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Tax Evasion and Financial Instability

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Abstract

This article explores the association between tax evasion and financial instability. The discussion also examines the effect of tax evasion for financial instability. The discussion shows that tax evasion can reduce the tax revenue available to governments to manage the economy and can weaken the government's ability to promote stability in financial systems, while on the other hand, taxpayers who evade taxes feel they can use the evaded tax money to rather improve their own financial stability.

JEL: G21, G28, H26; H32; D7

Keywords: Tax evasion, Tax avoidance, financial stability, financial crisis, government expenditure, financial crime

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1. Introduction

This article explores the relationship between tax evasion and financial instability. Tax evasion and financial instability are two problems that governments are concerned about. The public finance literature has not explored the effect, or contribution, of tax evasion to financial instability, requiring the need to bridge the knowledge gap in this area. Tax evasion and financial instability are not mutually exclusive because excessive tax evasion can prolong initial disruptions in financial systems since tax evasion already leaves governments with little resources to intervene, pressuring them to rely on debt. Tax evasion can also affect government's ability to intervene how it see fit to restore the financial/economic system. On the other hand, severe disruptions in financial systems can provide incentives to evade tax payments.

The association between tax evasion and financial instability can be viewed through new tax or modified tax expectations. For instance, when governments introduce new forms of taxation or when they review existing tax systems, they must consider the existing tax burden and taxpayers' feeling of being overtaxed, in order not to break the boundaries of absolute tax limit (Dimitrijevic, 2016), which encourages tax evasion. When the tax burden becomes excessive, whether new or modified, it can reduce the disposable income of individuals and make them react in ways that could disrupt the free working of financial systems particularly if overburdened taxpayers believe the government is corrupt and do not deserve their hard-earned income. Given these concerns about the interrelationship between tax evasion and disruptions in finance, an important question is what will be the effect of tax evasion for stability, or instability, in financial systems.

The discussion in this article contributes to the public finance literature, and contribute to the debate on the interrelationship between tax evasion and government financing. Also, the discussion in this article contributes to the financial stability literature that investigate the likely causes of instability in financial systems (see, Allen and Gale, 2004; Segoviano and Goodhart, 2009; Ozili and Thankom, 2018, Ozili, 2018, etc).

The remainder of the article is structured as follows. Section 2 provides a discussion on tax evasion, the factors encouraging tax evasion, and the effect of tax evasion. Section 3 discuss financial instability and its indicators. Section 4 discuss the relationship between tax evasion and financial instability and presents four propositions for this relationship. Section 5 provides the concluding remark. Section 6 presents a summary of the main themes of the discussions.

2. Understanding Tax evasion: Some Background

Tax evasion is the illegal and intentional non-payment or underpayment of tax (Alm 2012, paraphrased); some examples of tax evasion schemes include understating income, overstating deductions and falsifying financial records. Tax avoidance, on the other hand, is the use of legal means to reduce one's tax liability (Desai and Dharmapala, 2009); examples of tax avoidance schemes include redirecting income, postponing income and changing income.

To fully understand tax evasion, one need to first understand why governments require the payment of taxes. Revenue from taxation is central to the functioning of the modern state,

without them governments cannot perform its administrative or redistributive functions (Sikka, 2017). Modern governments rely on revenue from taxes to finance capital expenditure and to fund its tight budget each year. For these reasons, governments use tax officials/authorities to collect taxes on behalf of the government from corporations and individuals that have some identifiable source of revenue.

No government can announce a tax system and then rely on taxpayers to remit tax returns, as a moral sense of duty. This is because some dutiful people will undoubtedly pay the tax they owe, but many others will not pay (Slemrod, 2007). Furthermore, while some people pay taxes lawfully as they should, they do not pay the full extent of their tax obligation; and this behaviour in many cases go unnoticed for many years, if ever detected. The rich and wealthy can evade tax to channel those funds to better use while average individuals can either abuse their refundable tax credits or use the 'self-employed' status to avoid the payment of huge taxes. Therefore, the idea that the bulk of tax evasion is done by wealthy people, is a myth. This is because the propensity to evade taxes is not limited to income class. Any individual, regardless of wealth class, can evade tax. Large corporations can also evade tax by shifting profits (Haufler and Schjelderup, 2000), eroding the tax base, moving operations to countries or cities known as 'tax havens', or they can channel their funds to off-shore investments which are non-taxable in the domestic country, to mention a few.

Due to excessive tax burden for the taxpayer, there can be tensions between the state's willingness to levy taxes and taxpayer's willingness to pay, and there is documented evidence where these tensions have encouraged tax avoidance and even resulted in revolts and revolutions.¹ The tax burden, or the amount of tax to be paid, can be excessive on individuals and corporations, who are willing to find ways to lower their tax burden or tax liability through evasion of tax payments, where possible (Slemrod, 2007).

2.1. Factors encouraging tax evasion

High tax rates: It is difficult for governments to determine the optimal tax rate above which would encourage tax evasion (Slemrod, 1990). Imposing high taxes on specific products or services can have unintended consequences for tax revenue generation because high taxes can discourage customers from using such products or services, coupled with the tendency for suppliers to pass the full tax burden to customers depending on the price elasticity of product or service. High taxes, which cannot be passed on to customers can make suppliers discontinue the provision of such products and services, hence, reducing the government's expected revenue from such taxation program.

Tax evasion technologies: There are new and evolving technologies offered by sophisticated individuals and corporations to help wealthy individuals evade the payment of tax. These technologies are sophisticated and are constantly changing. Tax authorities may not have the resources to fully understand or monitor existing and emerging technologies used to evade tax in a country.

Weak tax enforcement strategies: Weak tax enforcement strategies in a country can lead to the under-collection of taxes when due (Marhuenda and Ortuño-Ortín, 1997). Factors such as poorly trained tax collectors, uneducated tax collectors, using the wrong tax codes for collection

¹ Daunton (2001), Frecknall-Hughes (2007) and Burg (2004)

purposes, illegal tax collection antics and tactics, etc; are some examples of weak tax enforcement strategies

Inaccurate tax data/records. Tax records or tax data when inaccurate or non-transparent can mislead tax collectors to charge a taxpayer twice. Taxpayers who are aware they can be taxed twice often feel they will be better-off if they evade tax since they know they are more likely to be taxed twice or more. Also, tax data are not only inaccurate but are also aggregated. Aggregated tax data do not reveal micro-information about income distribution which can help unmask income inequality among individuals (Hay, 2017). Tax authorities need accurate tax information and statistics to help them develop an effective income redistribution program.

Booming Tax Avoidance Industry. Many corporations can now exploit the laws of any country, onshore or offshore, to shift profits and avoid taxes in one or more jurisdictions (Rego, 2003). This practice is aided by a very lucrative tax avoidance industry, staffed by professional accountants, lawyers and finance experts². The players in this industry develop innovative and ever-changing schemes for tax evasion, making it increasingly difficult for tax authorities to regulate and monitor. Much is done in this industry to help corporations and wealthy individuals pay as little taxes as possible through tax avoidance schemes, in return for a fee.

Corruption. A corrupt society can encourage more tax evasion since corrupt officials will seek more income through bribes, and many bribe payments are often direct cash payments, to bypass tax authorities. Similarly, higher levels of tax evasion in a society can lead to increase in corruption which offers more opportunities for bribery. When tax officials are corrupt, they will collect bribes thus encouraging tax evasion (see. Chander and Wilde, 1992).

Inadequate collection mechanism and non-transparency. Some countries, mostly developing countries, lack the adequate mechanisms to collect taxes, coupled with the widespread belief that the citizens do not owe anything to the government because the government does nothing for them.³

Self-employed income. Many self-employed incomes are unreported and thus untaxed, particularly when most economic exchange occurs in cash transactions.

Other factors: Other factors that encourage tax evasion may include excessive tax burden, lack of honesty in the government, perceived unfairness, tax authorities' poor institutional infrastructure and responses, financial benefits of evading taxes, perceptions of inequality, low level of trust in tax authorities, perceived poor use of tax revenues, poor treatment of taxpayers, corruption in government, increase in banks' offshore activities with non-financial companies connected to banks, etc.

2.2. Effects of Tax Evasion

According to Slemrod (2017), some consequence of tax evasion includes the following:

1. Tax evasion reduces the extent of government intervention in the economy: tax evasion leaves the government with financial difficulties as they are unable to raise enough finances to run their countries. Tax evasion can make governments have little funds to

² Sikka and Willmott, 2010; Mitchell and Sikka, 2011).

³ McGee (1999)

implement sound economic policies and insufficient funds to provide essential products and services to its citizens (Pirttila, 1999)

2. Tax evasion redistributes the tax burden (Yamamura, 2014)
3. It affects the costs of raising taxes
4. Difficulty to fund the government's budget: This leads to fiscal deficits and contributes to a country having to borrow money from other countries and/or financial institutions such as the International Monetary Fund (IMF), which puts further strain on fragile economies (Ghosh, 1995).

2.3. Dealing with Tax evasion

2.3.1. Source of Information

Tax evasion is difficult to study because there is no single source of information capturing all of it, no single source of information can exhaustively reveal who evades taxes and why they do so. To obtain information on tax evasion, tax authorities must rely on several formal and informal source of information. For instance, a tax authority can use random audits to estimate the tax gap, that is, the total amount of unreported income and unpaid taxes (Bazart et al, 2017). Random audits can help tax authorities to uncover unreported self-employment income, abuses of tax credits, and other simple forms of tax evasion.⁴ Also, tax authorities can use available micro-data from leaked documents to obtain information on tax evasion by rich and wealthy individuals and families⁵. Recent examples include data obtained from the massive "Swiss leaks" from offshore financial institutions like HSBC Switzerland, and the "Panama Papers" leak by Mossack Fonseca.

2.3.2. Ethics and Tax evasion

Not everyone agrees that taxes are ethical. Some think taxes are illegal. McGee (2006) highlights three basic views on the ethics of tax evasion. The first view argues that (i) tax evasion is unethical, (ii) the state is illegitimate and has no moral authority to take anything from anyone, and (iii) tax evasion can be ethical under some circumstances and unethical under other circumstances; therefore, the decision to evade tax is an ethical dilemma which considers several factors.

2.3.3. Deterrent of tax evasion

Some factors that discourage tax evasion, may include the fear of prosecution, payment of heavy fines, the use of cashless payments, potential reputation damage if found guilty of evading tax, high morals and adequate governmental regulation. (see, Orviska & Hudson, 2003; Chang and Lai, 2004; Varma and Doob, 1998).

⁴ See. IRS 2016

⁵ Alstadsaeter, Johannesen & Zucman (2017).

3. Financial Instability - Overview

3.1. Definition

Financial instability is defined as a condition in which the financial system is incapable of withstanding shocks and incapable of correcting financial imbalances, thereby increasing the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities.

3.2. Aggregate Indicators of financial stability

There is no all-encompassing indicator of financial instability,⁶ because the indicators of financial instability will differ for the real sector, financial sector, financial market and household sector, and will differ for different economic systems. According to Gadanecz and Jayaram (2008), below are some measures or indicators of financial stability:

3.2.1. *Real sector indicators:* The indicators of financial instability in the real sector include: GDP growth, tax revenue of the government and the level of inflation. GDP growth reflects the amount of wealth created in the economy. A low GDP growth rate is a sign of instability in the real sector. Tax revenue reflect the ability of the government to generate funds from tax to finance its expenses and public expenditures. Low tax revenue is a sign of financial difficulty or instability in the real sector as the government would have to rely on borrowings to fund its capital expenditure in the real sector. Inflation is a general and persistent increase in price level, which often indicate structural problems in the economy. High inflation is a sign of financial instability in the real sector particularly if price imbalances do not reverse in the short term.

3.2.2. *Corporate sector indicators:* The indicators of financial instability in the corporate sector are assessed by the risk exposure of corporations on an individual basis or on aggregate terms. Such risk exposure may include high leverage ratios, high expense ratios, high net foreign exchange rates, abnormal low equity ratio, year-on-year losses, etc.

3.2.3. *The household sector indicators:* The indicators of financial instability in the household can be assessed by its stock of positive net assets (assets minus liabilities), net disposable income (earnings minus consumption minus debt service and principal payments). Households with negative net assets and low disposable income are more likely to experience financial difficulty during unexpected downturns.

3.2.4. *External sector indicators:* The indicators of financial instability in the external sector are reflected by the levels of real exchange rates, foreign exchange reserves, the current account, capital flows and maturity/currency mismatches. Sudden changes in these indicators can lead to loss of currency value and balance of payment deficits.

3.2.5. *Financial sector indicators:* The indicators of financial instability in the financial sector are assessed by monetary aggregates, real interest rates, and by risk measures in the banking

⁶ Ozili (2018) and Ozili and Thankom (2018)

sector such as banks' capital and liquidity ratios, loan quality and standalone credit ratings. These indicators can provide signals of problems in the banking or financial sector.

3.2.6. Financial markets indicators: The indicators of financial instability in the financial market sectors can reveal signs of instability in financial markets. The indicators include equity indices, corporate risk spreads, liquidity premiums and volatility, high levels of risk spreads, liquidity disruptions, etc.

4. Effect of Tax Evasion on Financial Instability

A government with a budget surplus will have excess funds that can be used to rescue the financial system when unprecedented events occur that transmit shocks to the financial system (Auerbach & Gale, 2000). During economic and/or financial crises, a government that has emergency funds or rescue funds in its reserve account can use such funds to revive the failing economy and correct financial imbalances in the financial system of the country. In developed economies, like the US, UK and Germany, the government is often the last resort for economic survival during severe economic and/or financial crises. A recent example is the 2007-2008 global financial crisis.

During the 2007-2008 global financial crisis, the UK and US government had to intervene to rescue their financial systems. The US government provided rescue (or bail-out) funds up to \$14trillion to revive its financial system which was highly interconnected with the financial systems of other developed countries at the time. The collapse of the US financial system would lead to financial contagion which could collapse the financial system of other countries connected to the US. The US treasury was pressured to provide bail-out funds to restore the global financial system.

I develop four (4) propositions for the relationship between tax evasion and financial stability:

Proposition 1: The absence of tax evasion can lead to greater financial stability

In a State where every individual and corporation pay the full amount of their tax liability, the government will have sufficient funds to respond directly and immediately to abnormal shocks that threaten the financial system. This expectation assumes that a government will set aside some tax revenue as 'emergency funds' for emergency use and would not use such funds for any purpose other than for emergency events. When this is the case, the absence of tax evasion should promote financial stability since the government will always have reserve funds for direct intervention in the economy.

Proposition 2: The absence of tax evasion can lead to greater financial instability

However, there are claims that no government can be trusted with a budget surplus because governments are inclined to spend more money to balance its public accounts, as opposed to saving money for the future. There is also the argument that even if taxes were paid in full (i.e., zero tax evasion), the resulting budget surplus from such tax revenues would be unavailable when it is needed for emergency use. The government may use reserve funds to meet outstanding recurrent expenditures, thus depleting the stock of reserve funds for emergency

use. When this is the case, the absence of tax evasion which generates budget surplus can lead to greater financial instability, or at worse, could leave the current economic situation unchanged if the government's stock of reserve funds is already depleted when it is needed. The government may need to rely on external borrowings to rescue its economic and financial system when such events occur.

Proposition 3: The presence of tax evasion can lead to greater financial stability

The government alone cannot bear the full responsibility for financial stability. Corporations and individuals also have some responsibility for financial stability. There are claims that evaded taxes are used by individuals and corporations to deal with their own financial difficulties when unfavourable events occur that threaten their own financial stability. This is because tax evaders believe the government would not help them individually when they go through personal financial difficulties even after they have paid their full tax liability, therefore, they prefer to insure themselves from financial instability by evading taxes. Since it is quite true that many governments do not necessarily help individuals and corporations on an individual basis or case-by-case basis, tax evaders believe they should morally pay fewer taxes to the government, to allow them to have enough financial resources to deal with their own personal financial difficulties. Corporations that evade tax may engage in tax evasion practices for the same reason, to have extra financial resources to help them remain financially stable in their corporate finances during bad times. In this case, the presence of tax evasion can promote financial stability for individuals and corporations who evade taxes.

Proposition 4: The presence of tax evasion can lead to greater financial instability

On the other hand, when taxes are evaded, the government will have limited resources to intervene directly and immediately to mitigate the effect of abnormal shocks that destabilises the economic system and could lead to panic and riots, which can worsen the current economic situation.

5. Concluding Remarks

Tax evasion is an important issue for all governments. The ability of governments to directly intervene to rescue the economy from severe crises is often limited by tax evasion which leaves the government with insufficient funds to bail out failing banks, systemic financial institutions and other too-big-to-fail non-financial institutions. Tax evasion and its effect on financial stability or instability is rather complex, and unfortunately, there is no single source of information capturing all of it. To understand the full impact of tax evasion on financial stability or instability, it is important to view tax evasion from two perspectives: the government viewpoint and the tax evader's viewpoint. The former believes the payment of full taxes should not be evaded to enable the government to have sufficient funds to meet its public expenditures, while the latter believe they evade taxes to promote stability in their own personal finance. These expectations demonstrate the interrelationship between tax evasion and financial instability.

6. Summary

In this study, we examined tax evasion, the motivations for it and the consequence for the State. The discussion highlights the importance of identifying an optimal tax system which encourages the payment of tax, while ensuring a low tax burden. The discussion also examines financial stability, and the effect of tax evasion for financial stability. The discussion shows that tax evasion can reduce the tax revenue available to governments to manage the economy while on the other hand taxpayers who evaded taxes feel they can use the evade tax money to rather improve their own financial stability. One direction for future research in this area is the need to examine the effect of tax evasion by too-big-to-fail institutions on financial system stability. It is interesting to understand how systemic (or too-big-to-fail) institutions might evade taxes, and whether they have higher incidence of tax evasion compared to non-systemic institutions. Insights from such study can help tax authorities understand whether they need to focus on large (and systemic) firms, compared to small firms, when undertaking their tax monitoring and compliance activities.

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