millions €)	3.365	3.681	3,606	3.610	3.463	2.241
	% of total	46%	44%	41%	40%	38%	31%
individuals with income >€42,000	Number of Tax Statements (millions)	0.3	0.3	0.4	0.5	0.5	0.4
	% of total	5%	6%	7%	8%	9%	8%
	Income (millions €)	18.070	21.035	25,414	29.014	31.272	29.230
	% of total	22%	24%	27%	30%	31%	30%
	Total tax (millions €)	3.937	4.604	5.123	5.489	5.527	5.036
	% of total	54%	55%	59%	60%	61%	69%

Source: Data on Taxation (2006-2011), Greek Ministry of Finance

The situation is similar when it comes to businesses. **In Greece in 2011, there were 220,000 businesses that declared less than 1.2 million euros annual profit**, and just 901 businesses that declared greater income. The latter category, which makes up 0.4% of Greek businesses, paid **61% of taxes**. Companies from the former category were paying on average **€5,400 a year**, while companies from the latter category were paying **€2.1 million.**

		2006	2007	2008	2009	2010	2011
With profits <€1,200,000	Number of businesses	190,839	202,767	212,115	220,131	223,989	220,137
	% of total	99.5%	99.4%	99.4%	99.4%	99.5%	99.6%
	Taxable income (millions €)	4.817	5.313	6.037	6.006	5.469	5.018
	% of total	33%	31%	31%	36%	36%	39%
	Main and supplementary tax (millions €)	1.403	1.411	1.414	1.400	1.276	1.186
	% of total	32%	30%	30%	34%	35%	39%
With profits >€1,200,000	Number of businesses	969	1,132	1,353	1,232	1,101	901
	% of total	0.5%	0.6%	0.6%	0.6%	0.5%	0.4%
	Taxable income (millions €)	9.610	11.677	13.366	10.704	9.604	7.793
	% of total	67%	69%	69%	64%	64%	61%
	Main and supplementary tax (millions €)	3.044	3.336	3.299	2.658	2.347	1.880
	% of total	68%	70%	70%	66%	65%	61%

Source: Data on Taxation (2006-2011), Greek Ministry of Finance

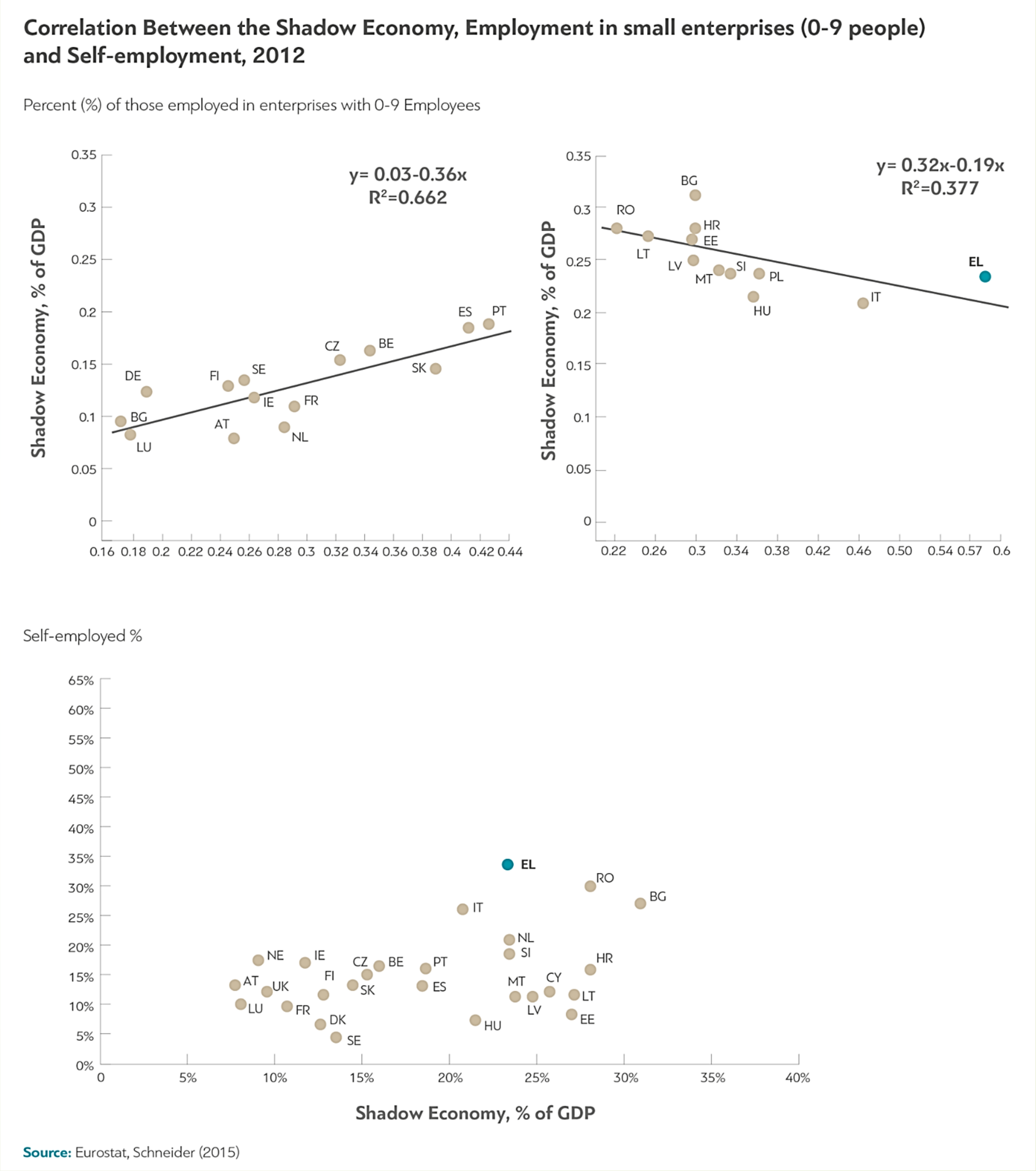
In other words, in 2011, 8% of taxpayers paid 69% of the personal income tax, and 0.4% of businesses paid 61% of legal entity income tax in Greece.
The "rich" were bearing the country’s tax burden. And who are these ‘rich’? In their large majority, they are highly paid salaried workers and large businesses. The great majority of revenue from income taxes came from them. This appears to be changing, however.
According to unofficial data available to diaNEOsis for the 2014 tax year, there has been a dramatic downward shift in income (individuals who declare income above **€42,000** are no longer 8% of total tax payers, but merely **1.6%**) and there has been a strong shift of the tax burden towards the middle class.

Total Declared Revenue per Income Range and Professional Category 2014 (unofficial data)

Range of Income	Total number of taxpayers (in millions €)	% of the total number of taxpayers	Total declared income (in billions €)	% of total revenue	Total tax (in billions €)	% of total tax
(0 - 12,000]	5.06	68.9%	22.97	31.1%	0.89	11%
(12,000 - 42,000]	2.16	29.5%	41.12	55.6%	4.79	59.5%
> 42,000	0.12	1.6%	9.84	13.3%	2.7	29.5%
Total	**7.34**	**100%**	**73.93**	**100%**	**8.6**	**100%**

	Salaried workers and pensioners		Freelancers		Others	
Range of Income	Total number of taxpayers (in millions €)	% of the total number of taxpayers	Total declared income (in billions €)	% of total revenue	Total tax (in billions €)	% of total tax
(0 - 12,000]	65.0%	35.8%	78.1%	25.8%	98.2%	58.3%
(12,000 - 42,000]	34.1%	58.3%	17.5%	39.4%	1.6%	21.3%
> 42,000	0.9%	5.9%	4.4%	34.8%	0.2%	20.4
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

in Greece, **the percentage of the self-employed is twice as high as the European average**. According to studies, the self-employed **hide around 57-58.6% of their income**, while salaried workers are only able to hide about **0.5-1%**. Very small businesses (0-9 people) in Greece employ a staggering 59% of all workers in the country -double the EU average. The percentage of workers in large businesses (with more than 250 employees) is just **13%** in Greece, compared to **33%** in the EU. This is a very serious problem, because small businesses can more easily employ undeclared workers, avoiding tax and social security payments, while issuing fewer invoices and paying less VAT.



The shadow economy is the sum of undeclared economic transactions in an economy. It is not synonymous with tax evasion. It includes a series of undeclared 'hidden' secret activities that range from smuggling, to private lessons, to casual restaurants that do not issue receipts.

Tax evasion without the Shadow Economy

Shadow Economy & Tax Evasion

Shadow Economy without Tax Evasion

Tax evasion without the Shadow Economy (Economic activity, where added value is recorded in national accounts, but the corresponding revenues are not declared and indirect taxes not paid to tax authorities (for example, contracting work, agricultural production). Tax evasion which is not linked with current economic activities, for example tax evasion in transfer of payments, inheritance tax, bequests and parental benefits, vehicle taxes.

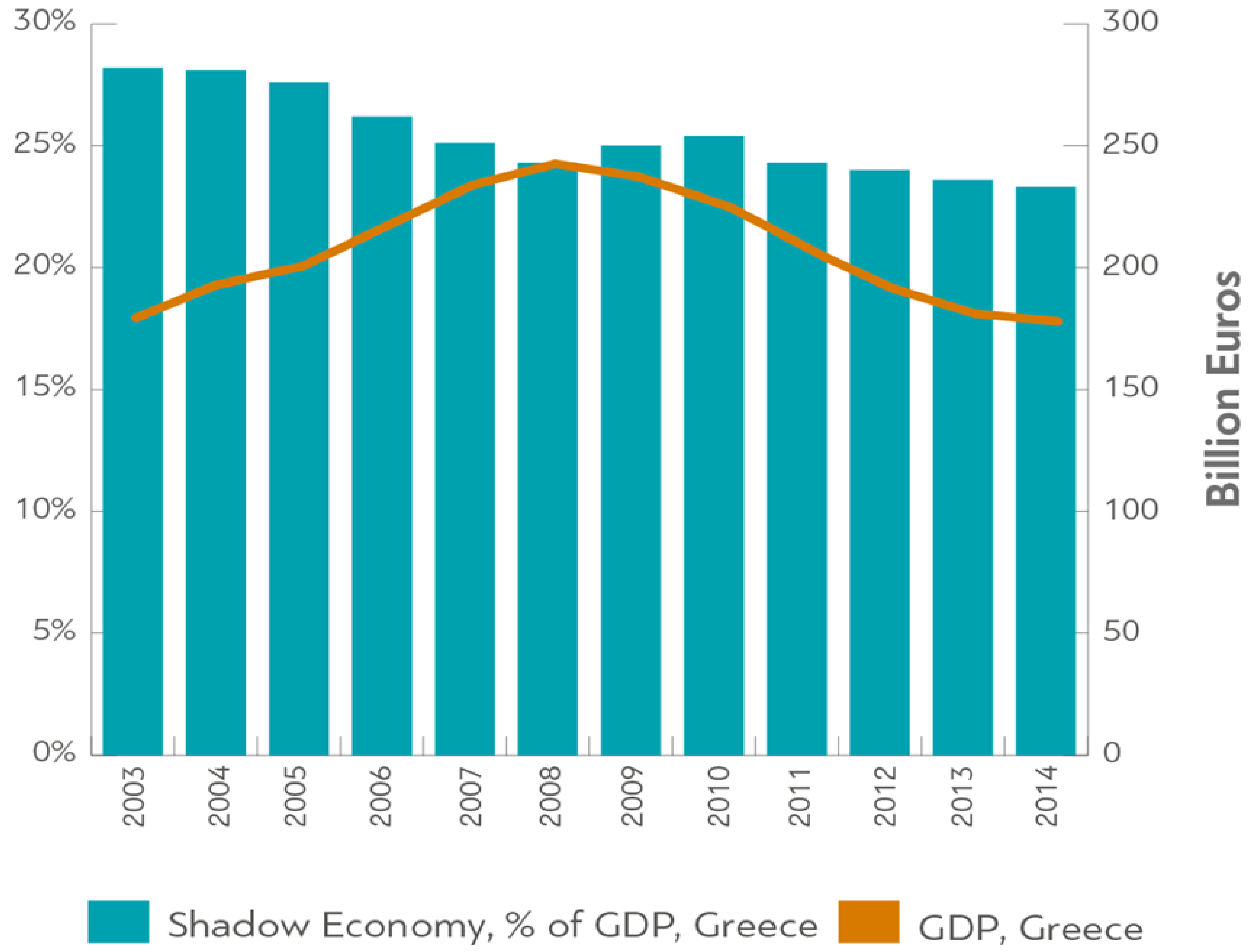
(Economic activities that are not recorded in national accounts, while the corresponding revenues are not declared and the corresponding indirect taxes are not paid to the tax authorities.

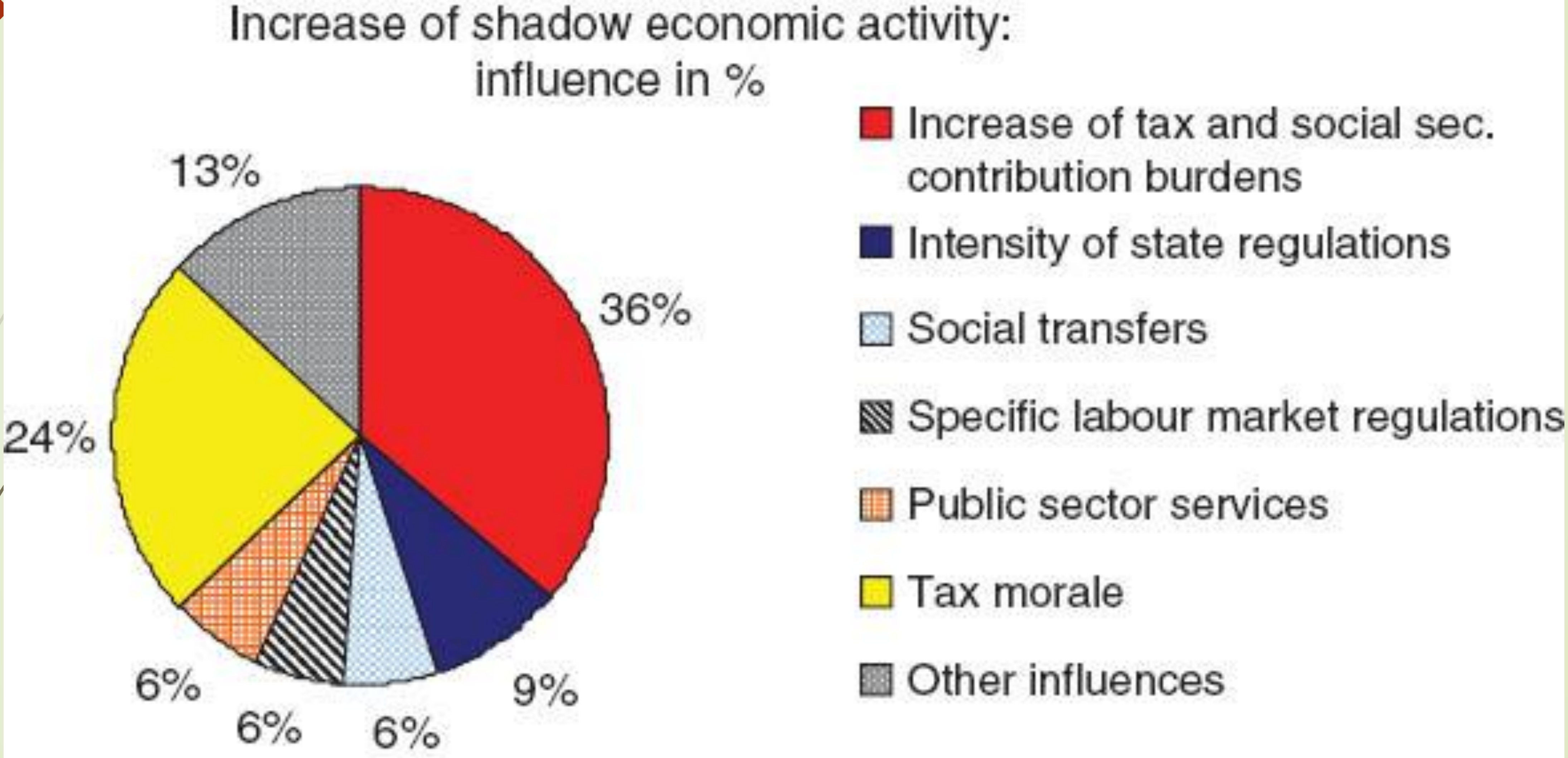
Economic activities that are not described in national accounts and on one hand are not part of the official economy, but the revenues from these activities are declared and indirect taxes paid to the tax authorities. This includes relatively new activities, for which the reporting framework has not yet been created

In contrast to what many believe, the largest part of the shadow economy (around two thirds of it) is attributable to **undeclared employment** - and that is one sector that has increased rapidly during the crisis. In 2010 the Hellenic Labour Inspectorate audited 22,000 private enterprises and found that a quarter of employees had not been declared. Since the crisis began, this number has increased dramatically: by 2013 it had reached 40.5%. According to research by the Ministry of Labour, 27% of those working undeclared had asked their employers to allow it.

In Greece, various studies have calculated that the shadow economy makes up **between 20 to 30% of GDP**, an unusually high percentage for a developed country. It is estimated around 4-5 percentage points above the average of the European Union. During the crisis it has decreased across Europe. For 2015 it was calculated to make up around 22.4% of Greece's GDP which, in absolute numbers, comes out to about €40 billion.

Shadow Economy as a Percentage of GDP and Economic Activity in Greece





Increase of shadow economic activity:
influence in %
13%
36%
24%
6%
6%
6%
9%
Increase of tax and social sec. contribution burdens
Intensity of state regulations
Social transfers
Specific labour market regulations
Public sector services
Tax morale
Other influences

8 main causes for tax evasion **in Greece**:

- The complexity of the tax system
- Legal uncertainty for taxpayers and employees of the tax administration
- Repeated tax hikes
- The lack of political will to address the problem
- Technological failures
- Bureaucracy
- Structural distortions of the Greek economy
- Tax culture

The first two problems are obvious, and linked to each other. Since 1975, Greece has voted in **250 tax laws and 115,000 ministerial decisions.** Within the last 30 months alone, 10 tax laws with 117 articles and 17 other laws with 71 tax provisions were voted in. For these provisions 111 ministerial decrees and 138 explanatory circulars were published.

It is clear that this complexity makes operating the tax collection mechanism exceptionally difficult. At the same time it inevitably causes uncertainty for tax payers and tax administration employees alike. Even tax experts often have a limited knowledge of what is legal and what is not. And, of course, among all this complexity, there exist opportunities and incentives for corruption.

The third cause is equally clear. During the crisis, the income tax on individuals has increased and the tax-free limit has been reduced. The tax-free limit has also been abolished for the self-employed, who now have to pay a larger percentage of tax in advance. The corporate income tax has increased, in the form of an advance tax burden. Finally, the rates of the "special solidarity tax", property taxes, the VAT rates on products and services, as well as consumption taxes on alcohol, tobacco and fuel have all increased.

It is commonly believed that by now taxes in Greece are exceptionally high. Indeed, the OECD calculated that Greece’s **tax burden in 2014 increased from 34.4% to 35.9%**. There is a threshold, predicted by the so-called "Laffer curve" above which tax revenues decline. According to a European Commission study, this limit for countries within the EU is at 54% for individual income tax and at 72% for income tax on legal entities. This is considered an exceptionally high rate, much higher than the rates in over-taxed Greece (personal income tax in 2012 was calculated at 38%, for example). Nevertheless, this does not necessarily mean that there is room in the Greek economy for further tax rate hikes. The same European Commission Study estimates that for countries with a sizeable "shadow economy", the Laffer curve is shifted downward. For countries like Greece, the threshold of individual income tax is at 39% - very close to the current rate. This means that a further increase of tax rates in Greece would have little effect.
Of course, high tax rates have other serious consequences, beyond their reduced efficiency. They are a serious disincentive for investment, they rapidly decrease the competitiveness of domestic enterprises, while they also negatively impact consumer spending (sales of alcoholic drinks in Greece have decreased 45.7% between 2009-2012).

What are the solutions?

- **a reduction of tax rates** and of emergency taxes on already-taxed income;
- expanded use of **"plastic money"** and expansion of **electronic invoicing**;
- effective and intensive auditing and **effective resolution of tax disputes** (through administrative and legal processes);
- improvement of **organization and modernization of the tax authorities;**
- creation of an **electronic tax administration**;
- **training and education of tax administration employees**, along with an increase of their wages;
- tightening of **penalties in cases of tax evasion**;
- creation of a **stable and simplified tax system**;
- a gradual change in the **structure of the Greek economy**;
- creation of **tax awareness** and **cultivation of tax education**.


Thank you