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The Relationship Between Tax Pressure and Economic Crime

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Abstract

Economic crimes such as financial fraud, money laundering and illegal lending are considerably influenced by the tax evasion phenomenon. In the context of Romania, characterized by a vast underground economy and tax evasion, these phenomena contribute directly to the perpetuation of economic crime. Tax evasion is a behaviour of taxpayers consisting in avoiding tax obligations by violating tax legislation. This behaviour includes ignoring mandatory tax rules, falsifying documents or providing incomplete and inaccurate data. Among the factors that can influence tax evasion are tax knowledge, tax morality, the taxation system, the perception of tax fairness and the cost of tax compliance. This study aims to identify the influence that tax pressure has on compliance and the factors that generate economic crime, thus providing useful information for academia, specialists in the field and those responsible for formulating tax policies.

It is observed that an increase in tax pressure increases the likelihood that individuals will opt for tax evasion and fraud. That is why efforts to combat tax evasion must be integrated into the fight against illegal credit, money laundering and financial fraud. Thus, an effective government strategy in combating economic crime must include not only sanction-based measures, but also improved tax auditing activity, along with the promotion of spontaneous and responsible tax compliance.

Keywords: economic crime, tax pressure, forensic accounting, shadow economy, tax evasion

JEL classification: H26, M41, P44

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➲ Introduction

The relationship between tax pressure and economic crime is a complex and multidisciplinary issue. Tax pressure, often represented by high taxes and strict regulatory requirements, can have various effects on the economic environment and the behaviour of management and companies. On the one hand, increasing the tax burden can lead to higher government revenues and, theoretically, more resources for public services and investment. However, on the other hand, excessive tax pressure can sometimes encourage economic crimes, such as tax evasion, fraud and participation in the shadow economy.

Economic crime, which includes activities such as tax evasion, fraud, illegal credit, corruption, money laundering and other illegal financial activities, is often motivated by a desire to avoid high costs associated with legal compliance or to exploit the system for personal benefit. When taxes or regulatory burdens are perceived

as too high or unfair, it can encourage entrepreneurs and companies to look for illegal ways to reduce their tax liability. This not only results in a loss of revenue for the government, but also undermines the fairness and efficiency of the tax system.

The relationship between tax pressure and economic crime is influenced by various factors, including the effectiveness of government institutions, the level of public trust in government, the efficiency of the tax system, and the perception of fairness of tax policies. Effective enforcement of tax laws and regulations is crucial in deterring economic crime. At the same time, a fair and transparent tax system can reduce incentives for such illegal activities.

➲ The concept of *tax pressure* and measuring instruments

The tax pressure is the level of taxes and duties levied by a government relative to a country's economy, often expressed as a percentage of gross domestic product (GDP). This not only reflects the total amount of taxes collected, but also the impact of this collection on citizens and businesses. The tax burden can be seen as an indicator of the degree to which a government's tax policies affect the economy and society, including how these policies influence the economic behavior of individuals and companies. A high level of fiscal pressure may discourage investment and growth, while a low level may suggest insufficient collection of taxes needed to finance essential public services.

Tax pressure and tax burden are two notions deeply intertwined with the concept of taxation. According to Cambridge Dictionary (2020), "tax pressure or tax burden is the total amount of tax paid by a certain group of individuals, industry, etc., especially compared to what other groups, industries pay".

The impact of the tax burden on the economy manifests itself in various ways, significantly influencing economic aspects.

Investment and economic growth	A high level of tax pressure can discourage investment from both businesses and individuals. High taxes can reduce profits and make investments less attractive, which can slow economic growth.
Consumer behaviour	High taxes can reduce consumers' purchasing power, limiting their spending. This can lead to a decrease in demand for goods and services, thus affecting the economy as a whole.
Resource allocation	The tax burden influences how resources are allocated in the economy. Taxes can cause companies to modify their business strategies or seek efficiencies to reduce costs, which can lead to changes in the economic structure.
Informal economy and tax evasion	High taxes can encourage the growth of the informal economy and tax evasion. This not only reduces government revenue, but can also create an unequal market, where businesses that don't pay taxes have an unfair advantage over those that follow the rules.
Innovation and competitiveness	A high tax burden can limit companies' ability to invest in R&D. This can reduce innovation and competitiveness in certain sectors.
Fiscal and financial stability	Balanced fiscal pressure is crucial for a country's fiscal and financial stability. An appropriate balance between tax collection and public expenditure contributes to macroeconomic stability.
Social equity and redistribution	Taxes are a key tool to redistribute wealth and mitigate social inequalities. A well-managed tax burden can contribute to social fairness by ensuring adequate funding for essential public services such as education and health.

In academic literature, the standard method of measuring the tax burden involves the use of specific indicators, mainly by calculating the tax rate, according to Tulai (2003, p. 287). This tax rate can be applied at different levels: at national (global) level, at the level of economic entities (companies, firms, etc.), and individually, at the level of individuals, i.e. individual taxpayers.

Schneider (2010) points out that defining the tax burden is challenging, given the variety of tax and social security systems across countries. He notes that there are various methods by which the tax burden can be estimated:

- at the level of tax revenues (% of GDP);
- at the level of the total tax rate (% of gross profit or turnover);
- at the level of the global indicator of fiscal freedom, which is a component of the broader indicator of economic freedom calculated by the Heritage Foundation, which serves as a measure of fiscal pressure. This way of measuring tax pressure, starting with the indicator of tax freedom, has been adopted by various authors such as Torgler and Schneider (2009) and Achim *et al.* (2018). This approach is considered a more complete method of assessing the tax burden.

According to the analyzed literature, but especially to the available data, the level of tax pressure in a country can be determined using the following indicators:

a) State tax revenue, as a percentage of GDP, based on data provided by the World Bank

In order to measure the fiscal pressure in our country, we analyzed the structure of Romanian state revenues between 2015 and 2022 as % of GDP in ESA 2010 standard. According to the Annual Report for 2022 of the Fiscal Council of Romania, the structure of budgetary revenues as % of GDP in the mentioned period is as follows:

- % -

	2015	2016	2019	2020	2021	2022	Changes 2022 vs. 2021
Total income	**35.5**	**32.5**	**31.6**	**32.3**	**32.7**	**33.5**	**0.8**
Indirect taxes, showing separately:	13.3	11.5	10.5	10.3	10.7	10.7	0.0
VAT	8.1	6.5	6.2	6.1	6.4	6.7	0.3
Excise duties and customs duties	5.2	5.0	4.3	4.2	4.3	4.0	-0.3
Direct taxes, showing separately:	6.6	6.5	4.8	4.7	5.1	5.9	0.8
Income tax	3.7	3.7	2.3	2.4	2.4	2.5	0.1
Corporate income tax	2.3	2.3	2.1	1.9	2.2	2.9	0.7
Social security contribution	8.1	8.9	11.2	11.8	11.3	10.6	-0.7
Other current income	2.0	1.6	1.8	1.8	1.5	1.9	0.4
Amounts received from the EU	2.7	1.4	1.1	1.6	1.9	2.3	0.4

Source: https://ec.europa.eu/eurostat/

Within the European Union, Romania ranks penultimate in terms of the ratio between taxes and GDP, according to data provided by Eurostat.

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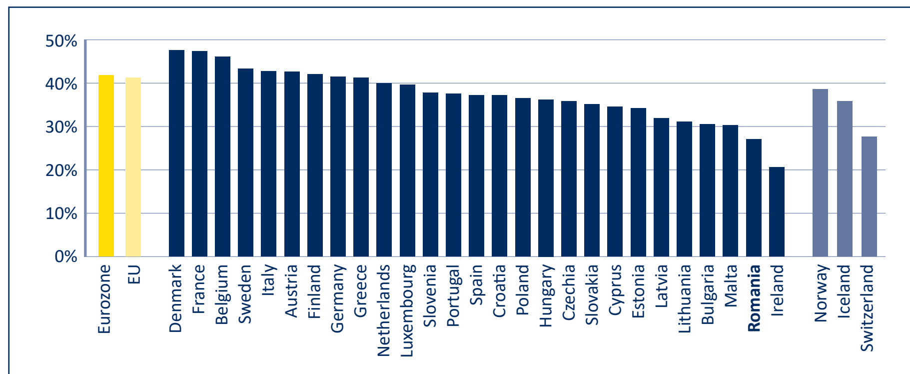


Tax revenues in 2020 (% of PIB)

Source: Authors' processing based on data provided by the Eurostat, https://ec.europa.eu/eurostat/.

b) Corporate income tax, as a percentage of gross profit of economic agents, based on data provided by the World Bank

Direct tax rates applied to corporate profits vary significantly around the world, depending on each country's tax policies. According to 2023 data, corporate income tax rates in different countries are between 12% (Ireland) and 50% (Comoros).

- % -

State	Corporate tax rate
Comoros	50
Puerto Rico	37
Suriname	36
India, Australia, Mexico, Philippines	30
Japan, Germany, Pakistan	29
China, United States of America, Spain, Belgium	25
Malaysia, Sri Lanka, Greece, Luxembourg	24
Indonesia, Egypt, Denmark, Norway	22
Russia, Vietnam, Thailand, Saudi Arabia	20
United Kingdom, Poland, Switzerland	19
Romania, Hong Kong	16
Chile, Serbia, Kuwait, Lithuania	15
Ireland	12

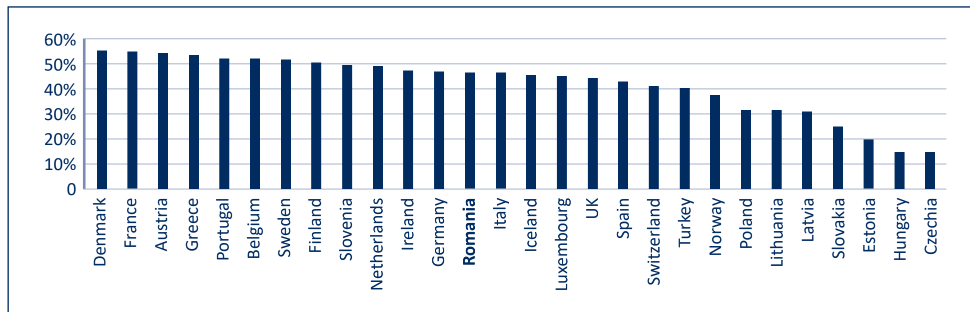
Source: Authors' processing based on data provided by the Eurostat, https://commission.europa.eu/business-economy-euro/accounting-and-taxes/company-tax_ro.

These rates reflect the diversity of tax approaches globally and can have a significant impact on investment decisions and business strategies of international companies, with Romania currently applying among the lowest tax rates.

c) Wage tax and mandatory contributions paid by companies to employees, as a percentage of income, based on data provided by the World Bank

In 2020, according to data from the Organisation for Economic Co-operation and Development (OECD), the highest statutory personal income tax rates in OECD European countries were recorded in Denmark (55.9%),

France (55.4%) and Austria (55%). At the bottom of the ranking, the Czech Republic (15%), Hungary (15%) and Estonia (20%) had the lowest rates. Romania ranks in a middle position as regards the level of personal income taxes.

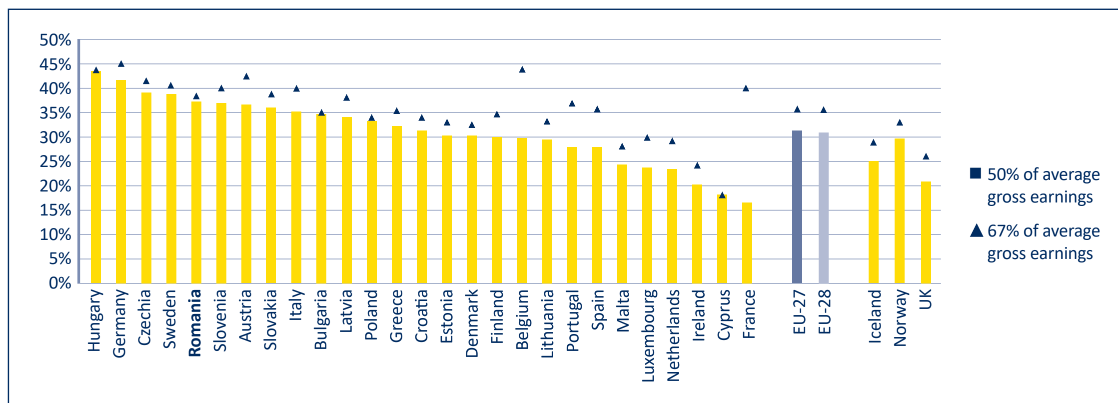


Legal rate of income tax in EU countries in 2020

Source: Authors' processing based on data provided by the OECD (2021).

d) Tax burden with an employee, calculated as the ratio between the total amount of taxes and mandatory social contributions of an employee and the total cost of work incurred by the employer

The indicator shows the extent to which labour taxation discourages employment, based on OECD data.



Tax wedge for an employee with income between 50% and 67% of average gross earnings in 2020 (% of labour cost)

Source: European Commission, 2021.

The graph above illustrates **the tax wedge**, calculated as the percentage of taxes in total labour costs. Romania is among the EU countries where the tax wedge is borne mostly by those with a lower salary (about 50% of an average salary).

e) Economic freedom indicator

Using the Heritage Foundation database, the fiscal freedom variable is used as a basis for calculating the economic freedom indicator. The calculation of the indicator is structured in three stages:

1. Individual calculation of each component:
   - Upper marginal individual income tax rate;
   - Upper marginal corporate income tax rate;

- Total tax wedge as a percentage of GDP.

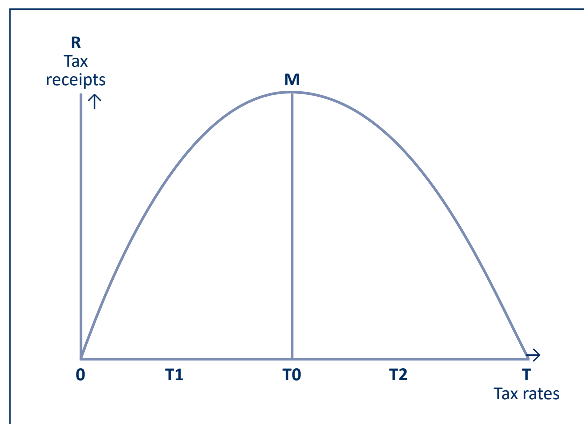
2. Weighting of each component. Each of the three components has equal weight, i.e. each contributes one third to the final calculation of fiscal freedom.

3. Final formula. The final score of tax freedom is calculated by taking the arithmetic mean of the three components.

$$\textit{Tax freedom} = \frac{\textit{Upper marginal individual income tax rate + Upper marginal corporate income tax rate + Total tax wedge as \% of GDP}}{3}$$

The score obtained will be between zero and 100, where a score closer to 100 indicates a higher level of tax freedom, i.e. a lower tax burden, and a score closer to zero indicates a low tax freedom, corresponding to a higher tax burden.

The Laffer Curve is a concept that describes the relationship between tax rates and tax revenues collected by the government.



Arthur Laffer is famous for his major contribution to the economic progress of the United States over the past two decades, gaining notoriety for his ability to simplify and clarify complex economic theories. He has been a member of a panel of influential experts who have guided US congressional economic legislation for the past 12 years. In 1974, Laffer marked a historic moment by sketching a graph that gave rise to his famous theory (Laffer Curve). This theory argues that reducing tax rates can increase budget revenues by stimulating economy.

The shape of the curve is a function of the elasticity of taxable income – that is taxable income changes in response to changes in the tax rate. As popularized by the theory-supporting economist Arthur Laffer, the curve is usually plotted as a graph that starts at 0% tax with zero income, rises to a maximum income rate at an intermediate tax rate, and then decreases again to zero income at a tax rate of 100%.

The relationship between tax rates and tax revenues is presented as follows:

✓ **Low tax rate.** At a very low tax rate, tax revenues are also low, because the tax on each unit of income is small.

✓ **Increasing the tax rate.** As the tax rate increases, tax revenues initially also increase. This happens because the state collects a larger percentage of the income of citizens and companies.

✓ **Optimal taxation point.** There is a point at which the tax rate maximizes tax revenues. This point is considered ideal from a fiscal standpoint, creating a balance between a tax high enough to generate significant revenues and low enough not to discourage activity.

✓ **High tax rate.** If the tax rate continues to increase after reaching this optimal point, tax revenues begin to decrease.

✓ **Excessive tax rate.** At an extremely high level of the tax rate, tax revenues can decrease significantly, even approaching zero, because economic activity is strongly discouraged and tax evasion becomes extremely widespread.

The Laffer Curve illustrates that there is no linear relationship between tax rates and tax revenues. There is a point of balance where tax revenues are optimized, and exceeding this point can lead to lower tax revenues. This theory is often used to argue that tax cuts can, under certain circumstances, increase tax revenues by stimulating economic activity. The Laffer Curve, although influential in fiscal and political theory, has been subject to significant **criticism**:

✓ **Difficulty identifying the optimal point.** One of the main criticisms is the difficulty of determining exactly where the optimal tax point is located on the Laffer Curve. Without knowing this point, it is difficult to formulate fiscal policies that maximize revenues without discouraging economic activity.

✓ **Considerable variations between economies.** The Laffer Curve does not take into account that different economies may have different optimal points due to differences in economic structure, levels of tax compliance and other factors. A tax policy that works in one country cannot automatically be effective in another.

✓ **Oversimplification.** Critics argue that the Laffer Curve oversimplifies the relationship between tax rates and tax revenues, ignoring factors such as the effects of different types of taxes, the structure of government spending, and overall economic dynamics.

✓ **Political usage.** The Laffer Curve has been used by some political groups to justify tax cuts, especially for those with high incomes, without sufficient analysis of potential consequences. This has led to the perception that theory is more of a political tool than an economic one.

✓ **Effects of tax cuts.** Some studies have shown that tax cuts do not always stimulate the economy to the extent suggested by the Laffer Curve and can lead to increased budget deficits and public debt.

✓ **Neglecting social equity.** The Laffer Curve focuses primarily on maximizing tax revenue, without considering social equity and income distribution. Tax policies based solely on this principle can lead to increased social inequalities.

✓ **Impact on government spending.** Focusing solely on tax revenues ignores the importance and effectiveness of government spending. Reducing taxes without taking into account the impact on financing public services can have long-term negative effects on social and economic welfare.

In conclusion, although the Laffer Curve provides an interesting perspective on taxation, its practical application and political interpretation require caution and a deep understanding of each country's specific economic and social context.

➲ The relationship between tax pressure and economic crime

In general, the tax wedge refers to the level of taxes and duties imposed by the government on citizens and companies. Economic crime includes a variety of crimes such as tax evasion, fraud, money laundering and other illegal activities related to finance.

There are several theories and perspectives on how tax pressure can influence economic crime:

✓ **Theory of deterrence.** Some experts argue that greater tax pressure can deter economic crime by imposing severe penalties for non-compliance with tax laws. This could theoretically reduce the temptation to commit economic crimes.

The theory of deterrence is a fundamental concept in criminology and criminal law, which is based on the idea that people can be deterred from committing crimes if the consequences of these actions are sufficiently

severe, certain and immediate. This theory applies both to conventional crimes, such as theft and violence, and to more complex crimes, such as economic crime. Key aspects of the theory of deterrence are:

Severity of the punishment	The theory assumes that the more severe the punishment for a crime is, the fewer people will risk committing that crime. The idea is that potential offenders will evaluate the cost of the action (i.e. the punishment) and decide that it's not worth the risk.
Certainty of the punishment	It is essential not only for the punishment to be severe, but also for there to be a reasonable certainty that offenders will be caught and punished. If there is a general perception that people can get away unpunished, the severity of the punishment loses its effectiveness as a means of deterrence.
Promptness of the punishment	The deterrence theory also suggests that punishments should be applied promptly after the commission of the crime. A prolonged delay between the crime and the punishment can weaken the perceived link between the two, thus reducing the deterrent effect.
Application in economic crime	In the context of economic crime, the deterrence theory would imply imposing severe punishments for offenses such as tax evasion, fraud, money laundering etc. This could include large fines, imprisonment or other serious sanctions. The goal is to make the cost of committing these crimes higher than any potential benefit.
Debates and criticism	Although the deterrence theory is widely spread and influences many justice systems, it is also the subject of debate and criticism. Some researchers argue that factors such as impulsivity, lack of opportunities or difficult social and economic contexts can limit the effectiveness of deterrence. There are also concerns about the fairness and proportionality of punishments.
Effectiveness	The effectiveness of the deterrence theory can vary depending on the type of crime, the characteristics of the offenders and the social and economic context. For some types of crimes and in certain contexts, it can be an effective tool for reducing crime, while in other cases it may be less effective.

In conclusion, the theory of deterrence is an important pillar of criminal justice systems and has significant implications for the development of criminal policies and legislation. However, its application must be balanced with considerations of justice, effectiveness and social context.

✓ **The reverse effect.** There is the argument that excessive tax pressure can actually stimulate economic crime. If fees are perceived as too high or unreasonable, both individuals and companies may be more inclined to resort to illegal methods to avoid paying them.

✓ **Complexity of the tax system.** A complex tax system can also create opportunities for economic crime. Ambiguities and loopholes in tax legislation can be exploited for tax evasion or other economic crimes.

✓ **Supervisory and enforcement capacity.** The effectiveness of supervision and enforcement of tax laws also plays an important role. Even if the tax pressure is high, if the implementation and enforcement of laws are weak, economic crime can flourish.

✓ **Socio-economic and cultural factors.** The socio-economic and cultural context can also influence the relationship between tax pressure and economic crime. Social norms, levels of trust in government, and general economic conditions can affect how people respond to fiscal policies.

✓ **Effect on the shadow economy.** The high tax burden can contribute to the growth of the shadow economy, where transactions and revenues are not reported to tax authorities. This can lead to an increase in illegal economic activities.

The effect of tax pressure on the shadow economy is a topic of great interest in economic and fiscal studies. Shadow economy refers to economic activities that are not reported to tax and regulatory authorities, thus remaining unincluded in official GDP figures or other economic indicators. Analyzing the relationship between fiscal pressure and shadow economy, the following effects are noted:

Increasing fiscal pressure	When governments raise taxes, the cost of tax compliance (i.e. the burden of complying with tax regulations) increases for businesses and individuals. In certain situations, this may lead companies or individuals to look for ways to avoid these taxes.
Migration to the shadow economy	As taxes rise, some businesses and individuals may be tempted to move some of their activities to the shadow economy to escape taxation. This can include activities such as undeclared work, unregistered transactions or even more sophisticated tax evasion.
Impact on state revenues	Although the intention behind tax increases is typically to increase government revenues, the shift of economic activities to the underground sector may lead to contrary results. This can reduce the tax base and, as a result, decrease the real income collected by the state.
Tax complexity	A high tax pressure, coupled with a complex tax system, can discourage tax compliance. If tax rules are too complicated or changeable, both individuals and companies can find justifications or methods to avoid taxation more easily.
Effects on competition and market	The shadow economy can distort competition on the market. Businesses that don't pay taxes can have an advantage over those that comply with the rules, which can unfairly affect competitiveness.
Risks and social issues	Activities in the shadow economy can lead to other social risks and problems. Workers in the shadow economy often do not benefit from social or labour protections and illegal activities can be linked to other types of crime.
Challenges for public policy	Managing and reducing the shadow economy are major challenges for public policies and require a balance between maintaining an adequate level of taxation, simplifying the tax system and ensuring effective compliance and anti-tax evasion measures.
Impact on inequalities	The shadow economy can also exacerbate economic inequalities. Tax avoiders can accumulate more resources at the expense of those who pay the due taxes.

Combating the shadow economy is a major challenge for governments, involving a range of strategies and policies aimed at integrating informal economic activities into the formal economy and reducing illegal activities. Here are some common approaches:

✓ **Simplification of the fiscal system.** Reducing the complexity of the tax system can facilitate compliance. Simplifying income statements, cutting red tape and clarifying regulations can make it easier for businesses and individuals to comply with tax laws.

✓ **Rational tax rate.** Setting reasonable tax rates can reduce the temptation to avoid taxes. Excessively high rates can motivate tax evasion, while lower but well-managed rates can encourage compliance and increase tax revenues.

✓ **Improving surveillance and control efforts.** Stepping up efforts to detect and punish tax evasion and illegal activities is crucial. This may include using advanced technologies to monitor transactions and improving cooperation between different government agencies.

✓ **Incentive for business legalization.** Providing incentives for businesses that choose to enter the formal economy, such as access to bank credit, legal and tax assistance, and other resources, can be effective.

✓ **Education and awareness.** Awareness campaigns about the importance of respecting tax laws and contributing to the formal economy can be useful. Public education can help change attitudes and promote a culture of compliance.

✓ **Improving legislation and law enforcement.** Creating and implementing effective laws to combat illegal economic activities, as well as ensuring that these laws are applied consistently and justly are essential.

✓ **Partnerships with the private sector.** Collaborating with the private sector in order to identify and address the causes of shadow economy can be beneficial. This may include partnerships to improve transparency and fight corruption.

✓ **Social protection and assistance programs.** Providing social and economic assistance programmes to reduce the need to work in the shadow economy, especially for vulnerable groups, is another important approach.

✓ **International cooperation.** As shadow economy can have transnational dimensions, international cooperation is crucial to combat phenomena such as money laundering and tax evasion globally.

✓ **Use of data and analytics.** Using advanced data and analytics to better understand the size and nature of shadow economy can help to make more effective policies.

➲ Conclusions

Overall, while the tax burden is necessary to generate government revenue, it needs to be balanced and well managed to prevent encouraging economic fraud. A comprehensive approach that includes fair tax policies, effective enforcement and efforts to increase public trust in government institutions is essential for minimizing economic crime as a result of tax pressure.

In conclusion, the relationship between tax pressure and economic crime is influenced by a multitude of factors, including the level and structure of taxes, the effectiveness of law enforcement and the broader socio-economic and cultural context. It is important to consider these factors when analysing and developing tax policies in order to minimise the risk of economic crime.

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