



ORIGINAL PAPER

Can the Tax Gap be a Useful Tool in Terms of Tax Performance?

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Abstract:

The tax gap can be defined as the difference between the effective taxes collected and those which would be collected under full compliance. By estimating the tax gap, it is possible to obtain relevant information about the degree of compliance and its components for a specific tax or for the tax system as a whole, including its evolution over time. This information can be essential for tax administrations when deciding how to allocate their resources to improve tax compliance. Consequently, it can be a useful tool for measuring fiscal performance, as it can provide insight into the effectiveness of a government's tax collection efforts. The fiscal impacts of compliance or non-compliance are of critical interest, not just to tax administrations, but also to other stakeholders, and a growing number of countries now regularly produce and publish estimated revenue losses due to non-compliance. A good tax gap analysis enables the detection of changes in taxpayer behaviour by consistent estimates over time.

Keywords: *fiscal space, tax space, tax capacity, revenue potential, tax performance, tax gap.*

JEL Classifications: H21, H26, H27, K34

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Introduction

Certain studies indicate that a correlation can be identified between a country's ability to collect taxes and its level of development (von Haldenwang & Ivanyna, 2012; Fenochietto & Pessino, 2013). The capacity to collect taxes, duties and contributions is essential to a country's ability to finance essential public services such as health and education, critical infrastructure (electricity, roads, etc.) and other extremely important public goods. Given the increasingly high needs of citizens, a low level of tax collection can endanger sustainable, social, and economic development in all countries. Thus, ensuring an adequate level of income through fiscal levies to meet economic and social needs becomes the goal of any government.

Although the concept of "fiscal space" is constantly evolving and taking on different meanings that emphasize different aspects of the resource mobilization problem, a generic definition of this concept can be as follows:

Fiscal space is the financing that is available to government as a result of concrete policy actions for enhancing resource mobilization, and the reforms necessary to secure the enabling governance, institutional and economic environment for these policy actions to be effective, for a specified set of development objectives (Roy et al., 2007)

In this context, the optimal fiscal space can be seen as budgetary dimension found at disposal of a government that allows it to supply necessary resources in order to fulfil all proposed purposes, without endangering sustainability of its financial position or economy stability.

Components of fiscal space can include aspects as: system of determination and collection of taxes (fiscal asieta), fiscal reforms necessary to improve system effectiveness, management of public debt and others. As a conclusion, fiscal space can be influenced by a series of factors such as: level of possible but also actually collected governmental incomes; the dimension of public debt; inflation rate; economic stability and so on.

Capacity of governments to collect taxes, duties and contributions, tax space, represents an essential component of fiscal space. Fiscal space and tax space are two interdependent concepts, because one government, in order to generate economic stability and responsible and sustainable development, cannot spend, on long term, more than taxes, duties and contributions which it collects.

By using this approach, revenue potential or tax capacity of a country, represents the dimension of incomes (of fiscal nature) which it can generate.

When we talk about incomes generated by a country economy, must be done a distinction between income potential based on inherent (intrinsic) economic capacity of a country: "economic income potential" and the one based on which is provided by the legal framework of a country (fiscal code and related legislation): "legal income potential". Therefore, can be identified two sets of revenue potentials: one can be denominated "revenue potential (economic)," and the other "revenue potential (legal)." The difference between the revenue potential (legal) and the actual revenue collected is commonly understood as the "tax gap" (Khawaja & Iyer, 2014).

Tax gap: definitions, components and main uses

The Internal Revenue Service (IRS) - the federal tax agency in the United States, was a pioneer in estimating the tax gap, its importance constantly increasing from 1973 (the year of its emergence) to the present. (Durán-Cabré et al., 2019).

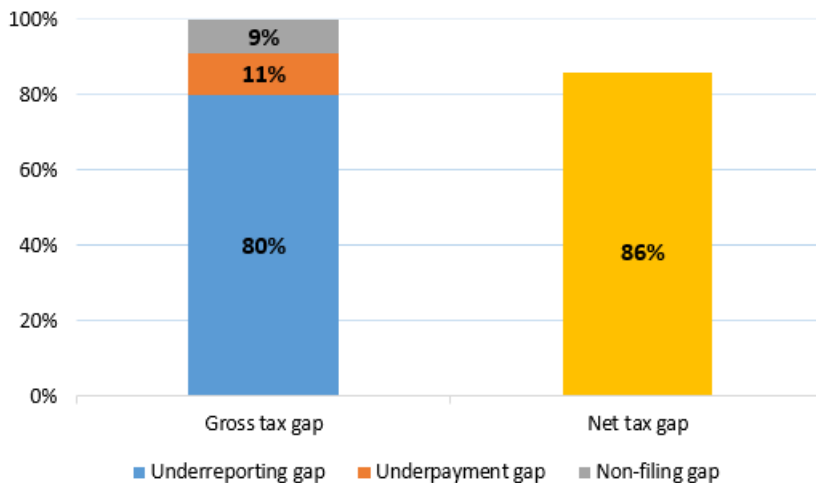
Broadly defined, the tax gap corresponds to the difference between the taxes legally due and the taxes actually collected. By tax gap estimation, can be obtained relevant information about voluntary compliance, the degree of non-compliance of fiscal obligations from perspective of fiscal system overall, or for a certain tax, including about their evolution in time. This information can become essential for governors when they decide which will be future fiscal politics capable to improve tax compliance and tax performance (Shaw et al., 2010).

In order to determine the degree of tax performance (or, more precisely, of lack of performance – the bigger is tax gap the more non-compliant is fiscal system that generates it), is also useful the tax gap differentiation in: gross tax gap and net tax gap.

The gross tax gap represents the difference between true tax liability for a given tax year and the amount that is effective paid on the legal due dates. In turn, it comprises in its composition the non-filing gap, the underreporting gap, and the underpayment gap (Alm & Borders, 2014). The percentage size of the tax gap components, in the USA, can be visualized in figure no. 1.

The net tax gap is the part of the gross tax gap that will never be recovered through enforcement or other late payments, and is calculated by adding back revenue generated by enforcement activities and other forms of late payment. (Johnson & Rose, 2019).

Figure 1. Components of the Tax Gap by Type of Non-Compliance in USA (%)



Source: Authors' processed, based on Internal Revenue Service (IRS) (2019)

Therefore, there are three sources of the tax gap: underreporting, underpayment, and non-filing. Underreporting covers non-payment due to understatement of income on timely-filed returns. Underpayment is making a payment below the legally owed tax on properly reported income on filed returns, and non-filing covers tax not paid on time when taxpayers do not file returns.

Determination and knowing the dimension of tax gap, and also the extent and development of phenomena which generates it is extremely relevant. As a consequence, according to Durán-Cabré et al. (2019), the estimation strategy of it must fulfil at least three conditions in order to guarantee rigor and transparency.

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First of all, the results must contain representative time intervals for public decision-makers. Second of all, methodology to determine tax gap dimension must be relatively stable in time, and third, data used for estimation must be available, for governors but also for citizens, periodically, at reasonable time intervals. Periodical estimation of this indicator can serve also as an effective method to consolidate governors' responsibility towards citizens, because they offer relevant public information about fiscal administrations' performance (Heald, 2003). In this way, the obtained information can become also an useful instrument of public management and social development (Olimid & Georgescu, 2017), providing a conclusive picture of degree of performance of fiscal politics and tax administration, allowing the contributors to adjust perceptions more close to what happens in reality (Kornhauser, 2005).

Decrease of tax gap is a good method to increase level of public budget incomes in comparison with alternative ways to raise the incomes, even though, many of tax gap reduction ways come with their own costs as higher compliance burdens for taxpayers (costs for enforcement, costs for supplementary information, costs for computerization of fiscal system and so on).

Information obtained after tax gap quantification can be used to measure inequality that comes from non-application in a unitary and equitable way of fiscal legislation (Murphy, 2019). Even though this issue is rarely mentioned in public speech of governors, is of great importance.

The law must be applied equally to all. There must be confidence that the law is applied equally to all sectors of society. Inequality in public administration gives rise to unequal treatment and hence unfairness. Governments and tax professionals must create a tax system that is fair, clear and applied equally to all taxpayers. Tax fairness and equal treatment principle should look to limit the legislation, rules and behaviour that favour one segment of the taxpaying population over another (Mitu, 2016; Mitu & Stanciu, 2018).

It's also important to consider the principles of tax equity. Tax equity is a measure of the fairness of the tax system based on an individual's ability to pay. Equity in terms of contributory capacity is generally considered in two senses: vertical and horizontal. The "horizontal" concept is that those who are in a similar situation, in terms of contributory capacity, should pay the same amount of tax. The "vertical" concept means that people who are at different levels in terms of contributory capacity, must be taxed differently.

Ultimately, equality and equity, means that fiscal legislation should be applied unitary, to have as few exceptions as possible, and that all taxpayers (natural and/or legal persons) should be obliged to pay what they owe. On the contrary, there is a real social issue, that in the mind of taxpayers is translated as: the ones that are paying for their taxes are dumber than the ones that are not doing it. Once this presumption is anchored in the collective mind, can generate resentments which lead to an increase in the degree of voluntary non-compliance and sharp drop of tax performance. The honest business is sub mined by the dishonest business. This means that the honest business has more chances to fail. As a result, the economic growth, financial stability, investments in business and employment perspectives will be negatively affected. The cost of tax inequality is big, especially if this becomes endemic.

If the fiscal system is abused on large scale, the entire economic politics of a state can become inefficient. Few states can afford now to be in this position and, as a

consequence, efficient measurement of tax gap is a key instrument to evaluate fiscal and tax performance.

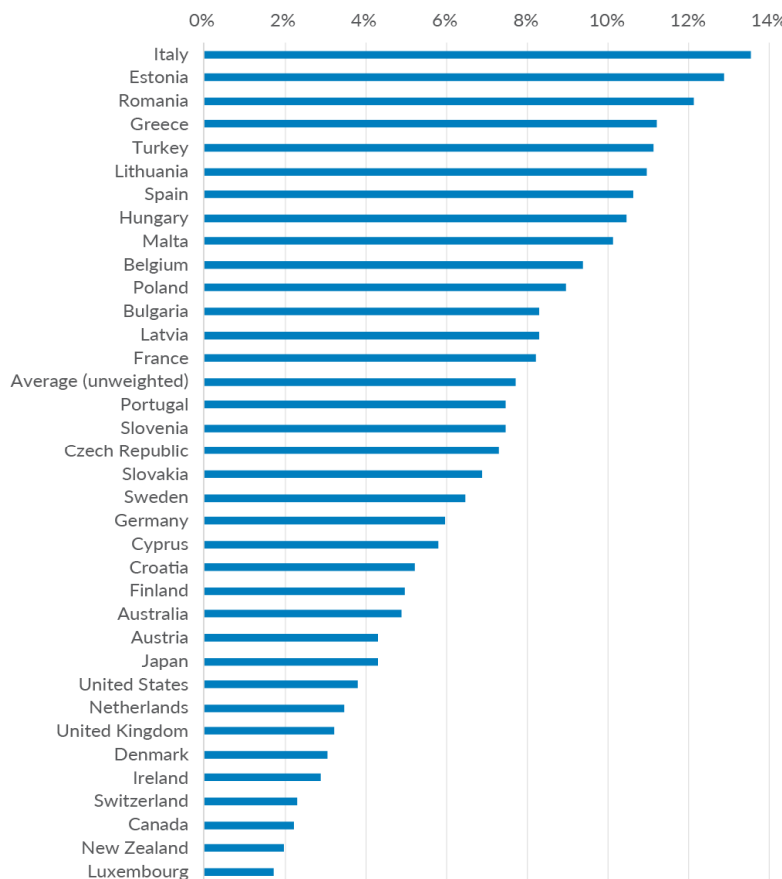
Measuring the tax gap

Literature dedicated to tax gap measurement, depending on the data used and degree of calculation detailing, identifies two major approach lines (Gemmell & Hasselidne, 2014; Raczkowski, 2015).

Macro approach (or top-down approach) uses aggregated data, with two alternatives: tax gap can be estimated by taking over of data about shadow economy and application of an average tax rate (Giles, 1997; Schneider & Buehn, 2008); or by using macroeconomic indicators, such as national consumption of GDP (Finardi & Vančurová, 2014). The main disadvantage of these methods is the fact that are not capable to make difference between each type of tax, they only measures the total tax gap (for all types of taxes). The evident advantage is given by the simplicity of their application (Dare et al., 2019), because use simple data, that are not difficult to collect.

Such an approach was used by Raczkowski și Mróz (2018) to estimate the level of tax gap for 35 countries (Figure 2):

Figure 2. The level of the tax gap (as %GDP) in 35 countries in 2015



Source: Raczkowski & Mróz (2018)

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Micro approach (or bottom-up approach) uses microeconomic data based on taxpayers' statements corroborated with results of inspections and controls performed by tax administration, being estimated an approximate tax base for each taxpayer according to owed tax type. For example, Mazur & Plumley (2007) mention the possibility to use methods based on audit, meaning a calculation based on data obtained during fiscal controls. Among disadvantages of this approach are delayed results in time, because these are based on data which are collected *ex ante*; alteration of overall quality of control activities and fiscal inspection (Toder, 2007) due to corruption, deficient training of fiscal inspectors or very sophisticated methods used of eluding tax obligations. Another microeconomic partial approach, considered to be more precisely, is tax gap extrapolation by using data obtained in other ways than from fiscal controls and inspections. (Toro et al., 2013; Ghezzi et al., 2013). This kind of data are collected in separated investigations which covers the income field, including information related to applying individual fiscal credits/fiscal bonuses or tax-free parties of tax basis. Micro approach represents the advantage that provides information detailed on different fiscal incomes categories, allowing performance of a redistributive analysis of tax gap, which is particularly relevant when you want an *ad personam* tax gap estimation.

Conclusions

Tax gaps exist, firstly, because of tax evasion. Tax gap determination represents, many times, performing of some estimations and finding the "invisible proof" (Slemrod și Weber, 2012). Even though, tax gap cannot be totally assigned to tax evasion, because this presumes deliberated non-compliance of legal framework. Still, non-compliance can have also benign causes. Results of non-compliance by the taxpayers, without intention, of fiscal legislation can be found included in tax gap, but these are not considered to be tax evasion (Olson, 2021).

Not distinguishing between causes of non-compliance can have as a result disproportioned actions of tax bodies, of which effect can transform honest taxpayers into intentionally tax evaders. This type of tax vision failure can lead to strong erosion of taxpayers trust, which is never a good thing for a fiscal system and about which researchers showed that is vital to perform and raise voluntary tax conformity (feature of a performant fiscal system) (Mitu, 2018).

Even though there is a unanimous recognition of advantages in precise determination of tax gap and important role which it has in substantiating of some performant fiscal politics, is surprisingly how little attention is given from many national governments in determination of this indicator. Recent study of Murphy (2021), regarding number of governments that performs estimations of tax gaps, suggest, for example, that within European Union only one ex member, Great Britain, determines an annual estimation of tax gap. In approximate half of all EU member states are not performed at all local estimations for tax gap. In many of the other countries (Italy being the exception to the rule), the single tax gap considered to be a partial and particular one, because is addressed to one single tax- value added tax (VAT) – VAT gap. This punctual approach can be given by European Commission concern, which analyses this issue and publishes an annual report regarding VAT (European Commission, Directorate-General for Taxation and Customs Union, Poniatowski et al., 2022).

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