

**Comments on Søren Bo Nielsen, Poul Schou and
Jacob Krog Søbysgaard: Elements of income
tax evasion and avoidance in Denmark**

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The task of discussing a paper is, to some extent, facilitated, but also hampered, by really enjoying the paper and the work behind it. Such is the case with the paper by Nielsen, Schou and Søbysgaard. The authors make a pertinent contribution to the discussion of tax evasion and tax avoidance. In more specific terms, they provide some general discussion and explore two issues quite thoroughly. First, they exploit the relationship between the tax base for income taxation and the tax base for consumption taxation in order to indirectly identify an anticipated shortfall in the tax base for income taxation. Their conclusion is that there is indeed such a shortfall in the range 1.8-3.6 per cent of GDP. Second, the authors explore migration out of and into Denmark in order to assess whether such migration threatens the personal-income-tax base. They conclude that the evidence does not indicate the existence of a serious threat in this regard.

The paper takes on important aspects of tax evasion and tax avoidance. The conclusions drawn are corroborated by solid empirical evidence, and as regards the basic analysis of the paper, I have found it very hard to mount any criticism. Nevertheless, I have some comments, and in the following, I will start by providing some general comments, and then proceed to painting a somewhat more pessimistic picture regarding the pressures likely to be exerted on the tax bases in Scandinavia by the mobility of skilled labour.

1. General comments

First, I would like to somewhat more specifically re-iterate the fact that I really appreciate the authors' undertaking. I think that the kind of work represented by their efforts to obtain a reasonably reliable estimate of the extent to which the income-tax base is eroded by income shifting and other means of tax avoidance and tax evasion is a

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prime example of work that one would like to see more frequently. In particular, it would be very interesting to see a similar undertaking for Sweden. Although it may seem an inessential detail, I would also like to compliment the authors for the crystal clear way in which they note how marginal vs. average, and statutory vs. effective, tax rates are relevant for different types of decisions affecting tax bases; the confusion about what is relevant in these regards is pervasive.

Second, I would have been interested in seeing some comment on the authors' view of the importance and magnitude of underground-economy activities. Although estimates of the size of the underground economy vary widely, even the lower-range estimates indicate that it is a major source of revenue loss. One reason for paying more attention to the underground economy is that some of the uncontroversial prescriptions typically offered to fight tax avoidance may have adverse consequences on the size of the underground economy. Another reason is that the Scandinavian countries rank relatively highly in some cross-country comparisons of estimates of the size of the underground economy.¹

2. The significance of skill mobility

The authors do not seem particularly worried about the pressure on the Danish income-tax base exerted by the mobility of skilled workers. Although they provide solid empirical corroboration for their view, I think there is complementary evidence that—along with some other observations—calls for a slightly more alarmistic view. I will devote the rest of my comments to tentatively taking issue with the authors' relative complacency in this regard. In doing so, I will appeal to some recent evidence for Sweden; some theoretical observations that may be increasingly relevant due to certain developments that may be mutually reinforcing and may increase mobility; and the emergent popularity of “expert taxes”, not least in the Scandinavian countries. I will stretch my own view a bit for the sake of the argument.

The authors' view that there is little evidence of increasing migration propensities in Scandinavia is broadly consistent with other work I have seen; in particular with the recent work by Pedersen et al. (2002) which explores migration in Denmark, Norway and Sweden in the 1980s and 1990s. However, the work of Pedersen et al. highlights

¹ This is true, for instance, for the estimates of Schneider and Enste (2000) based on the controversial “currency demand approach.”

a number of important qualifications of this view: First, it does seem that Sweden is different; according to their figures, annual emigration from Sweden increased by 195 per cent between 1988 and 1997. Although this figure is clearly in part due to business-cycle effects, Sweden was well out of the slump in 1997. Even taking into account the fact that the increase starts from a low level, it does not seem insignificant. Second, Pedersen et al. note an increase in emigration from the early 1980s to the late 1990s in Denmark and Norway as well; the increasing number of emigrants corresponds roughly to that implied by the combination of an expansion of higher education, the fact that migration propensities vary positively with education, and emigration propensities given education levels that have stayed essentially constant. Finally, and probably most interestingly, Pedersen et al. have obtained data on migration across occupations for Sweden. One cut of the findings obtained using these data shows that in spite of experiencing net immigration of workers with a university education between 1987 and 1999, there was a net outflow from Sweden of some categories of skilled workers with presumably mobile human capital. The net outflow of individuals with a Master's Degree in engineering was 4.5 per cent of the 1998 population of such individuals, and the corresponding figure for individuals with a Master's Degree in economics or business was 4.9 per cent. Even though the figures reflect a 12-year period, they seem significant.

My second argument for being a bit more worried than the authors about skill migration stems from the fact that some barriers to migration may currently be weakening and that migration is not a direct measure of mobility; the observed patterns may partly reflect incentives for migration being relatively moderate so far. This distinction is important in the light of some recent developments combined with the well-known theoretical arguments for the existence of a conflict between creating and maintaining an egalitarian income distribution on the one hand, and attracting mobile highly skilled workers on the other. Borjas (1987) has spelled out conditions for this conflict to arise; the upshot is that if earnings are strongly positively correlated in the country of origin and the country of destination, selection will depend on the relationship between wage variances in the two countries. If the wage variance is higher in the country of destination, the flow (in that direction) will be positively selected; it will be more attractive for workers with a high earnings potential to migrate. This argument clearly points out a risk faced by countries striving to attain an egali-

tarian income distribution. The Scandinavian countries have, however, long pursued this goal, and the fact that out-migration of skilled labour has not been a large problem so far may seem to reject the fears of its becoming important any time soon. Currently there are, however, changes taking place that serve to reduce the impediments to migration: Within Europe, serious efforts are being made to improve the portability of social benefits. There has, again particularly within Europe, been a substantial expansion of student-exchange programmes, which is not only likely to have the direct effect of making university graduates more internationally-minded, but also to have the indirect effect of making employers more informed about, and less suspicious regarding, potential employees with a foreign-acquired education. Also, as noted, the expansion of education increases the proportion of the population being prone to migration. In sum, there are a number of developments which one by one seem of minor significance, but which might have a larger joint effect due to their being mutually reinforcing.² Although this argument is somewhat speculative, I do believe that complementarities along these lines exist.

My final point concerns the special “expert taxes” that have been introduced in a number of countries, including Denmark, Sweden, and Finland. The thrust of these arrangements is that foreign skilled workers fulfilling certain criteria may, for a limited amount of time (3 years in Sweden), be exempt from income taxation; instead, they pay a rather low withholding tax (in the range of 25-35 per cent).³ Although there is an “actuarial” basis for the arrangement in that temporary immigrants cannot enjoy the social benefits in their country of temporary residence and cannot—due to imperfect portability—enjoy the corresponding benefits in their country of permanent residence, it seems clear that the main reason for their popularity is the desire of governments to attract this kind of skilled labour. A number of remarks can be made on the expert tax. First, it clearly indicates that some tax competition for skilled labour *is* going on. Second, it diminishes—from the governments’ perspective—the possible gains from temporary migration. In effect, it essentially amounts to a government subsidy to temporary migration; importantly, the size of the subsidy is a complex function of taxes and benefits in both countries involved. Finally, it might be good or bad as regards over-all tax competition;

² This point is made with a little bit of further corroboration and some additional references in Andersson and Konrad (2002).

³ Cf. Lodin (2000).

Keen (2001) has shown that the possibility to discriminate between parts of the tax base may bring a smaller total distortion as compared to a case where this is not possible.

In summary, the authors have thus produced a valuable assessment of elements of income tax evasion and avoidance. As regards the importance of the mobility of skilled labour, it seems to me that the jury is still out, however.

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