OPERATING UNDER THE RADAR

New research gives insights into the often hidden world of tax evasion

By Miguel Almunia

The central role that businesses play in modern tax systems is under exceptional political and economic scrutiny at the moment. With austerity the rule in the UK, Europe, the US and elsewhere, questions about firms' tax payments have raised public ire, as underscored by the recent "tax shaming" of multinational companies in the UK over apparently legal but nonetheless controversial methods of minimizing tax bills.

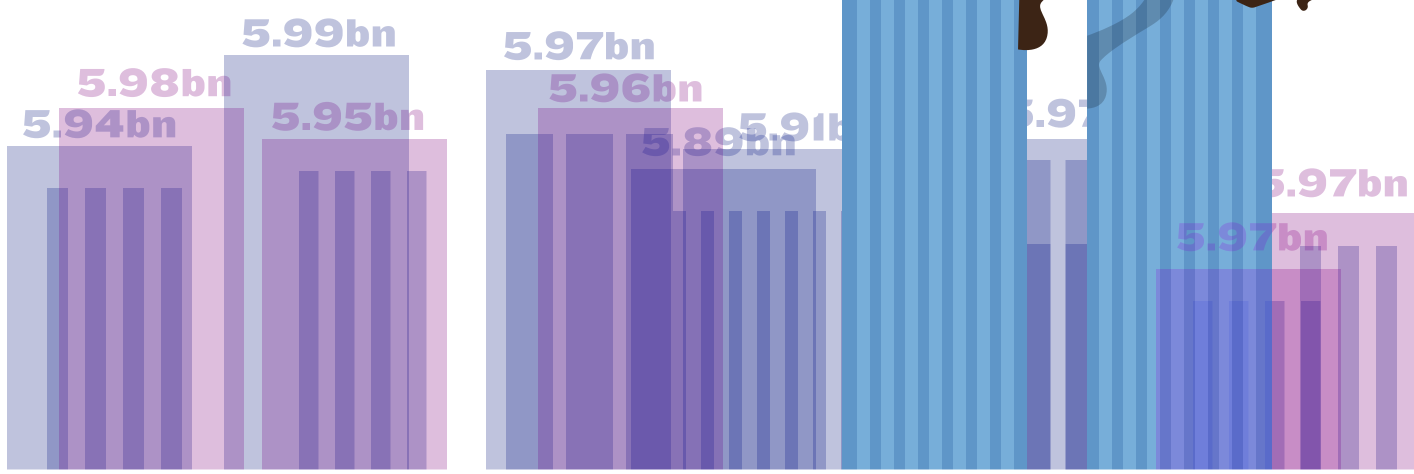
Ensuring firms' compliance with tax policies is critical. Businesses' incentives are to pay as little as possible, while governments rely on businesses for most of the tax collected – through VAT, income tax, national insurance taxes, and as conduits for individuals' withholding taxes.

Tax evasion - by definition a crime - is extremely difficult to observe because evaders put their best efforts into hiding it. So, we have to find creative ways to try to study and measure it. My recent research with David Lopez-Rodriguez has found one way to gain insight. Our examination of a feature of tax enforcement policy in Spain offers a window into the way policies can affect the firms' tax evasion behavior, and suggests ways that governments might re-think certain policies to remedy the situation.

In Spain, the Large Taxpayers' Unit (LTU) monitors and enforces taxation of firms with operating revenues above €6 million. This arbitrary threshold was established in 1995 and has not been modified since. In practice, firms above this threshold are more likely to be audited by the tax agency. In addition, firms above this revenue threshold must submit their tax returns in electronic form, a provision that did not apply to smaller firms until 2008. It is important to note that the tax rate on profits is the same above and below the threshold. The only differences are related to intensity of tax enforcement efforts. The LTU has more resources per taxpayer than the other units within the tax agency, and its tax inspectors are on average more skilled in the art of uncovering evasion.

Using publicly available financial statements for the period 1999-2007, we observe an accumulation, or "bunching", of firms reporting revenues just below the €6 million threshold. This bunching is a clear sign that firms are trying to remain "under the radar" of the LTU, meaning that they want their activities to go unnoticed. Firms that bunch just below this €6 million revenue line would have reported up to €6.45 million in operating revenue, we estimate. In other words, some firms are reporting revenues about 7 percent lower than they would have

A policy improvement would replace the arbitrary threshold of the Large Taxpayers' Unit (LTU) with a more nuanced policy in which enforcement increases with firm size and complexity.



reported in a world without this policy. We arrive at this number by assuming that, in the absence of this policy, the firm size distribution would have been a smoothly decreasing curve without any bunching at the €6 million threshold.

This bunching response might be due to lower production – a "real" response - or to revenue underreporting – an "evasion" response. There is a distinction between tax avoidance, which consists of looking for legal ways of lowering tax payment, and the illegal activity of tax evasion. Sometimes the distinction is not clear because the laws may have flexible interpretations. In the context of this study, underreporting revenue is unquestionably considered to be tax evasion, while a reduction in production could be considered avoidance. An intermediate response would consist of shifting activity from the current year to the next, in order to remain under the threshold for one more year.

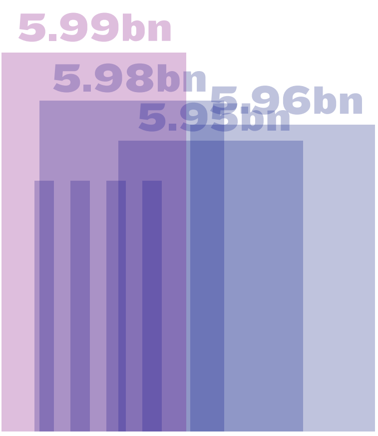
Without further information, it is impossible to disentangle which type of response predominates. To shed light on the issue, we look at the patterns of input expenditures around the threshold. We find that firms just below the threshold report relatively higher expenses on material inputs and lower labor expenses than firms just above. These patterns are inconsistent with a "real" response, because firms that are producing less than they can would simply use less of all inputs. Instead, the evidence is broadly consistent with an evasion response whereby firms not only underreport their revenues, but also over report their material inputs, which lowers the amounts of corporate tax and VAT remitted to the government, and labor expenses, which lowers the amount of national insurance contributions remitted.

So, what should the government do? Many people consider tax evasion a problem largely because it is unfair – giving lawbreakers advantage over their law-abiding competitors. But some argue that, from an economic point of view, the money is just changing hands: it stays with the evaders instead of going to the government. Since the evaders will save or spend that money, the economy doesn't lose.

However, the act of evading taxes is often costly – and not only for the government, which loses out on potential income, but for the evader individually and for society more broadly. A business has to hire tax consultants who can figure out the best way to evade (or avoid) taxation and are willing to skirt the law. The firm may lose business opportunities because the clients may refuse to operate in cash, which is much easier to hide than an electronic payment. More efficient firms that operate within the legal tax structure may find themselves at a disadvantage to competitors that don't. Therefore, tax evasion is costly for society from a perspective of economic efficiency, not just fairness.

An obvious policy improvement would be to eliminate the arbitrary LTU threshold and replace it with a more nuanced policy in which tax enforcement intensity increases not only with firm size, but also with other characteristics (complexity of the operations, tax evasion risks). Within this new policy, the government may consider whether to extend the high level of enforcement to more firms, because currently only 35,000 firms out of a total of 1.3 million are under the responsibility of the LTU. To determine what the right number of firms should be, the government must weigh the benefits of lower tax evasion against the additional costs of tax enforcement. Besides the costs for the tax agency, the government needs to consider the costs for businesses, because tax audits take up a lot of time from accountants and other employees.

A more innovative approach would be to increase the use of new technologies in the fiscal process, e.g. requiring all firms to submit detailed electronic tax returns. If done right, this will greatly reduce compliance costs because essentially all firms already keep their records electronically. Moreover, it makes monitoring cheaper and reduces the need for in-person audits because the tax agency has the ability to cross-check business transactions. The future of tax enforcement policies thus resides in making use of technology to identify potential evasion, while reducing compliance costs for all.



The Researchers

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Publication details

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