

## *Combating the shadow economy: a taxpayer-centric approach*

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Informal economic activity is described through a diverse range of terms: commentators refer variously to the shadow sector, hidden work, concealed employment, or the underground economy (to mention but a few examples) to describe fundamentally similar phenomena. What unites these concepts is the idea of otherwise licit remunerated activity that is carried out beyond the full scrutiny of the state. Informal economic activity is distinct from criminal activity (for instance, drug-trafficking) as its illegality consists only in the fact that it is not adequately declared to the relevant authorities for tax, social security and/or labour law purposes. It is distinct from the domestic or family economy, as work that occurs in this sphere is generally unpaid.<sup>62</sup> This definition includes the market trader who finds it too costly or burdensome to meet the requirements of the tax system, particularly if the risks of discovery and prosecution seem remote; well-educated professionals otherwise operating on a legitimate footing, such as the doctor who does not declare cash receipts from certain patients; and large enterprises that have the understanding and capacity to comply but choose to avoid some or all of the burdens involved, for example by keeping employees off the books and out of the reach of labour laws, or by only putting part of their salaries through the formal payroll system.

Bringing economic activity out of the shadow economy is an important objective for governments across the world. From a revenue authority perspective, the focus of formalisation efforts is usually on increasing revenue yields, but combatting informality can advance a diverse range of public policy objectives. Formalisation can drive economic efficiency by ensuring that all businesses compete on a level playing field, under the same tax and regulatory burdens; it can improve quality of life for employees by guaranteeing minimum working conditions and salary levels; it can enhance growth by offering businesses better access to finance; and it can strengthen civic engagement, as citizens demand a say in how their taxes are spent.

This is not to say that the shadow economy is entirely without value, either for those who participate in it or for society more broadly. Some commentators have suggested that the informal sector is home to a dynamic and vibrant entrepreneurial culture, though the low productivity levels associated with informality suggest a more nuanced picture.<sup>63</sup> Informal economic activity also acts as a valuable source of employment, helping people to enter the labour market who might otherwise be excluded, benefiting them and increasing the productive capacity of the economy as a whole. Many of the informally employed are drawn from marginalised groups, such as the low-skilled, young people, female workers, and migrants (legal and otherwise). Clearly, however, undeclared work can be a mixed blessing for these individuals: often exposing the already vulnerable to insecure jobs, exploitative practices, and dangerous working conditions.

<sup>62</sup> Colin C. Williams and Jan Windebank (1998) *Informal employment in the advanced economies: implications for work and welfare*, Routledge.

<sup>63</sup> International Labor Office (2002) *Decent Work and the Informal Economy*, International Labor Office; Colin C. Williams and Alvaro Martinez (2014) "Is the informal economy an incubator for new enterprise creation? A gender perspective", *International Journal of Entrepreneurial Behavior & Research*, 20(1), 4-19; Colin C. Williams & John Round (2007) "Entrepreneurship and the informal economy: a study of Ukraine's hidden enterprise culture", *Journal of developmental entrepreneurship*, 12(1), 119-136.

From a public policy perspective, informal economic activity constitutes one of the more intractable problems facing governments. While most countries have seen a downward trend in informality over the last decade, the gains have been gradual. Convergence with the level of informality enjoyed by leading countries is slow, with corresponding implications for the development of public services and the economy as a whole. Moreover, even countries with highly developed economies and tax administrations show surprisingly high residual levels of informal economic activity. Figure 3.3 illustrates the persistence of informality, limited convergence, and gradual pace of change by reference to EU15 countries and new member states acceding to the European Union in 2004 and 2007.

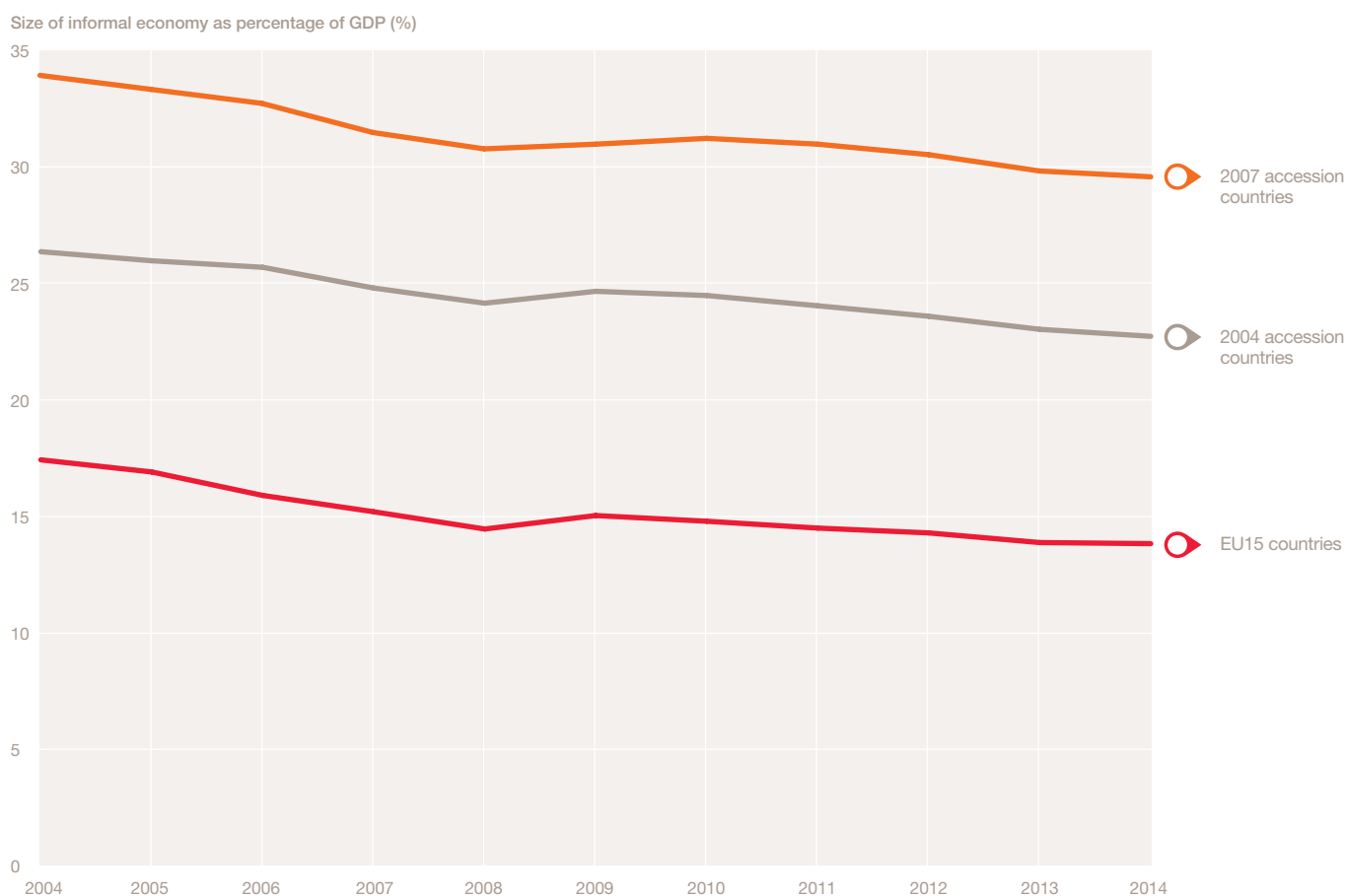
### *Paying Taxes and the informal economy*

One of the key drivers of informality is taxation: both tax policy, and how that policy is administered. Perhaps the most often-cited reason for operating informally is the desire to avoid paying taxes, and the associated compliance costs.

Traditionally, revenue authorities have adopted a repressive approach to bringing the informal economy into the tax net: focusing on effective penalties and improving detection and enforcement rates. In recent years, however, greater emphasis has been placed on facilitating formalisation, reducing the costs of compliance that can deter businesses from exiting the shadow economy.<sup>64</sup> This has led to a proliferation of initiatives, including the introduction of online tax returns, investment in improving taxpayer services, information campaigns designed to boost tax morale, tax amnesties to encourage movement out of the undeclared sphere, and simplified tax regimes for smaller sized businesses.

**Figure 3.3**

Trends in the size of the informal economy as a percentage of GDP in selected EU member states, 2004-2014 (unweighted averages of national-level data).



Source: Friedrich Schneider, Konrad Raczkowski & Bogdan Mróz (2015) "Shadow economy and tax evasion in the EU", *Journal of Money Laundering Control*, 18(1), 34-51.

<sup>64</sup> Colin C. Williams, Jan Windebank, Marijana Baric & Sara Nadin, (2013) "Public policy innovations: the case of undeclared work", *Management Decision*, 51(6), 1161-1175.

Here, the *Paying Taxes* sub-indicators can be an invaluable source of information to decision-makers, providing an independent assessment of whether interventions are resulting in a simplified compliance process for a standardised model business, and highlighting instances of best practice internationally.<sup>65</sup> For example, Turkey and Romania are countries where informal economic activity accounts for a substantial proportion of GDP, but which have also seen a higher reduction in these levels over the last decade than many of their peers. Examining their *Paying Taxes* sub-indicators, we find that in both countries the Total Tax Rate and time to comply have fallen dramatically over the same time period.

### **Understanding the formalisation choice**

Nevertheless, it is important to recognise that correlation does not equate to causation, and the decision to formalise or operate in the shadow economy is affected by much more than tax compliance costs alone. By adopting a taxpayer-centric perspective on the informal economy, policy-makers become better able to understand the drivers of informal economic activity, and thereby appreciate the diverse range of measures that they can deploy to improve compliance (See Table 3.1). These include measures to reduce the costs of formalisation, enhance deterrence, increase the benefits of formalisation, and improve tax morale.

The centrality of tax policy and administration to the problem of informality is particularly evident in the first two of these four categories. Reducing the costs of formalisation might involve reductions in both the direct financial burden of tax (for example, through lower or zero-rated bands for smaller enterprises) and the indirect burden of tax compliance (for example, through simplifying and consolidating taxes, streamlining the administration of tax, improving online services, or offering information and support throughout the compliance process). Enhancing deterrence increases the costs of non-compliance – primarily, non-compliance with the tax regime – for any given taxpayer, by making it more likely that they will be caught and punished. This category might include novel uses of data and technology, strengthening tax investigations and enforcement proceedings, or closing off opportunities for tax inspectors to grant exemptions in return for bribes. One of the more innovative schemes to deter VAT avoidance has been the introduction of VAT lotteries, whereby consumers can submit sales receipts to a government-sponsored competition offering prizes such as luxury cars, as well as other benefits such as income tax reductions.<sup>66</sup> Following the introduction of a VAT lottery in Portugal in 2014, a 4% increase in VAT revenue has been reported, against only a 2% rise in private consumption.<sup>67</sup>

**Table 3.1**

<b>Taxpayer perspective</b>	<b>Measures to combat the informal economy</b>
Reduce costs of formalisation	<ul style="list-style-type: none"> <li>• Improve tax policy and administration</li> <li>• Improve taxpayer services</li> <li>• Improve wider business environment</li> </ul>
Enhance deterrence	<ul style="list-style-type: none"> <li>• Improve detection and enforcement</li> <li>• Review penalty regime</li> <li>• Combat corruption in revenue collection</li> </ul>
Increase benefits of formalisation	<ul style="list-style-type: none"> <li>• Access to property rights/contract enforcement</li> <li>• Access to welfare entitlements/labour rights</li> <li>• Access to finance/business support</li> </ul>
Improve tax morale	<ul style="list-style-type: none"> <li>• Minimise inefficient uses of public funds</li> <li>• Provide high quality public goods and services</li> <li>• Increase tax compliance in population as a whole</li> </ul>

<sup>65</sup> Friedrich Schneider, Konrad Raczkowski & Bogdan Mróz (2015) "Shadow economy and tax evasion in the EU", *Journal of Money Laundering Control*, 18(1), 34-51.

<sup>66</sup> Joe Stanley-Smith (2015) "VAT lotteries – driving up compliance from the consumer's end", *International Tax Review*.

<sup>67</sup> Patricia Kowsmann (2015) "Get Receipts, Win a Car: How Greece's VAT Lottery Plan Worked in Portugal", *The Wall Street Journal*.

However, it is also clear from a taxpayer-centric approach that taxation is not the sole factor influencing the decision to operate on a formal or informal basis. The wider benefits of formalisation have a significant impact on the attractiveness of compliance for any given business or individual. Businesses operating on a legitimate footing generally enjoy better legal protection than their informal counterparts; conversely, where even formal businesses struggle to access justice due to an inefficient or corrupt court system, the incentive to formalise is reduced. Finance is another key area where formal businesses tend to have an advantage, as they offer a more secure prospect to lenders; but again, a lack of finance or financial institutions serving particular regions or market sectors may undermine the potential incentive effect. From an employee perspective, legal protections and welfare entitlements will make formal employment preferable to informal employment, other things being equal. However, without industrial representation workers may find they have limited capacity to demand formalisation from their employers.

The fourth category of measures focuses on tax morale. To a large extent, this is a function of the level of compliance in the population as a whole: it is very easy to rationalise non-compliance when no-one else appears to pay tax either, and especially so when paying tax puts individuals and businesses at a disadvantage vis-à-vis their competitors. However, it is also important to look at the other side of the fiscal contract between citizens and the state, and scrutinise how tax revenues are spent. High quality public goods and services will increase tax morale, whereas money lost to poor political decisions and corruption will tend to decrease it. Initiatives such as participatory budgeting and increased transparency may help to improve the allocation of resources and the efficiency of public spending.

Finally, it is crucial to note that the public needs to be aware of these measures for them to have the desired behavioural impacts. Initiatives targeted at raising public awareness should be understood as an integral component of any reform intended to combat informal economic activity. For example, in 2010 and 2011 the Estonian Tax and Customs Board launched a series of public information campaigns, linking the payment of tax to the provision of prominent public services such as ambulances and kindergarten places.<sup>68</sup>

### *The role of revenue authorities*

Public servants working in the field of taxation have limited control over many of the policy areas outlined above. Generally speaking, they cannot directly influence the wider business policy agenda, let alone factors such as the justice system or the overall efficiency of public spending. While improvements in tax policy and administration can remove many of the obstacles to compliance, and a well-constructed investigation and enforcement regime can help to compel compliant behaviours, the best efforts of revenue authorities and tax policy-makers may be undermined by poor decision-making in other parts of government.

Nevertheless, a taxpayer-centric approach to the problem of formalisation highlights the importance of coordinated cross-governmental action as part of efforts to increase tax compliance and reduce the scale of the informal economy. Given their investigative remit and overall responsibility for revenues, tax authorities have a unique insight into the informal economy that leaves them well-placed to play a constructive or even coordinating role in developing and evaluating policy ideas.

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<sup>68</sup> European Monitoring Centre on Change (2013) "Information campaign on tax compliance, Estonia", European Foundation for the Improvement of Living and Working Conditions (Eurofound).

## Conclusion

The informal economy poses a complex set of problems for revenue authorities, and for governments more broadly. Viewed over a longer time horizon, informal economic activity tends to reduce as countries develop, and as populations shift from agriculture to industry, from rural settings to large cities. Yet the rates of change are not uniform, and even over relatively short periods of time, policy interventions can have a tangible impact.<sup>69</sup>

Improving both tax policy and tax administration is central to any action plan intended to tackle informality. While the formalisation process takes place against a baseline that is conditioned by many social, cultural, economic and historical factors that are unrelated to taxation, reductions in the financial and administrative burdens of taxation do appear to be associated with increases in the level of compliance. Moreover, adopting a taxpayer-centric approach to the shadow economy can help policymakers to appreciate the wealth of options that are available to promote compliance. These options are not limited to repressive measures intended to enhance detection and enforcement. Rather, they include reforms aimed at reducing the financial and administrative costs of formalisation, encouraging individuals and businesses to operate on a formal basis from the outset, enhancing the wider social, legal and economic benefits available to those who do operate on a formal footing, and assisting vulnerable individuals currently dependent on undeclared employment to transition to the formal sector. Taken in aggregate, these reforms have real potential to improve taxpayer morale and drive forward formalisation. Convergence with the low rates of informality seen in some countries cannot be achieved overnight, but there are many ways to speed up the journey.

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<sup>69</sup> Timothy Besley and Torsten Persson (2014) "Why do developing countries tax so little?", *Journal of Economic Perspectives*, 28 (4), 99-120.



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