TAX EVASION AND FINANCIAL DEFICIT IN CZECH REPUBLIC

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Abstract: *Evasion and corruption are complex matters, and the analysis has abstracted from many aspects that may be important in practice. This paper presented brief understanding for total cost of tax Evasion to Czech Republic and it's reflect on budget deficits. Which the paper found that tax evasion and tax avoidance are important insofar as they affect both the volume and nature of government finances. And the share of tax evasion from total revenue is twice than Czech deficit in almost all last decade.*

Keywords: *Tax Evasion, Tax Avoidance, Redistribution of Income. Financial Deficits.*

1. Introduction

Studying of tax evasion is complicated by the sensitive nature of the topic. In general, tax evasion is perceived to be an illegal and socially undesirable behavior. Individuals are reluctant to admit to having evaded tax. The threat of penalties, prosecution and stigmatization can induce individuals either to lie about their tax evasion behavior (response bias), or to refuse to take part in the study because they wish to avoid answering sensitive questions (non-response bias). Response and non-response biases in a survey affect the validity and the genera liability of the results, making reliable estimates of tax evasion difficult to obtain.

Tax avoidance and tax evasion are widely believed to be important factors limiting revenue mobilisation. This study reviews existing empirical estimates of tax gaps, i.e. tax revenue losses due to tax avoidance and tax evasion, in Czech Republic, and discusses the role of tax expenditures and other determinants of revenue mobilisation

The paper is organized as follows: In the first section the paper tries to find definitions of tax avoidance, tax evasion, and the differences between them. Section 2 deals with the economic analyzing for tax evasion, and in section 3 are explaining the variety of ways of tax evasion. In the section 4 we try to mention some methods are used to measure tax evasion. The last section deals with some examples of tax evasion in EU countries which contain also the reflection of tax evasion on governmental budgets. The paper ends tax evasion in Czech republic and concerning on why Czech people evade tax and how can estimate tax evasion and also modeling tax evasion risk with brief conclusion of the main goals of this article.

2. Tax Evasion and Tax Avoidance

Drawing the line between legal (but undesirable) tax avoidance and illegal tax evasion is sometimes difficult, that tax avoidance comprises activities which exploit loopholes in the tax system but run counter to the purpose of the law whereas tax evasion describes illegal activities that involve elements of concealment.9 From this perspective, non-declaration or underreporting ofincome, which characterizes the shadow economy, would clearly be classified as tax evasion. This would also apply to income from financial assets held abroad and notreported to domestic tax authorities. (Clemenes and Nadine, 2009, 5).

Tax evasion refers to an illegal reduction of tax payments, for instance by underreporting income or by stating higher deduction-rates, whereas Tax avoidance refers to an attempt to reduce tax payments by legal means, for instance by exploiting tax-loopholes. Since tax avoidance, tax evasion, have similar effects, namely a reduction of revenue yields, and are based on the same desire to reduce the tax burden, economists suggest not to differentiate between them, but rather to analyze their effects jointly (Schneider, 2001, 3).

Tax evasion and Tax avoidance they have similar impacts on tax reduction arrangements that may deferes from the specific wording of the relevant legislation view of point. Effective Tax evasion occurs when the results of these arrangements are consistent with the intent of the law. When Tax evasion reduces taxes in a way that is inconsistent with the overall spirit of the law, the arrangements are referred to as tax avoidance; a taxpayer may lawfully arrange his affairs to minimize taxes by such steps as deferring income from one year to the next. (For example, interest on property sold on 12/31/2007 is taxable as part of 2007 income. If the property is sold on 1/1/2008, it would be taxable as part of 2008 income). It is lawful to take all available tax deductions. It is also lawful to avoid taxes by making charitable contributions. Sometimes avoidance depends on country's law itself , for example in Iraq there is a law for forgiving any one from tax for three years if he or she build a mosque, thereby a lot of businessman are building small mosque in order that avoid paying tax for several years.

Finally, the distinction between evasion and avoidance can be taken as purely a question of legal boundaries: Evasion is outside the law; avoidance is not. But in Moralistic point of view It is sometimes argued that certain types of avoidance are just as morally wrong as evasion and therefore should be treated the same as evasion for the purposes of analysis.

3. Analyzing of Tax Evasion

The tax gap is the difference between the amounts of tax that taxpayers should pay under the tax law and the amount they actually pay on time. The tax gap is having three primary components unfilled tax returns, taxes associated with underreported income on filed returns, and underpaid taxes on filed returns. Within the underreported income component, even may has further delineated specific categories of taxes, such as individual, corporate, employment, estate, and excise taxes.

So here we should think about why people try to avoid the tax, the analyzing tax evasion need to analyze the main reason of it. For example, some researchers hold that tax evasion is seen as a risky decision. Agents weigh the risk of detection against the gains from evasion. These models are mainly concerned with optimal audit and detection policy as in the literature on the economics of crime and do not model tax evasion over extended periods (Hanousek, 2002, 4). That is, finding the main reasons for evading tax would be useful here because people will not take this risk if they do not feel that they will gain from it more probably. (The paper will talk about this model in more details in the last section)

There are some other researches indicate that tax evasion will increase as the tax rate increase and also will decrease when the wages are increase as a proportion of income, although their major focus was the fact that inflation raised evasion, the result also showed that increased marginal tax rates also raised evasion (Myles, 1995, 399)

Varieties of Ways of Tax Evasion

The study found that when tax increases occur, people immediately undertake tax evasion activity. For instance, they are evaded by underreporting income or by stating higher

deduction-rates. In other way , tax flight which refers to the relocation of businesses, only in order to save taxes, for instance by making use of offshore tax havens (Kirchler, 2002. 2). But do people always take such behavior in response to tax increases in reality? Usually there are psychological costs or moral constraints to prevent taxpayers from undertaking such illegal activity. Tax revenue losses due to tax avoidance and tax evasion can occur for a number of reasons. Existing estimates of these revenue losses distinguish between a domestic and an international component of tax avoidance and tax evasion. The domestic component of tax evasion and avoidance would include, for instance, non-declared or under-reported income from work or domestic business activities. The international component of tax avoidance and evasion includes practices like transfer price manipulation by multinational firms or the holding of financial assets in offshore bankaccounts by private individuals with the purpose of concealing capital income (Clemenes and Nadine, 2009, 4).

We can list some of verity way used for evaded tax (Cobham, 2005, 8-9):

1. Income derived from shadow economy. First, much economic activity is not reported to the authorities. This activity ranges from that of unregistered businesses, to undeclared profits of registered businesses, to profits from criminal activity (e.g. drug trafficking).
2. Income accruing to assets which are held offshore (typically by wealthy individuals) and are therefore untaxed.
3. Corporate profits which are shifted to other jurisdictions (e.g. by transfer pricing) where lower tax rates apply.
4. Tax competition. Tax competition from competing investment locations, lobbying from wealthy individuals and corporate, international pressures and the trade liberalization agenda may all contribute to reduce the tax rates paid by high-income individuals, large companies and importers
5. Non-payment. A final leakage which may be significant is that of taxes which are due but not paid, for various reasons

4. Methods Use to Measure Tax Evasion

Different types of empirical methods have been recently adopted to measure the size of tax evasion and informal economy, mentioned in some paper; the extent of the tax evasion and fraud in the individual EU countries is largely determined by the difference between the hypothetical and the collected tax revenues in a given fiscal year. For the calculation of the hypothetical tax revenues of a country, national accounts data and input-output tables published by the national statistical office, annual reports of various state owned companies and other relevant statistics are adopted as the tax base. In other words we can use this simple equation to measure the tax evasion :(Chang, 2001, 4-5)

$$1\text{- Tax collection performance ratio} = \frac{\text{Collected Tax Revenues}}{\text{Calculated Hypothetical Tax Revenues}}$$

2- Ratio of tax evasion = 1 – Tax collection performance ratio

If we look at this table we will find that in most EU countries the ratio of tax evasion growing between 1994 -1996 this table has measure tax evasion by using the above equations:

Table 1. Ratio of Tax Evasion in the Selected EU Member States for 1994-1996 (In %)

Countries	1994	1995	(1996)	average
Belgium	18.0	19.9	20.1	19.3
Denmark	4.5	4.3	3.8	4.2
France	8.1	8.5	9.8	8.8
Germany	1.6	5.2	7.5	4.8
Greece	19.8	20.5	20.3	20.2
Italy	33.2	35.5	34.9	34.5
Netherlands	3.8	1.7	1.6	2.4
Portugal	13.9	13.0	15.6	14.2
Spain	19.2	24.6	24.0	22.6
United Kingdom	0.4	4.4	6.5	3.8

Source: Chang Woon Nam, Rüdiger Parsche, Barbara Schaden "Measurement of Value Added Tax Evasion in Selected EU Countries on The Basis of National Accounting Data CESinfo". Working Paper, March 2001

The other measurement can be the electricity method of measuring the underground economy holds that the underground economy can be measured by using a single economic indicator, namely, electricity consumption. To measure the size of the underground economy in the Ukraine and other FSU countries, (Kaufman and Kaliberda) began with the assumption (based on previous studies of the Soviet economy) that in 1989, most of these countries had an underground sector of 12% of GDP. They also assume that electricity consumption reacts with unit elasticity to economic growth. If an economy had GDP of $100 billion in 1989, then it had an underground economy worth $12 billion. If electricity consumption economy grew 10% in the next year this must mean the true economy grew by 10%. So the true economy's size would be $123.2 billion. One would then subtract government estimates of the official economy to get at underground economy size. (Hanousek, 2006, 3-4)

There are many other measurement has used for this propose but none of them was perfectly provide the main information about the real size and kind of tax evasion in any area.

For EU countries the usual gain from a tax reform must be balanced against the Losses that arise due to their limited ability to raise domestic taxes and prevent tax evasion. If the revenue loss from the tax reform is not fully offset, the government budget shrinks. In addition, to the extent a coordinated domestic tax reform is implemented, there is a distortion loss due to tax evasion that must also be balanced against such gain. While in other words, it is always possible to lose from a tax reform, such an outcome becomes quite likely when very plausible such constraints are imposed on the government policy in EU countries. Thus, if government cannot effectively fight tax evasion, a coordinated domestic tax reform that only partially recovers revenue lost due to the tariff reform, as has happened in many developing countries, may only saddle the economy with additional distortion losses due to larger tax evasion. (Atolia, 2006, 4)

Since the late 1990s, most EU countries have taken advantage of buoyant revenues to reduce tax rates. Though some of these tax measures have involved cutting indirect taxes with little overall impact on supply-side conditions, many have been resigned to have a structural impact: increase employment incentives and opportunities and boost productivity. Main candidates for cuts have been social security contributions and the personal income tax (e.g. in Germany, Finland, France, Ireland, Italy, the Netherlands, Spain, Sweden and the United Kingdom). Overall, this has implied a slight decline in tax wedges on labor, though sometimes with a more pronounced impact on low-wage earners. In addition, several EU countries have also introduced measures to achieve a general reduction in corporate income taxes and improve the functioning of capital markets (e.g. Germany, Ireland, and Italy) (Joumard, 2002, 95). But in recent years VAT has remained as one of the major revenue sources in the EU. Although there are controversies existing about the definition of tax evasion and the shadow economy, their size seems to be growing steadily in the EU and in other OECD countries. Of course, growing tax evasion rate in any country may reflect its effects on governmental budget, in other words, as much as tax evasion grow the reducing from the governmental spend will increase , and the services will decrease. Thereby, all EU countries look for alternative way to reduce the tax gap. Whenever tax evasion prevails, the tax authorities would take some action against it. For example, the tax authorities may change their frequency of inspection or penalty fees. Moreover, it may demand bureaucrats or members of Parliament to erect new law so as to reform the tax system such as transforming the direct tax system into the indirect tax system (i.e., consumption taxes). (Itaya, 2)

The flowed table will show the size of tax evasion in some of EU countries which indicate also for the size of amount of money lose from the governmental budgets

Table 2. Comparison of Hypothetical and Collected VAT Revenues in the Selected EU Member States for 1994 (in Billion National Currencies)

Selected EU Countries	VAT Hypothetical 1994	VAT Collected 1994	Evasion
Belgium	667.3	547.3	120
Denmark	95.7	91.4	4.3
France	560.3	514.8	45.5
Germany	239.6	235.7	3.9
Greece	2 160.0	1 735.5	424.5
Italy	121 448.8	81 112.0	40336.8
Netherlands	42.7	41.1	1.6
Portugal	1 259.1	1 084.5	174.6
Spain	4 482.2	3 569.0	913.2
UK (GBP)	38.7	38.5	0.2

Source: Chang Woon Nam, Andrea Gebauer, Rudiger Parsche "Is the Completion of EU Single Market Hindered by Vat Evasion?" CESifo Working Paper, March 2003

5. Tax Evasion in Czech Republic

According to some previous studies on tax evasion in Czech Republic, evasion rate in Czech very high in comparison of other European countries , in this paper we try to find how and why this high percentage of tax evasion.

(Hanousek and Palda, 2004) found in their study in (2004) that tax payers in Czech Republic (21.4%) evade tax, however, this value estimated from their survey which they did during years (2000- 2004) and this values was more than shows here in previous year as its shown by table.(3)

Table 3. Tax Evaders and Predictions Using fixed Markov (long-term) Transition Matrices

year	2000	2002	2004
2000	25.1%		
2001	26.9%		
2002	28.6%	25.9%	
2003	30.2%	26.3%	
2004	31.9%	26.7%	21.4%
2005	33.6%	27.1%	21.5%
2006	35.1%	27.5%	21.7%
2007	36.5%	27.9%	21.8%
2008	38.0%	28.2%	22.0%
2009	39.5%	28.5%	22.2%

Source: Hanousek, Jan, and Filip Palda, "The Evolution of Tax Evasion in the Czech Republic A Markov Chain Analysis", Discussion Paper No. 134, 2004 CERGE-EI

If we suppose that this survey reflecting the reality, and 21.4% of Czech taxpayers was evading tax in 2004, therefore the real amount of tax evasion in this year was 225609.714 million czk which it's 18.98% from total government revenue and its 280.6% of government deficits (see the table below)

Table 4. Percentage of Tax Evasion in Czech Government Revenue during (2000-2006) Million Czech Crowns

year	Government revenue from tax	Estimated tax evasion	Total government revenue	%from total government revenue	%of government deficits
2000	741,418	186095.918	833,942	22.31	228.42
2002	858,489	222348.651	974,432	22.81	133.3
2004	1,054,251	225609.714	1,188,082	18.98%	280.6%
2006	1,172,226	254373.042	1,223,413	20.79%	179.05 %

Source:1- Estimated by author with using of data from Table (3)

2- Czech Statistical Office, Statistical Yearbook of the Czech Republic, 2006 and 2007 http://www.czso.cz/eng/redakce.nsf/i/statistical_yearbooks_of_the_czech_republic

From the above table we can find that percentage of tax evaders increasing every year rapidly which is mean that more than 20% of Czech government revenues was evaded. Sometimes government deficits consider as a healthy situation, because it reflect that the government spend more than its revenue to provide more better service for its citizens, but for in Czech republic case the situation is different because the deficit is coming because of tax evasion has taking twice than deficit of there budget. In other words, It is shown that the presence of tax evasion will alter the tradeoff for redistribution the higher tax rate imposed, the larger will be the benefit from redistribution on the hand, but the cost of tax distortion on the other hand, that is, the level of redistribution should be lower; nevertheless Tax evasion is a kind of illegal activity which reflect its effects on governmental activities and stimulate the service providence by them.

However from the statistical view point we can find, for tax evasion to be optimal from the taxpayer's point of view, it is a necessary and sufficient condition that the expected penalty rate is less than the regular tax rate. Otherwise, they will not involve with tax evasion, obviously, we do not know how many people evade taxes, but it is fairly certain that there are a large number of people who do not, even though they have the opportunity to do so. The behavior of these people can only be explained by the model if one assumes that for them the inequality is reversed. Is this reasonable? If, to take an illustrative example, the penalty rate is twice the regular tax rate, this may implies that the probability of detection which is sufficiently high to deter tax evasion is greater than 0.5. This number is far in excess of most empirical estimates and raises the question of whether the model depicts people as either too rational or too cynical compared to what we believe that we know about their actual behavior. (Sandmo, 2004, 10)

On the other hands, if we should think about why people try to avoid the tax in Czech Republic, we first should think about how much Czech people are risk averse for evading tax. For example, some researchers hold that tax evasion is seen as a risky decision. Therefore agents weigh the risk of detection against the gains from evasion (Christian, 2006.4). Here for modeling this risk of decision, lets suppose that an agent i receives a pre-tax income yi, $0 < yi < 1$, which is subject to a linear income tax at rate t, $0 < t < 1$. The taxpayer chooses to conceal a share ei of his income. Hiding income from authorities entails (non tax-deductible) costs of c, related to the individual's evasion efforts. These costs also depend on the income level, as different income groups, with a fixed probability p an evader gets detected and has to pay full taxes plus a penalty proportional to the taxes evaded. If the taxpayer gets away with the evasion, only the declared income is taxed, where the detection probability depends on the share of income concealed as well as on the income level. The expected after-tax income is then given by[1]

[1] For more details on this model see also : Christian, Traxler, Voting over Taxes: The Case of Tax Evasion, University of Munich, Volkswirtschaftliche Fakultät udwig- Maximilians-Universität München, Discussion paper 2006-27

$$EY = (1- p)\ (yi\ (1 - t) + t^*e) + p\ (yi\ (1 - t) – t^*e\ (s - 1)) - c$$

Y: *after-tax income,*

yi: *pre-tax income,*

t: rate of tax

t*e; amount of tax evaded,

p: *probability when an evader gets detected,*

c; cost of hiding income (for non tax-deductible),

s; penalty rate

This can simplify to;

$$EY = yi\ (1 - t + ei\ t\ (1 - ps)) - c \ldots\ldots\ldots (1)$$

Where s > 1 denotes the penalty rate, expected fines are assumed to be such that ps < 1. Hence, evading income yields a positive return.

The preferences of risk neutral agents are characterized by an additively separable utility function defined over expected income EY and a public good g,

$$U\ (yi;\ ei;\ g) = EY\ (yi;\ ei) + v\ (g) \ldots\ldots\ldots\ldots\ldots\ldots (2)$$

Taxpayers choose ei so as to maximize (2). The first order condition to this problem is,

$$yit\ (1 - ps) = ce(yi;\ ei) \ldots\ldots\ldots\ldots (3)$$

One can easily derive from (3):

$$\frac{\partial ei^*}{\partial p} < o, \qquad \frac{\partial ei^*}{\partial s} < o, \qquad \frac{\partial ei^*}{\partial t} > 0$$

That's mean an increase in the detection probability and/or the penalty rate will reduce evasion, while a rise in the tax rate will trigger more evasion. From this results we conclude that the high rate of tax evasion in Czech Republic comes from the probability of detection is very low that make the risk of any evasion getting low, and also the penalty rate still low or not enough to make Czech taxpayers to consider how big the risk of tax evasion. In addition, the level of income of Czech is low if we compare with other European countries, so that, the rate of tax consider as a high rate for Czech people. However, we can find also how rate of evasion may change with the level of income. From equation (3) we can derive that;

$$\frac{\partial ei^*}{\partial yi} = \frac{t(1 - ps) - Cey\ (y, ei^*)}{Cee\ (yi, ei^*)} \ldots\ldots\ldots\ldots\ldots (4)$$

Although marginal benefits of evasion are (linearly) increasing in income, the sign of $\partial e/\partial y$ is ambiguous and depends on the cross derivative of the cost function – *i.e.* on how the marginal costs of concealing change with the income level. If the inequality

$$Cey\ (yi, ei^*) > t\ (1 - ps) \ldots\ldots\ldots \quad (5)$$

Holds, the share of concealed income (ei*) is non-increasing in income. In this case, the marginal costs to dodge taxes are strongly increasing in income, such that richer taxpayers would declare a larger share of their true income than poorer agents However, if the marginal costs of concealing are declining or not too strongly increasing in income, condition (5) would be violated. In this case, the share of income concealed would increase as income rises: Richer taxpayers would conceal a larger share of their income as compared to poorer agents.

For analyzing last result of Czech taxpayers we can go back to the survey of Hanousek and Palada (see table, 5)

Table (5) Percent of Respondents Admitting to undeclared Income within Certain Ranges in Czech Republic

Income Range	*% of Undeclared Income*
<10,000 – 15,000 Crowns	34.8%
10,000 – 15,000 Crowns	10.8 %
15,000 – 20,000 Crowns	11.1 %
20,000 – 25,000 Crowns	5.5 %
25,000 – 30,000 Crowns	7.3 %
30,000 – 35,000 Crowns	3.3%
35,000 – 40,000 Crowns	4.6 %
>40,000 Crowns	5.6 % .

Source: Hanousek, J., Palda F., Why People Evade Taxes in the Czech and Slovak Republics: a Tale of Twins, Discussion Paper No. 85, 2002, CERGE-EI, p 7

From the figure above we can see that marginal cost for evading tax in Czech republic is strongly increasing in income, such that people with lower income (10000- 15000 crowns or less) were 34% of them tending to evading tax while richer taxpayers would only 5.6% of them tending to evade tax. In other words, richer taxpayers more risk averse than poorer. As it mentioned above the level of income consider low in comparison with other European countries, therefore most of Czech taxpayers are consider as risk neutral agents

On the other hand, richer taxpayers in Czech would have more possibility to avoid tax than poorer , because richer people always has ability to find some lawyers to advice them how to avoid tax but poor people will think mainly about evade tax than to pay a part of his income to lawyer for avoiding tax payments.

6. Conclusions

The results show that despite the similar effects of tax avoidance, tax evasion, on revenue yields. Tax avoidance was perceived as legal and as moral, and was amongst others associated with intention to save taxes, with cleverness and with a good idea. Tax evasion, on the other hand, was perceived as illegal and immoral, and was, for instance, associated with fraud, criminal prosecution, risk, tax-audit, and with penalty. The paper mention some of tables or the size and the way used in EU countries which found that it may consider as a significant proportion in their revenues has yielded. The paper conclude as well that tax evasion in Czech republic is very high, which was present a big share of governmental budget, and also it seems that Czech deficits in government budget is not resulting from high spending of government but it mainly comes from inability of tax system to collect tax and protect it from evasion, which mean that Czech tax system still in need of more reforms and improvements, Finally, it could be shown that despite the fact that tax avoidance, tax evasion, lead to similar effects on revenue yields especially on governmental budgets in Czech republic , taxpayers discriminate between them and evaluate them differently. Moreover, it could be shown that these evaluations depend, for instance, on personal affectedness, experience, profession, and knowledge, and also their level of income.

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