

CRITERIA FOR DEFINING TAX EVASION AS TAX TERRORISM

Māris JURUŠS

Riga Technical University, Latvia
 Corresponding author e-mail: Maris.Juruss@rtu.lv

Abstract. There are significant losses in tax revenues across the European Union (EU). National governments lose billions of euros in the revenues from non-paid taxes and other illegal activities. The fight against aggressive tax planning, tax fraud and illegal activities is on the agenda of the EU, OECD and all the national governments. However, due to the size of tax losses it should not be treated just as tax evasion, but rather as tax terrorism! Therefore, the author has set criteria when tax evasion should be named as “tax terrorism” as well as designed the principles for tackling tax terrorism and other ways of non-payment of taxes. The tax evasion could be treated as “tax terrorism” in case of international evasion from taxes by organized groups of persons for criminal purposes as well as when it creates significant losses in government revenues. The term “tax terrorism” would have impact to communication and cause response of society and politics, therefore it would have more social and political consequences.

Keywords: Taxes, avoidance, evasion, terrorism, administration.

INTRODUCTION

The fight against aggressive tax planning, tax fraud and illegal activities is on the agenda of the EU, OECD and all national governments (Council of the European Union, 2016).

There are significant losses in tax revenues across the European Union (EU). The value added tax (VAT) gap in the EU is €160 billion, including €547 million or 23 % in Latvia (TAXUD, 2016). The VAT gap has decreased in the Baltic States, nevertheless it still remains very high (see Fig. 1).

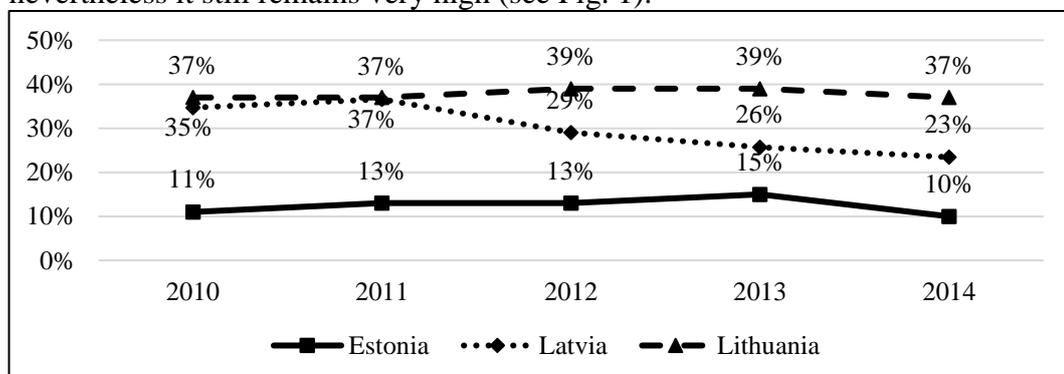


Fig. 1. VAT GAP, as the percentage of VAT of Total Tax Liability in Estonia, Latvia and Lithuania (developed by the author; TAXUD, 2016).

Currently, within excise tax harmonization minimal tax rates (in EUR) have been adjusted. It means that countries should increase actual excise tax rates which would impact the growth of the retail sales price. However, if we compare the tax rates and the retail sales price by purchasing power in each country, there are huge price differences. For example, in Fig. 2 we can see the work time in minutes to purchase a package of cigarettes in the EU.

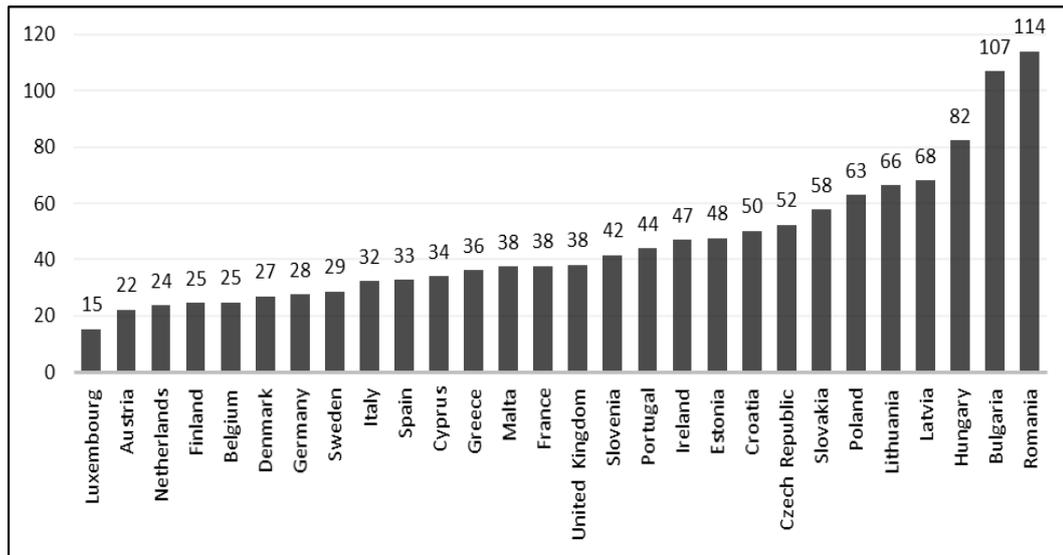


Fig. 2. Work time in minutes to purchase a package of cigarettes (Developed by the author; TAXUD,2016; Eurostat, 2016).

Latvia is in the fourth position in this table. In other words, the excise tax rate and the retail sales price therefore, is very high for consumers in Latvia comparing with other countries (see Fig. 2). This motivates the consumers to buy cheaper duty non-paid cigarettes, consequently promote smuggling and tax evasion. There is a huge illicit cigarette market in the EU amounting to 9.8 %, with tax losses of €11.3 billion, including 26.7 % or €77 million in Latvia (KPMG, 2015).

Global corporate income tax (CIT) revenue losses are estimated from about 4 % to 10 % of global CIT revenues, i.e. USD 100 to 240 billion annually (OECD, 2015). Even Latvia has one of the lowest tax burdens of capital and the income of capital in the EU (Eurostat, 2016), while businesses remain sceptical. There have been changes in implicit tax rates of CIT in the Baltic States, however, now it remains fairly low and comparable (see Fig. 3).

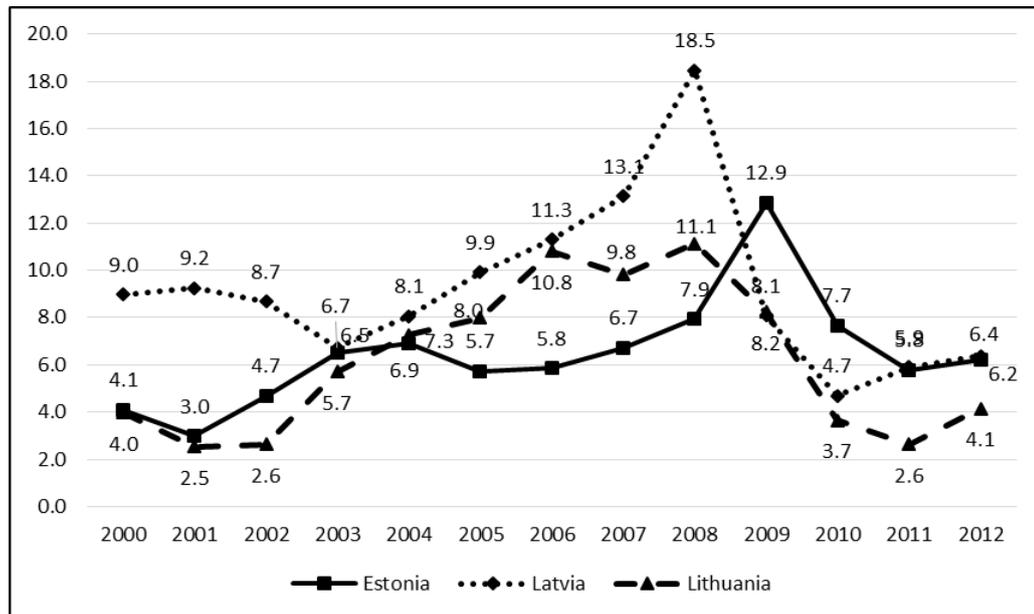


Fig. 3. Implicit tax rates in % – corporate income in Estonia, Latvia and Lithuania (Developed by the author; TAXUD, 2016).

To remain competitive in the global market, companies use different schemes for corporate income tax avoidance. The most popular of them is the profit shifting or investments in low tax burden territories. Instead of cooperation, governments compete for the most attractive corporate income tax regime.

Non-payment of taxes or tax minimization usually can take the form of tax avoidance or tax evasion (Blaufus et al., 2016).

However, nowadays due to significant losses for governments, it should not be called tax minimization, but rather “tax terrorism”?! This is the main question of this research. As there is no common universal definition of “tax terrorism”, the author would like to develop such a definition to encourage international and national governments to pay more attention to this problem.

The aim of this research is to develop the criteria for the cases when tax evasion should be named “tax terrorism” and has designed the approach for tackling tax terrorism and other ways of not paying taxes. The objectives of this article are to analyse the factors of non-payment of taxes, to present an overview of the study of losses in tax revenue, to discuss the best practice of limiting tax avoidance and evasion, as well as to develop recommendations for the improvement of tax administration.

Qualitative analysis of studies and regulations was used as the research methodology. The paper contributes to different information sources and literature on tax evasion and related issues.

1. LITERATURE REVIEW

There is no universal definition of “terrorism”. Various jurisdictions and governments use different definitions. The term is more political nowadays.

Usually it is related to threat of violence due to political, religious, or ideological principles; it could impact a larger part or group of society and more than the immediate target victims; it certainly is crime, illegal, immoral and wrong.

There is “The Counter-Terrorism Act” in the United Kingdom (Blackbourn & Walker, 2016) and similar legislation in many other countries. Many international conventions deal with various aspects of terrorism, but in all these conventions terrorism is defined as a specific subject of the particular convention (Sorel, 2003).

With the term “terrorism” governments used to describe activities, which use methods that are illegal. The aim is rather to condemn than to define the activities (Grozdanova, 2014). “Terrorism” has an international aspect and is related to violence against civilians in order to attain political aims (Saleem & Tahir, 2014). The term “terrorism” has impact on communication and creates response of society and politics, therefore it has social and political consequences (Bruce, 2013). For evaluation of public policy decisions, a definition of terrorism should be developed that distinguishes terrorism from other forms of violence (Reitan, 2010).

Usually, terrorism is not considered in the cases of financial or tax crime. Attention to the problem is drawn only if it is related to financing of terrorists. There is evidence that many illegal activities, such as tax evasion, tax fraud, illegal import or similar activities are related to illegal income that is used for financing of terrorism. So, a common point can be found between the problem of the definition of terrorism and the problem of fight against the financing of terrorism (Sorel, 2003). Why should we not consider and combine the definitions more widely? A distinction could be set among tax evasion, tax avoidance and tax terrorism. However, what could be the criteria?

The distinction between the tax avoidance and tax evasion is more legal than economical. The overlap of the tax avoidance and tax evasion is indisputable and unsurprising. Every crime requires a prohibited act. In tax evasion the prohibited act is by definition unlawful tax avoidance (Mullineux, 2014).

Tax evasion can have many forms and happen in any industry. It is very popular among individual entrepreneurs or self-employed persons. For example, in 2009, there was 43 %–45 % of unreported self-employment income in Greece (Artavanis, Morse, & Tsoutsoura, 2015).

The factors of tax non-compliance are tax rate, penalty level, tax system fairness and others (Sinnasamy, Bidin & Ismail, 2015).

Due to shadow economy countries have serious implications for public policy. Shadow economy weakens the government’s capacity to generate revenue. (Blackburn, Bose & Capasso, 2012).

Tax evasion often goes hand-in-hand with corruption. Corruption and the misuse of government revenue often provide moral justification for tax evasion. Trust to government and to institutions is vitally important, too. Individuals are more likely to respond either to enforcement or to tax services if they believe that the tax administration is honest; that is “trust” in the authorities can have a positive impact on compliance (Litina & Palivos, 2016).

Studies show the results of evidence of increasing levels of tax evasion as well as welfare losses during fiscal reforms and consolidations, which could be reduced substantially by combating tax evasion and corruption. Accounting for tax evasion

and corruption is the key for understanding the effects of fiscal consolidation. The reforms aimed at fighting public corruption and tax evasion should go hand-in-hand with austerity measures in order to mitigate the welfare costs of fiscal consolidations (Pappa, Sajedi & Vella, 2015).

Tax evasion is a bad thing and cannot be justified as society loss revenues, however, in some cases money comes back in economy through people investments. Thereby, tax evasion and tax corruption may contribute to the development of private capital if people find an opportunity to invest the proceeds of their illegal activities in equity markets. (Célimène et al., 2016).

In a right-to-manage collective bargaining setting, the level of tax evasion affects wages and employment, thereby altering output. Furthermore, in an efficient bargaining context, tax evasion will also affect wages (Wu, 2016).

Tax evasion might be very closely related to terrorism. Using companies situated in “tax havens”, today, billions of US dollars are “recycled” in complicated financial operations supported by well-organized mechanisms and then, after “the black money” having origin in organized crime activities are reinserted in the legal economy and very often used to finance terrorism. Cooperation between law enforcement agencies, the establishment of common rules regarding tax havens and not least criminalizing of any actions related to recycling of funds is the only way to stop terrorist groups (Popa, 2013).

Tax haven and money laundering services share some complementarities. Tax havens behave uncooperatively in implementing regulations to increase the probability of detecting money laundering (Schwarz, 2011). Off-shores often have been used for tax evasion. The assumption that the money deposited in off-shores in a majority of cases means unpaid taxes. Global tax harmonization could be the solution regarding tax havens and off-shores (Joppe & Sproge, 2016).

Tax evasion is the result of national tax regimes and cumbersome legislative imperfections, encouraged by the existence of tax reduction or in terms of fiscal freedom. To limit this phenomenon, the state must work towards developing administrative capacity by improving the coordination of actions to control and monitor the activities of taxpayers, especially concerning the calculation, collection and payment of tax obligations (Vasile & Croitoru, 2015).

While corruption and tax evasion can exist separately, they can easily become entangled. Corruption enables tax evasion by making it easier for taxpayers to hide their income, while tax evasion can contribute to corruption by creating additional opportunities for corruption to thrive. Policymakers must understand the relationship between the two problems. Our basic estimation results provide consistent evidence that corruption is a driver of evasion (Alm, Martinez-Vazquez, & McClellan, 2016).

2. APPROACH IN FIGHTING TAX TERRORISM

On the basis of the discussions about the definition of terrorism and according to international experts’ opinions about non-payment of taxes, the definition of “tax terrorism” could be proposed according to the following main criteria:

- there is an international aspect of non-payment of taxes, when more than

one country is involved;

- evasion is done by organized groups of persons;
- schemes or weakening of tax system are not used for business purposes but for tax fraud or other illegal activities, that is, only for criminal purposes;
- evasion or fraud creates significant losses in revenues of governments.

Indeed, in practice it could be quite difficult to set the distinction between the tax terrorism and other forms of non-payment of taxes, however, perhaps the size of tax evasion could play the most important role. As in the case of terrorism which affects society generally, also tax evasion should be treated as tax terrorism if it has internationally wide effect and impacts society globally. The term “tax terrorism” would have an impact on communication and create response of society and politics, therefore it would have more social and political consequences. In practice, VAT fraud, illegal import and profit shifting to off-shores to avoid income taxation could be classified as tax terrorism, as it is usually done at international level by organized groups of persons mainly for criminal purposes.

It should be decided how to react to tax terrorism, therefore, the author has developed the approach for fighting against tax terrorism. It is showed in Fig. 4.

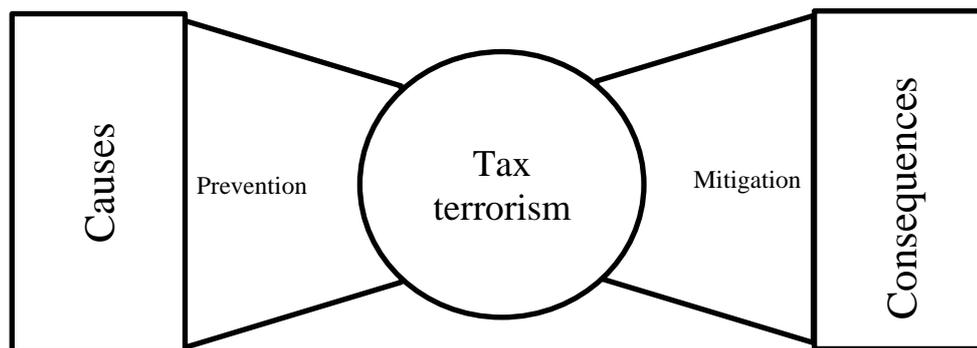


Fig. 4. The approach for fighting against tax terrorism (Developed by the author).

Again, in practice the approach to limit tax terrorism could be similar, as it used to be in the case of tax evasion or avoidance. Perhaps, only different instruments can be used or more emphasis put on the activities.

Generally, there can be two approaches used to limit the tax terrorism (see Fig. 4). The first, the causes of tax terrorism should be prevented. This is a long-term issue and may require a lot of resources and activities. It mainly depends on general economic situation and other external factors; therefore, it might be a difficult task. Moreover, maybe it is mainly a tax policy issue. The second, the consequences of avoidance and evasion should be mitigated. This task is more related to tax administration and could require active participation of controlling and enforcement institutions.

There can be different causes for tax terrorism. For example, factors for non-paying taxes commonly cited by the members of the Commonwealth Association of Tax Administrators (CATA, 2006) are:

- Economic: lack of employment, poverty, the need to be competitive, unemployment benefits;
- Cultural social: attitudes and perceptions towards taxation, fairness of tax system;
- Administrative and regulatory: high marginal tax rates, complexity of tax law/system, limited resources and capacity of the tax administration, restrictions and prohibitions;
- Developments in society: technology and infrastructure, low literacy and education.

There are different consequences of tax evasion:

- Smuggling: illegal import, counterfeit;
- Undeclared income: envelope wages, cash without bill;
- Incorrect application: personal expenses from business account, exemption;
- Fraud: VAT schemes, fictitious transactions.

Tax evasion causes loss of revenue, underreporting, illegal market, distortion of competition, insufficient budget for government spending and other consequences. Therefore, it should be limited in context and in the interests of the society.

It is more difficult to fight with the consequences of tax terrorism than with causes. It also requires resources and need for different actions. Risk management process should be applied as the key tool in mitigation of consequences. Governments should find the right balance of investments between the causes and consequences of tax terrorism.

3. DISCUSSION

Governments and policy makers should be involved in the prevention of causes of tax terrorism by developing common strategy and action plans. For example, to plan measures to improve business environment, to motivate taxpayers, to develop tax initiatives, to educate stakeholders and inform society. Or in other words, increase public awareness about the importance of paying taxes. There may also be the need for some tax reforms and probably changes of the traditional tax system and application of taxes. The prevention of causes of tax terrorism is a challenge and may require solving of several dilemmas at national and international level.

A new action plan has been developed to limit the shadow economy in 2016–2020 in Latvia (Ministry of Finance, 2016). The action plan envisages many activities in order to limit the causes and consequences of tax evasion, including such activities as limiting unregistered unemployment in building industry, introducing special taxation of taxi services, introducing the “one-stop-shop” principle in state and municipality agencies, investing and developing the infrastructure of detector dog service. However, the action plan is very general and it might have more specific actions included regarding the fight against excise tax, VAT and corporate tax evasion as the tax gap from these three taxes is the biggest.

In excise tax harmonization actual purchasing power should be considered. Therefore, excise tax policy should be adjusted to the real situation rather than simply harmonizing minimal rates. Moreover, restrictions of business and trade should be adjusted to the capacity of legal business, as well.

On the other hand, or from point of view of tax administration the fight against smuggling and tax fraud should be on the daily agenda of tax and customs administration. To improve the collection of taxes, it would be necessary to increase the penalty for illegal activities as well as to perform many other specific tasks, where adequate resources would be needed. As customs administration works for all the EU market, financial and technical support from the EU should be requested.

Investments in technologies and technical equipment, such as scanners, automated identification tools, and night vision equipment at border checkpoints are needed to help in discovery of smuggling. For example, the development and implementation of *Track&Trace* system is mentioned as one of the possible solutions to control the illicit market of cigarettes (TAXUD, 2014). Moreover, the development of detector dog service could help in the process of limiting the smuggling.

VAT fraud is one of the biggest problems in collecting of revenues nowadays. With the VAT gap of 23 % Latvia is one of the leaders in this issue in the EU (TAXUD, 2016). Also in this context, we should probably start with possible changes in tax policy (fight the causes of evasion) rather than tax administration (mitigate consequences), for example, definitive VAT regime may replace the traditional VAT system very soon (European Commission, 2016).

The problem is in the EU VAT system itself. VAT is generally a universal tax, applied in all multi-stages of sales of goods or supply of services contrary to the sales tax in the US which has been charged in a single – end or retail stage of the sales process. Therefore, according to the principles of VAT input/output calculation or credit method, trader in chain transactions has rights to deduct input VAT. Normally, it works as any taxpayer should pay the tax only on added value. However, if there is a fictive trader involved in such transactions the system becomes wrong as it allows deducting the input tax of legal trader, but if in the previous stage the trader does not make legal business he also does not pay the output tax. The consequence is government loss in tax. As a result, carousel schemes are widely spread among all the EU countries, fast money for tax terrorists – huge losses for national governments.

One of the solutions is the expansion of application of reverse charge of VAT which has also recently been used in Latvia regarding electronic devices, computers and similar products. However, it could just temporarily limit the fraud as the tax terrorist may switch to other industries and sectors.

The main dilemma is to keep the VAT system based on the destination principle or to consider the changes in origin based principle. At the beginning of VAT harmonization, the destination principle was as a temporary solution while the member states agree to implement the origin based principle in VAT taxation. However, the origin principle was not introduced due to the member states not being able to agree on the collection of tax revenues under such system, because of fear of risk of damages in the national budgets as well as due to lack of practical

solutions for the clearance system for intracommunity transactions. Therefore, now, after long discussions as “golden egg” for the solution in fight against VAT fraud the European Commission has been presented the new definitive VAT system (European Commission, 2016). The Commission considers that in the definitive VAT system the taxation rules according to which the supplier of goods collects VAT from his customer should be extended to cross-border transactions. This will ensure consistent treatment of domestic and cross-border supplies along the entire chain of a production and distribution, and re-establish the basic features of the VAT in cross-border trade, i.e. the fractionated payments system with its self-policing character. However, further studies on this system probably will show how it will really impact the future of VAT collection.

One of the actual discussions in Latvia is regarding the changes of corporate income tax (CIT). This is the issue of tax policy. The dilemma is whether to focus on the expansion of tax base or on the change of the principle of taxation. Businesses and experts propose either to consider the change of principles of taxation and to introduce CIT system as it is in Estonia or to apply a 0 % tax rate if a company reinvests profit and charge only the distributed profits. One of the arguments in favour of such system is that it would attract investment. To answer this questions further research and studies might be necessary to prove the effectiveness of such reform. Indeed, tax base should be reviewed and the audit of the effectiveness of applied corrections and reliefs should be examined. Currently, taxpayers can use the incentive of loss transfer (SRS, 2016). In practice a lot of commercial banks still forward losses of 2008–2009, however, the situation has improved and changes might be considered to limit such transfers in time as a lot of commercial banks started to gain huge profit and significantly increase ability to pay taxes. Moreover, in the context of economical and administrative effectiveness other tax incentives and relief should be reviewed, too.

Maybe, the best tool in the prevention of tax terrorism is cooperation (Burton, 2002). Base Erosion and Profit Shifting Action plan has been developed for fighting against aggressive tax planning and limiting international tax avoidance activities (OECD, 2015). Both, the EU and OECD as well as the national governments should continue close cooperation and go further behind BEPS Action plan also fighting with tax evasion and other illegal activities. Future researchers should extend this study and look into the business strategy and type of operation run by respective companies and their subsidiaries together with their notes to the account on related party transaction (Omar & Zolkafilil, 2015).

CONCLUSION

To reduce non-payment of taxes some tax reforms and changes in traditional tax system might be required, both, at national and international level. For example, definitive VAT regime should replace the traditional VAT system. The effectiveness of tax incentives should be examined, in order to attract more investment and promote business environment. It is proposed to consider changes in the principles of taxation and to apply 0 % tax rate if company reinvests the profit.

Investments in technologies and technical equipment such as scanners, automated identification tools, and night vision equipment at border checkpoints are needed to help to discover smuggling.

Thus, perhaps it is time to call tax evasion a “tax terrorism” in cases of international evasion from taxes performed by organized groups of persons for criminal purposes, as well as when it creates significant losses in the revenues of governments. The term “tax terrorism” would have impact to communication and create response of society and politics, therefore it would have more social and political consequences. Both, the EU and OECD as well as national governments should continue close cooperation and take further steps in fighting the “tax terrorism”.

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Māris Jurušs received the degree of Dr.oec. from Riga Technical University in 1999. The theme of his research project was “Theoretical Aspects of Improvement of Tax System”.

From 1996 to 2007, he worked at the Ministry of Finance. He was involved in many European Commission’s and Council’s working groups on harmonization of Latvian tax legislation with the EU principles. From 2007 to 2012, he was a Tax Manager with PricewaterhouseCoopers. He has been involved in many tax projects regarding excise duty, customs matters and others.

Since 2012, he has been an Assistant Professor with Riga Technical University. He has been involved in several research projects: mineral oil and alcohol losses during customs procedures (2013), optimal excise duty structure on cigarettes (2013), landfill taxes (2013).

E-mail: Maris.Juruss@rtu.lv