

Comparing how some tax authorities tackle the hidden economy



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Preface

The UK National Audit Office commissioned RAND Europe to compare tax authorities' approaches to tackling the hidden economy. The purpose was to place the performance of Her Majesty's Revenue & Customs in an international context and identify good practices elsewhere for tackling the problem that could be adopted by the UK. The National Audit Office has drawn on the results of this work in producing its report on how HM Revenue & Customs tackles the hidden economy. A copy of its report can be found on the National Audit Office's website (www.nao.org.uk).

The tax authorities covered in this report are Australia, Belgium, Canada, Sweden, and the United States. In undertaking the work, we systematically reviewed published documents and contacted officials working in the tax authorities and the supreme audit institutions (audit offices) of each country. Details on our methodology are at Appendix A. The examples we have selected for this report are used to illustrate a particular practice and do not provide a comprehensive view of each tax authority's approach.

This report will be of particular interest to tax authorities, policy makers and supreme audit institutions as well as a wider audience involved with the challenges of estimating the size of the hidden economy and tackling the problem.

The RAND team were Christan Van Stolk, Amanda Scoggins, Jan Tiessen, Richard Warnes and Joachim Krapels. We are grateful for the help provided to us by each organisation mentioned in this report. We are also grateful to the help provided by Professor Colin Williams at Sheffield University who provided information on the academic research into the hidden economy and various policy initiatives countries have used to tackle the hidden economy. Jane Wheeler, Peter Lilly and Tom Wallace of the UK National Audit Office also worked closely with us in producing this report.

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Summary

The background to the work

1 The UK National Audit Office commissioned RAND Europe¹ to carry out a study placing the performance of HM Revenue & Customs in tackling the hidden economy in an international context. The study also sought to identify good practices used by other tax authorities that could be adopted by the UK. This report covers:

- Estimating the size of the hidden economy (Chapter One);
- Tax authorities' strategies and how they are organised to tackle the hidden economy (Chapter Two);
- Encouraging people into the formal economy (Chapter Three);
- Detecting people in the hidden economy (Chapter Four); and

- The sanctions imposed by tax authorities (Chapter 5).

2 We compared the approaches of five tax authorities – Australia, Belgium, Canada, Sweden, and the United States. These countries are similar to the UK in wealth per capita and demographics. Each of the tax authorities has identified the hidden economy as an important area to tackle and has a range of measures to deal with the problem. The structure of the tax systems in these countries and their tax rates are however different. Some such as Belgium and Sweden have higher rates of tax than countries such as the United States and Australia (**Figure 1**). In carrying out the work we also drew on work by the European Commission on undeclared work. The study used a template agreed with the National Audit Office to gather information from a review of publicly available documents and from contact with officials in each tax authority and other organisations.

1 Each country has different rates of tax

	Total tax receipts as percentage of GDP in 2003	Personal Income Tax (% of tax receipts) in 2003	Corporate Income Tax (% of tax receipts) in 2003	Taxes on goods and services (% of tax receipts) in 2003	Other (% of tax receipts) in 2003
Sweden	50.6	31.3	5.0	26.3	8.9
Belgium	45.4	31.4	7.4	24.6	7.5
OECD average	36.3	24.9	9.3	32.1	10.4
United Kingdom	35.6	28.7	7.8	32.7	13.0
Canada	33.8	34.6	10.4	26.1	14.0
Australia	31.6	38.5	16.7	29.7	15.1
United States	25.6	35.3	8.1	18.2	13.5

Source: Taxation 2003, OECD (2007)

Estimating the size of the hidden economy

Definitions

3 The hidden economy affects everyone. Honest businesses suffer from unfair competition from those in the hidden economy. People working in the hidden economy do not benefit from the protection of employment legislation. Customers of people working in the hidden economy do not get guarantees for work carried out or have legal recourse for poor quality work. From governments' point of view, the hidden economy can lead to:

- tax losses;
- benefit fraud where unemployed people are engaged in undeclared work while claiming benefit; and
- avoidance of employment legislation, such as minimum wage agreements or certain health and safety and other standards in the workplace.

4 Tax authorities tackle the hidden economy to reduce the amount of tax revenue lost and to be fair to taxpayers who are complying with their obligations. They use various definitions to cover the hidden economy. For example some include within their definition all forms of income that is undeclared, while others include only undeclared cash transactions. Tax authorities also use different terms such as "underground", "hidden", "black", "shadow" or "cash" economy to describe income that is undeclared for tax purposes.

Estimation methods

5 To estimate the size of the hidden economy, some academic studies analyse macro-economic indicators such as income and expenditure data. Other research uses the results from surveys and reviews of tax records. Each method produces different results on the size of the hidden economy usually in terms of a percentage of GDP rather than an estimate of the amount of tax lost. The results from surveys and reviews of tax records tend to produce lower estimates than methods using macro-economic data. This is because tax records provide

only a partial view of the size of the hidden economy (a review of tax records will exclude from the calculations those people and businesses who do not file a tax return) and respondents to surveys are likely to understate their involvement in the hidden economy. Commentators suggest that analysing macro economic data tends to overstate the size of the hidden economy. In the academic literature, there is a growing consensus that using direct methods (surveys and tax records) to estimate the size of the hidden economy are preferable to indirect methods (macro-economic data).²

6 Whichever method is used the results from the research examined tends to show that the same countries have a relatively large or small hidden economy. The results of recent research indicate that the UK has a smaller hidden economy than many other countries (**Figure 2**). They also show that the size of the hidden economy has changed little in some but is increasing in others. The size of the hidden economy is influenced by a number of factors. For example, higher taxation countries appear to have a larger hidden economy. The complexity of the tax system and the rigidity of labour market regulations can also have an impact on the size of the hidden economy.³ Specific factors in each country such as the role of social networks can affect the size of the hidden economy. This means that the range of measures used by tax authorities to tackle the hidden economy cannot be viewed in isolation from other factors that could also affect the size of the hidden economy.

7 Estimates of the tax lost to the hidden economy could potentially help tax authorities with understanding the scale of the challenge. They can also help tax authorities assess trends and the possible effects of their efforts. The very nature of the hidden economy has meant that none of the tax authorities have been able to estimate on a regular basis the amount of tax lost. Some have tried and are continuing with their efforts. In 2006 HM Revenue & Customs employed the University of Bristol to produce estimates of the amount of tax lost to the hidden economy. They carried out a pilot project to assess the feasibility of carrying out a

2 The size of the UK's hidden economy appears relatively lower than a number of other countries examined

	Belgium	Sweden	Canada	Australia	United Kingdom	United States
Size of hidden economy as percentage of GDP 2001-2002	22.0	19.1	15.8	14.1	12.5	8.7

Source: Schneider, F. (2004)

NOTE

Schneider, F. (2002), *The Size and Measurement of the Hidden Economy in 110 Countries Around the World*, presented at a Workshop of Australian National Tax Centre, ANU, Canberra, Australia, 17 July 2002.

questionnaire survey of the UK population as a way of estimating the amount of tax lost to the hidden economy. HM Revenue & Customs considered that the proposed methodology was unlikely to produce worthwhile results because a significant number of people would refuse to take part. It is now looking at new IT solutions to assist in the measurement of the hidden economy. The United States is planning to estimate the tax gap, a broad indicator of tax evasion, on a more regular basis (a four yearly measurement supplemented by annual reviews of a small sample of tax records). Sweden has undertaken ad hoc studies on the basis of macro-economic data and reviews of tax records. The Belgian tax authority has used survey data in the past and has relied on the results of a number of academic studies. The European Commission intends to undertake a study in 2008 to identify the best methodology for providing comparable estimates of the amount of undeclared work across the European Union.

8 Some tax authorities such as Australia and Canada do not consider that estimating the amount of tax lost to the hidden economy is worthwhile⁴ because of the many different approaches and methodologies which result in a wide range of estimates. They are also concerned about the cost of preparing estimates from which there would be little discernible benefit.

Strategies and objectives for tackling the hidden economy

9 Tax authorities have broadly similar objectives and strategies for tackling the hidden economy. For example important objectives are to protect the revenue base and increase voluntary compliance. They emphasise the importance of tackling the hidden economy in their national strategies as part of meeting their objectives because of the amount of tax that could be potentially at risk. Their approach includes a range of measures to encourage people into the formal economy, detect those in the hidden economy, and deter individuals from entering the hidden economy (**Figure 3 overleaf**).

10 In tackling the hidden economy, tax authorities focus on particular sectors or groups based on perceived risks to tax revenue. They have identified broadly similar sectors. For example tax authorities consider as high risk sectors where cash transactions are commonly used for payment. They are also mindful of emerging new risks such as internet trading which provides new opportunities for businesses to operate in the hidden economy without detection.

3 Tax authorities use similar measures to tackle the hidden economy

Prevention

Research into motivations
Media campaigns
Disclosure schemes

Detection

Risk assessment
Information from the public
Data matching
Tax audits

Deterrence

Prosecutions
Administrative penalties

Source: RAND Europe

11 Tax authorities have organised their staff resources in different ways to tackle the hidden economy. Some use general tax compliance staff to tackle the hidden economy as part of their wider activities of tackling non-compliance. In others, there are dedicated staff for tackling the hidden economy who may be used in combination with other tax compliance staff.

Encouraging people into the formal economy

12 Tax authorities are focusing more on encouraging people into the formal economy as a way of improving voluntary compliance in addition to the traditional detection and deterrence approaches. For example, tax authorities are using information campaigns to inform people of their responsibilities and to change attitudes. They have also used short-term voluntary disclosure schemes to encourage individuals to declare income from the hidden economy. The UK's use of these schemes has attracted interest from others. HM Revenue & Customs' recent Offshore Disclosure arrangements has several characteristics that independent evaluations⁵ identify as good practice, namely that the scheme respects the tax rates of the UK, is limited in scope and duration, and uses direct targeting such as writing to those individuals suspected of holding income and/or capital outside of the tax system.

Detection methods

13 Compared to other countries, HM Revenue & Customs is at the forefront in using a telephone hotline to obtain information from the public on those suspected of operating in the hidden economy.⁶ Only Australia uses a similar hotline. In Canada, the Revenue Agency plans to set up a single regional number for the hotline. Tax authorities are increasingly using data matching techniques to detect those in the hidden economy. Data matching appears successful where tax records are matched with external sources of information to identify taxpayers with income streams that have not been declared.

Sanctions

14 In most cases, tax authorities impose a financial penalty on those they detect in the hidden economy. The penalty may or may not be applied on top of the amount of tax owed. The amount of the penalty imposed varies widely between tax authorities. Tax authorities only prosecute people/businesses in a relatively small number of cases because of the costs involved. They tend to prosecute more serious cases and where a wider deterrent message is needed. From the available information it is not possible to determine the cost effectiveness of sanctions including the extent of the deterrent effect.

Overall conclusions

15 Assessing the comparative effectiveness of tax authorities' efforts to tackle the hidden economy is difficult because:

- The very nature of the hidden economy has meant that none of them has successfully estimated on a regular basis the amount of tax lost to the hidden economy. Some are continuing with work to produce robust estimates on the overall tax losses from the hidden economy. Without such estimates it is not possible to assess whether the amount of tax lost is increasing or decreasing over time or measure the effect tax authorities are having on the problem. Academic studies suggest that the size of the hidden economy (expressed as a percentage of GDP) is lower in the UK than in many other countries.
- The total amount of tax lost could be affected by factors outside of the control of tax authorities. For example high rates of tax, the complexity of the tax system, economic conditions and cultural factors can have an impact on the willingness of people and businesses to participate in the hidden economy.
- There is little published information available on the cost-effectiveness of the measures used by tax authorities to tackle the hidden economy. This is an area where tax authorities could usefully share more information on what measures work and why.

16 Despite these limitations, our work has identified a range of good practices used by tax authorities in tackling the hidden economy. Overall, we consider that the UK compares well with others. It is at the forefront in using telephone hotlines to enable the public to report their suspicions of people working in the hidden economy and in the use of voluntary disclosure schemes where there has been success in collecting large amounts of tax owed. In many areas, the UK has practices that are comparable to

others. There is a trend internationally to do more data matching exercises that draw on large external databases to compare against tax records on a regular basis as a way of detecting those in the hidden economy. Some tax authorities use surveys regularly to gauge peoples' attitudes to the hidden economy. Where the results indicate that sectors of the community consider it acceptable to participate in the hidden economy, the tax authority uses information campaigns to change attitudes. The tax authority then follows up with further surveys to assess whether attitudes have changed as a result.

17 On prevention, good practices include:

- Tracking the motivations of those in the hidden economy through surveys to feed into the overall risk assessment for compliance activities (Australia and Sweden);
- Targeted educational campaigns at specific sectors (e.g. home repair and maintenance or small businesses) and cooperating with trade associations to tackle industries with a high incidence of non-compliance (Australia, Belgium and Sweden);
- Offering voluntary disclosure schemes (UK, Belgium and Australia);
- Surveys tracking the attitudes of those in the hidden economy to assess the impact of media campaigns (Australia and Sweden);
- Community visits, workshops, and specific internet sites to encourage individuals into the formal economy (Australia and Canada); and
- Schemes to displace the hidden economy such as the use of work 'vouchers' in Belgium. These are policy initiatives requiring decisions by government.

18 On detection, good practices include:

- Using telephone hotlines to enable the public to report their suspicions of people working in the hidden economy (UK and Australia);

- The regular use of data matching to target specific sectors and activities in the hidden economy particularly where there is a high incidence of non-compliance (Canada and Sweden); and
- The wider use of external data in data matching to increase the rate of detection (Australia, Canada and United States).

19 On sanctions, good practices include:

- The systematic use of sanctions and adjusting penalties for inflation to increase deterrence;⁷ and
- Tracking the perceptions of people on sanctions to assess the deterrent effect (Sweden).

Estimating the size of the hidden economy

1.1 This chapter sets out the various definitions of the hidden economy used by tax authorities and the differences between them. It also looks at estimates of the size of the hidden economy and whether tax authorities estimate the amount of tax lost from the hidden economy.

Tax authorities use different terms and definitions to describe the “hidden economy”

1.2 Research shows that the hidden economy affects everyone. Honest businesses suffer from unfair competition from those in the hidden economy. People working in the hidden economy do not benefit from the protection of employment legislation. Customers of people working in the hidden economy do not get guarantees for work carried out or have legal recourse for poor quality work. From governments’ point of view the hidden economy can lead to:

- tax losses;
- welfare fraud where unemployed people are engaged in undeclared work while claiming benefits; and
- avoidance of employment legislation, such as minimum wage agreements or certain health and safety and other standards in the workplace.

1.4 Tax authorities are concerned with reducing tax losses from any source of income. This is often referred to as the tax gap: the difference between the theoretical tax that could be collected and the amount that is collected. The tax gap includes errors made by taxpayers on their tax returns through to tax evasion. Tax losses from the hidden economy form a part of the tax gap.

1.5 Some tax authorities use specific definitions and terms to describe the hidden economy. These definitions usually focus on an aspect of the tax gap which reflects the particular concerns of these countries. For the purposes of this report we use the term “hidden economy” for convenience to refer to the work tax authorities undertake based on their own definitions. **Figure 4 overleaf** sets out various terms used by organisations and how they are defined.⁸ Although the definitions are different in what they include or exclude, there is a common core, which is undeclared income from work or self employment.

4 There are differences in the terms and definitions used to cover the hidden economy

Country	Concept	Definition
Australia ¹	Cash Economy	The cash economy arises from that area of business activity which takes advantage of the opportunity offered by cash transactions to evade taxation obligations. Typically, this involves the under-reporting or non-reporting of cash income or cash surrogates (for example, through barter activities) by businesses or individuals.
Belgium ²	Non Organised Fiscal Fraud	Includes for example: "black" labour, "black" receipts, non-registration in the tax system, offshore holdings.
Canada ³	Underground Economy	The Canada Revenue Agency (CRA) definition of the underground economy includes: <ul style="list-style-type: none"> ● failure to file or register; ● failure to report a business activity ("moonlighting"); ● failure to report part of a business activity ("skimming"); ● failure to report employment income ("tips & gratuities"); and ● mischaracterisation of employment status (such as claiming to be self employed when in fact the person should be an employee). <p>The definition does not include criminal activities</p>
Sweden ⁴	"Black" Work	Payment for work carried out, that should be subject to tax, but has not been declared to the Swedish Tax Agency. This can be undeclared income from employment (pay or benefits) or undeclared business income for the self employed.
United States ⁵	Tax Gap (Internal Revenue Service)	The difference between the tax that taxpayers should pay and what they actually pay on time ... the tax gap can be divided into three components: nonfiling, underreporting and underpayment. Nonfiling occurs when taxpayers who are required to file a return do not do so on time. Underreporting of tax occurs when taxpayers either understate their income or overstate their deductions, exemptions and credits on timely filed returns. Underpayment occurs when taxpayers file their return but fail to remit tax owed by the payment due date.
	Cash Economy (National Taxpayer Advocate)	Although there is no universally agreed-upon definition of "cash economy," the National Taxpayer Advocate uses the term to mean taxable income from legal activities that is not reported to the IRS by third parties. This definition can include businesses dealing strictly in cash as well as others that handle a portion of their transactions in cash or receive other payments not subject to information reporting. For example, a retailer who receives most of their revenue through debit and credit cards can be considered part of the cash economy because these forms of payment are not subject to information reporting.
United Kingdom	Hidden Economy	Unknown income sources on which tax is due regardless of the source whether from employment or from capital such as interest on deposit accounts. If a person or businesses underreports income from a known source on their tax return it is not within the definition of the hidden economy used by HM Revenue & Customs (HMRC). More specifically HMRC uses the term hidden economy to cover "unregistered businesses", "moonlighters", and "ghosts". Unregistered businesses are those trading above the Value Added Tax (VAT) threshold of £64,000 who are not registered with HMRC, "moonlighters" are those paying tax on one or more employments, but failing to report income from other forms of employment; and "ghosts" are those working wholly within the hidden economy and are unknown to HMRC.

4 There are differences in the terms and definitions used to cover the hidden economy *continued*

Country	Concept	Definition
European Commission ⁶	Undeclared Work	“Undeclared work” is defined as any paid activities that are lawful as regards their nature but not declared to the public authorities, taking into account differences in the regulatory system of Member States. Applying this definition, criminal activities would be excluded, as would work not covered by the usual regulatory framework and which does not have to be declared to the public authorities, such as activities undertaken within the household economy.
OECD ⁷	Underground production	All legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: <ul style="list-style-type: none"> ● to avoid payment of income, value added or other taxes; ● to avoid payment of social security contributions; ● to avoid having to meet certain legal standards such as minimum wages, maximum hours, safety or health standards, etc; ● to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.

Source: RAND Europe

NOTES

- 1 Interview with a senior official in the Australian Tax Office, October 2007.
- 2 Pouseele Bedrijfsrevisoren (2002).
- 3 Interview with a senior official in the Canada Revenue Agency, October 2007.
- 4 Skatteverket, Skatter I Sverige. *Skattestatistisk Årsbok 2006 (Tax Statistical Yearbook of Sweden 2006)*, Stockholm: Skatteverket, 2006.
- 5 IRS (2005) *Understanding the Tax Gap*, <http://www.irs.gov/newsroom/article/0,,id=137246,00.html>.
- 6 European Commission (1998), Brussels, COM (98) – 219 *Communication of the Commission on Undeclared Work*, 1998.
- 7 OECD (2002), *Measuring the Non-Observed Economy: A Handbook*, Paris: Organisation for Economic Co-operation and Development.

Some research shows that the size of the hidden economy in the UK is smaller than in some countries

1.6 Academics have used macroeconomic data to estimate the size of the hidden economy in terms of the percentage of GDP. Two main methods are used – the currency demand method and the physical input method (**Figure 5 overleaf**).⁹ These are referred to as indirect methods of measurement of which the currency demand method is the most widely used. The currency demand method is based

on the assumption that most hidden economy transactions are paid for in cash and the method captures the difference between cash used in formal and hidden economy transactions. The physical input approach measures the difference between estimates of how many inputs are expected to be used to produce the official national income compared to the actual use of inputs. The most common input is electricity. Research using these methods suggests that the size of the hidden economy as a percentage of GDP is smaller in the United Kingdom than in many other countries (**Figure 6 on page 15 and Figure 7 on page 16**).

5 Indirect methods for measuring hidden economy

Indirect approaches use macro-economic indicators and focus on discrepancies in various markets or use econometric models on the causes and effects of the hidden economy. In terms of the discrepancy approach, studies have looked at a variety of markets, such as:

- monetary markets: discrepancies in the demand for cash (currency demand approach);
- labour market: discrepancies in participation rates;
- expenditure: discrepancies in national or household income;
- transactions: discrepancies in the number of transactions in the economy; and
- physical inputs: discrepancies in consumption patterns (e.g. household electricity consumption).¹

The advantages of indirect methods are that they rely on easily identifiable data. There are some important limitations to these studies:

- few provide longitudinal estimates or a systematic overview.
- most are old and use historical data.
- they make various assumptions that could limit the accuracy of the results or do not include certain aspects. For example the currency demand approach does not capture non-cash transactions. It is assumed that these transactions could represent 20 to 30 per cent of total hidden economy transactions.
- some use different base levels.² In the physical input approach, some studies look at national consumption whereas others focus on household consumption.
- they often overstate the size of the hidden economy.

Source: RAND Europe

NOTES

1 Compiled from Pacolet J. Perelman S., Pestieau P., and Baeyens K. (2007), *Een Indicator voor de Omvang en Evolutie van Zwartwerk in de Belgische Economie*, HIVA et al and Pacolet J. and Marchal A. (2003), *Zwartwerk en Fraude: Een Drievooudige Bedreiging voor de Belgische en Europese Verzorgingsstaat*, HIVA.

2 Frey B. and Schneider, F. (2000), *Informal and Underground Economy*, in O. Aschenfelter (ed.).

1.7 Some have also used direct methods to estimate the size of the hidden economy. There are two main methods:

- tax audits of those filing returns; and
- surveys to establish the extent to which people and businesses may be operating in the hidden economy.

The advantage of direct methods is that they can provide detailed information on those who work in the hidden economy.

1.8 The small number of studies using direct methods also suggests that the size of the hidden economy in the UK is smaller than in many other countries. Using survey data for hours worked in a number of countries (using the difference between declared and non-declared working hours), the Rockwool Foundation found the extent of the hidden economy as a percentage of GDP is 1.5 per cent in the United Kingdom compared to 2.3 per cent for Sweden, 2.6 per cent for Norway, 3.8 per cent in Denmark, and 4.1 per cent for Germany.¹⁰ A recent European Commission cross-national survey examined the extent of

6 The results of research to estimate the size of the hidden economy shows the UK to be at the lower end

	Australia	Belgium	Canada	Sweden	United Kingdom	United States
Currency Demand (CD) 1990 Lacko ¹	15.3	19.8	11.7	11	13.1	10.5
CD 1990-1993 Average Johnson ²	13.1	15.3	10.0	10.6	7.2	13.9
CD Schneider 1970 ³	n.a	10.4	n.a	6.5–6.8	2.0	2.6–4.6
CD Schneider 1980	n.a	16.4	10.1–11.2	11.9–12.4	8.4	3.9–6.1
CD Schneider 1994	13.0	21.4	14.6	18.3	12.4	9.4
CD Schneider 1996	13.2	21.9	15.1	19.2	13.1	8.8
CD Schneider 1998	14.1	22.6	15.6	20.0	13.0	8.9
CD Tanzi 1986-1990	n.a	n.a	n.a	n.a	9.7	6.2
Physical input 1986-1990	n.a	n.a	n.a	n.a	13.2	9.9
CD Schneider 1999-2000 average ⁴	14.3	22.2	16.0	19.2	12.7	8.7
CD Schneider 2001-2002 average	14.1	22.0	15.8	19.1	12.5	8.7

Source: RAND Europe compilation

NOTES

- 1 Taken from Bovi. M. (2002), *The Nature of the Underground Economy: Some Evidence from OECD Countries*, ISAE.
- 2 Taken from Bovi. M. (2002), *The Nature of the Underground Economy: Some Evidence from OECD Countries*, ISAE.
- 3 The next seven rows are taken from Schneider, F. and Enste, D. (2000), *Shadow Economies Around the World: Size, Causes, and Consequences*, IMF Working Paper.
- 4 The Next two rows are taken from Schneider, F. (2002), *The Size and Measurement of the Hidden Economy in 110 Countries Around the World*, presented at an Workshop of Australian National Tax Centre, ANU, Canberra, Australia, 17 July 2002.

undeclared work as a percentage of respondents purchasing goods from the hidden economy and as a percentage of respondents undertaking undeclared work over the last 12 months. In the United Kingdom, 9 per cent of respondents reported purchasing goods from the hidden economy compared to the European Union average of 11 per cent. Of the West European countries, Germany had the lowest rate at 6 per cent and Denmark the highest at 27 per cent.¹¹ In terms of those admitting to undertaking undeclared work, the United Kingdom had one of the lowest rates with two per cent of respondents answering 'yes'. Denmark had the highest rate with 18 per cent.

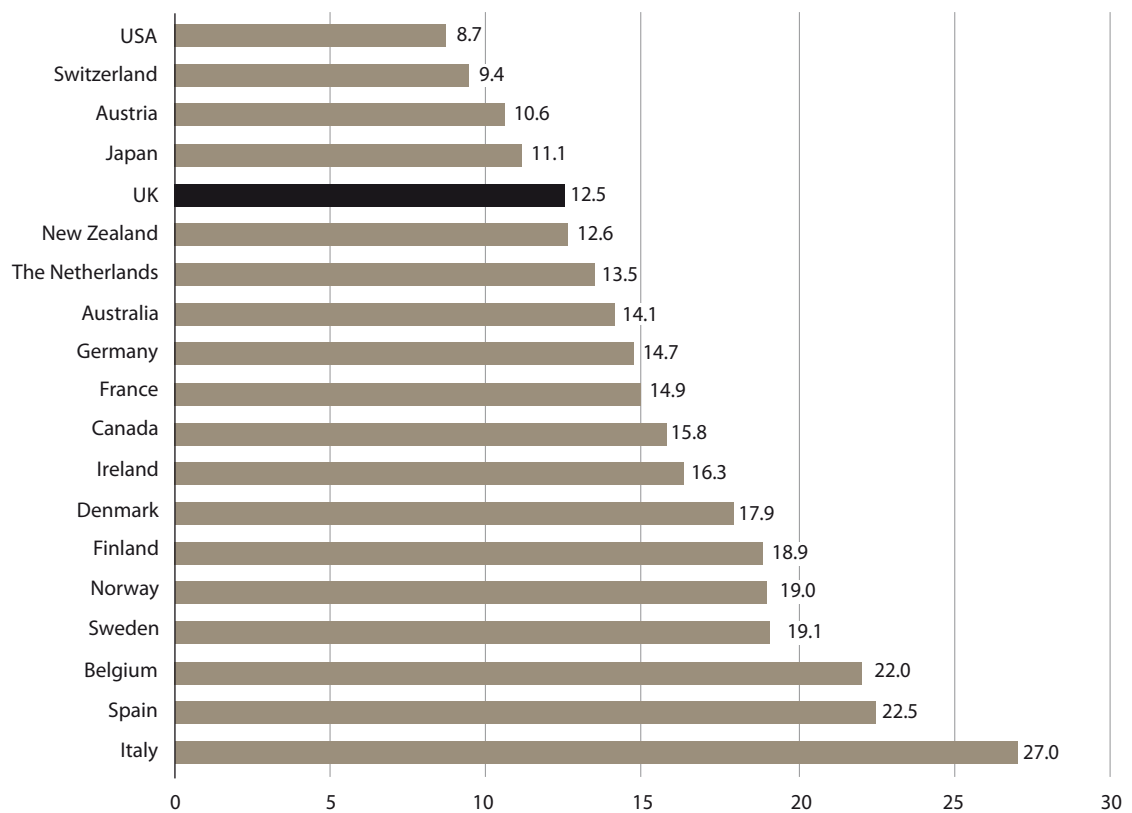
1.9 Although studies using direct methods give lower estimates for the hidden economy than those using indirect methods. With direct methods, respondents to surveys tend to understate their participation in the hidden economy and/or tax audits only reveal part of the hidden economy. The wide differences in the various estimates illustrate

the difficulties in pinpointing the actual size of the hidden economy.¹² Some officials and academics tend to believe that the size and extent of the hidden economy is staying around the same level or increasing in some countries. For example, in the United States, most economic officials and academics believe that the US hidden economy is "substantial and growing – perhaps more quickly than the economy as a whole."¹³ In Canada, the most recent estimate of the size of the hidden economy suggests that the underground economy has grown steadily relative to GDP over the period 1976 to 2001 from 7.9 to 16 per cent respectively. In real dollar terms (1997), the size of the hidden economy increased from about CA\$40 billion (£19.8 billion) in 1976 to CA\$166 billion (£82 billion) in 2001.¹⁴ Schneider's currency demand data in Figure 6 shows the hidden economy is increasing in the countries studied throughout the eighties and nineties. More recently, Schneider's estimates show a small decline but no particular reasons for this were identified.

1.10 In January 2006, the OECD Inter-secretariat Working Group on National Accounts issued a declaration (*Estimates of the unrecorded economy and national accounts* – oecd.org/dataoecd/0/42/36333066.pdf) which noted that the degree to which official national accounts estimates cover the economy differs between countries. Some statistical authorities make explicit and comprehensive estimates of activities not recorded from the usual data sources - be it because these are illegal, underground, or simply outside scope. Other statistical authorities do not provide such estimates, a situation that sometimes prompts unofficial estimates. These unofficial estimates may have a sound statistical underpinning, but many are based on bold assumptions and few actual data.

The Working Group felt it was necessary to alert users to the limited value of these unofficial estimates in terms of reliability and accuracy. Unofficial estimates are often based on macro-economic models. For instance, they may assume a fixed relation between the size of the economy and money in circulation. Such methods may yield grossly exaggerated results, attracting the attention of politicians and newspapers and thereby gaining wide publicity. The OECD-ILO-IMF-CIS manual on measuring the non-observed economy rejects such “macro-model” methods because they suffer from serious problems which cast doubt on their utility for any purpose for which accuracy is important. In particular, they are completely unsuitable for use in compiling national accounts.

7 The size of the hidden economy as a percentage of GDP for selected OECD countries in 2002



Source: Schneider (2002)

1.11 Some academics do not consider that estimating the size of the hidden economy is worthwhile. Professor Thomas in the *Economic Journal* (July 1999) on *Quantifying the Black Economy: "Measurement without Theory Yet Again?"* says that "a mere guestimate of the overall size of the black economy is of limited value for the policy maker: it is also important to know who is doing what, where, how and why. Then we can see what should and/or can be done about legislating for or against the black economy".

Tax authorities do not systematically estimate the tax lost from the hidden economy

1.12 Estimating the tax gap on a regular can help tax authorities judge the scale of the challenge, assess trends and whether they are doing enough to tackle the problem. An overall estimate of the tax gap does not however help with identifying where the losses are occurring. Some tax authorities have therefore tried to estimate the components of the tax gap. In some cases one of the components has included the amount of tax lost from the hidden economy. Estimating the components enables them to direct resources to the areas where the greatest losses

are occurring. Even so, none of the tax authorities regularly estimates the amount of tax lost to the hidden economy (**Figure 8**).

1.13 Examples of where tax authorities have estimated tax losses are:

- In the **United States**, the Internal Revenue Service undertook a major review of tax filers in 2001 to estimate the tax gap (Appendix C). From 2008, the Internal Revenue Service (IRS) is sampling around 16,000 taxpayers each year who file a tax return (form 1040) to update the estimate of tax losses which will help with targeting the IRS effort. In 2007 the National Taxpayer Advocate stated that "underreported income from the "cash economy" – taxable income from legal activities that is not subject to information reporting or withholding – is probably the single largest component of the tax gap, accounting for over \$100 billion per year. The significance of the compliance problem in the cash economy is not surprising since research shows that taxpayers report well over 90 per cent of net income reported to the IRS by third parties, but about 50 per cent of net income is not reported in this way. Cash economy transactions are difficult to quantify, however, because they are, by definition, unreported."¹⁵

8 Tax authorities do not systematically estimate the amount of tax lost to the hidden economy

	The United States	Sweden	Belgium	The United Kingdom	Australia	Canada
Type of measurement by tax authority	Measures the tax gap in certain years on the basis of reviews of tax filers	Measures size of the hidden economy occasionally using tax audits and national income data	Has undertaken some ad hoc measurement on the basis of tax audits	Some ad hoc estimates on the basis of tax records and data sharing. Abandoned survey measurement	Does not measure size of hidden economy. Australian Bureau of Statistics has produced an estimate	Does not measure size of hidden economy

Source: RAND Europe compilation

- In **Belgium**, in testimony to Parliament in 2001, the Government Commissioner for Anti-Fraud Activities estimated that on the basis of tax audits total fraud could be between €15.5 billion (£10.7 billion) and €30 billion (£20.7 billion), representing 10 to 20 per cent of GDP.¹⁶
- In the **UK**, HM Revenue & Customs has produced overall estimates of the amount of VAT lost and provided a break down of the various components including losses from the hidden economy. In 2002 it estimated that it lost between £400 million and £500 million in VAT from between 125,000 and 180,000 businesses that should be VAT registered but were not. For other taxes, HM Revenue & Customs has produced broad estimates of the tax lost. In 2005, it estimated that using certain assumptions there were some 2 million ghosts and moonlighters with tax losses of at least £1.5 billion. It emphasised that the estimate is unreliable as it is based on patchy data and is subject to a high margin of error.
- In **Sweden**, the broadest estimate of the amount of tax lost from “black” work is based on the discrepancy between households’ income and their expenditure in the national accounts. In 2002 the Swedish Tax Agency, estimated that the upper limit of income from black work was close to £8.5 billion or around five per cent of GDP.¹⁷ In 2006 the Swedish Tax Agency also systematically analysed the results from tax audits between 1995 and 2003 to estimate the amount of unreported income. The results show that total income from undeclared work was £5.2 billion, of which half is undeclared income from employment and the other half is undeclared income by the self employed.

1.14 Some countries do not consider that estimating the amount of tax lost to the hidden economy would be useful. For example, the Canada Revenue Agency (CRA) does not consider that the results of such an exercise would be meaningful because different approaches and methodologies produce significant variances in the estimated size of the hidden economy. The Agency has however found estimates on the relative size of the hidden economy by industry sectors more useful in targeting its efforts. The Australian Taxation Office (ATO) considers that it is not possible to produce robust and defensible estimates of the tax gap. It also considers that the time, cost and the intrusive burden on taxpayers imposed by estimating the tax gap would not be worthwhile.¹⁸ In 2001 the Australian Bureau of Statistics estimated the cash economy at two per cent of GDP or at AU\$13.4 billion (around £6 billion).

There is a general consensus that direct methods are a better way of measuring the size of the hidden economy

1.15 There is a developing consensus among analysts and tax authorities that direct measurements either through surveys or by using the results of tax audits are preferable to indirect methods, such as analysing national account data, the currency demand approach, or other macro-economic approaches.¹⁹ The main reason is that detailed information can be collected using direct methods on those in the hidden economy, providing a better understanding of the problem and how it might be tackled.²⁰

1.16 The OECD has found that macroeconomic models are often used when basic data are not available. This is usually the case, for example, in making estimates of illegal production. It recommends that models should be at the most detailed level possible so that they reflect more accurately the phenomena being modelled. In this context, an electricity consumption model, for example, may have its place, not in modelling the growth of the entire economy, but at a detailed level, such as estimating the growth of a particular industry for which survey data are not available and for which electricity is a primary input and reflects the movement in output.²¹

1.17 Sweden, Belgium and the United States use direct methods by mainly analysing the results of tax audits on an ad hoc basis. The United States has plans to use this method more regularly and systematically to estimate the size of the tax gap. HM Revenue & Customs plans to undertake regular comparison exercises of tax records against external information sources to provide an improved picture on the extent of the hidden economy and trends within it. None of the countries studied actively use surveys of the general population to estimate the tax lost to the hidden economy. HM Revenue & Customs decided not to use surveys for estimating the amount of tax lost to the hidden economy after a pilot in 2006, because insufficient respondents in the hidden economy would take part.²²

1.18 The European Commission intends to undertake a study in 2008 to identify the best methodology for providing comparable estimates of the amount of undeclared work across the EU. The results of this study could provide some useful pointers for tax authorities on how to estimate the amount of tax lost to the hidden economy.

Conclusions

1.19 There are differences in the way tax authorities and other organisations define the hidden economy. Many use a broader definition of the hidden economy than the UK. Some tax authorities have produced some ad hoc estimates on the amount of tax lost to the hidden economy. Some comparative studies suggest that the size of the hidden economy in the UK is lower than in some other countries. Trends seem to indicate that the size of the hidden economy is stabilising or growing in some countries.

Tax authorities' strategies and organisation

2.1 This chapter outlines the objectives and strategies of tax authorities and discusses differences and similarities in how they strategically approach the issue of the hidden economy.

Key objectives for tax authorities are protecting the revenue base and increasing voluntary compliance

2.2 Some tax authorities have developed and published strategies for tackling the tax gap of which the hidden economy is a part. For example in the United States, the Internal Revenue Service has published *A Comprehensive Strategy for Reducing the Tax Gap* (September 2006). The document notes that 80 per cent of the gross tax gap, estimated to be \$345 billion, is caused by underreporting of tax, with roughly one half of this amount attributable to underreporting of net business income by individuals. Non compliance is highest among taxpayers whose income is not subject to third party information reporting or withholding requirements. Given that this is the case, the National Taxpayer Advocate has suggested that the Internal Revenue Service should produce a comprehensive strategy for addressing the cash economy because of the possible size of the problem.²³ The Australian Taxation Office has published its *Compliance program 2007-08: Meeting the challenge of a changing environment*. One of the main areas on which this strategy focuses is tackling the cash economy more effectively. In the

UK, HM Revenue & Customs published a strategy for *Protecting indirect tax revenues* (November 2002) including the hidden economy.

2.3 Tax authorities have various objectives but they cluster around four main themes:

- **Protecting the tax base.** The Australian Taxation Office's (ATO) objective is to protect revenue flows;²⁴ the Belgian Ministry of Finance sees effective anti-fraud interventions as an important in increasing revenue and as a way to reduce the tax burden in the future;²⁵ protecting Canada's revenue base is included in the Canada Revenue Agency's (CRA) objectives,²⁶ the Swedish Tax Agency's objective is to ensure financing of the public sector and more specifically to reduce the tax gap by half until 2012.²⁷ The Internal Revenue Service's (IRS) target is linked to the Treasury target of "collecting federal tax revenue when due through a fair and uniform application of the law" and stresses the role of deterrence and detection in protecting the tax base.²⁸
- **The importance of voluntary compliance.** The Australian Taxation Office's objective is to increase voluntary compliance by making it as easy and as inexpensive as possible for businesses to comply.²⁹ The Canada Revenue Agency wants as many taxpayers as possible to comply with their tax obligations without it intervening directly.³⁰ Encouraging voluntary compliance is also at the core of the Swedish Tax Agency's strategy.³¹

- **Maintaining trust and confidence in the tax system and the tax authority.** The Australian Taxation Office and Swedish Tax Agency stress this aspect as an important part of their voluntary compliance strategy.³²
- **Eliminating unfair competition by companies not complying with tax regulations.** The Belgian tax authority sees this as the driving force of its enforcement activities.³³ Driving non-compliant companies out of business is also the stated objective of some of Swedish Tax Agency's sector programmes.³⁴

2.4 Tax authorities also have lower level operational targets. For example the Canada Revenue Agency has targets on:³⁵

- Filing compliance – the proportion of taxpayers that file their returns on time.
- Registration compliance – the proportion of Canadian businesses that have registered as required by law to collect the Goods Services Tax.
- Reporting compliance – the degree to which tax payers report complete and accurate information to enable the Agency to determine their liability for tax.
- Reliance on the Agency as a key service provider – value/number of programs and services administered on behalf of its clients.

Tax authorities assess the risk to tax from the hidden economy using different approaches but identify similar high risk sectors.

2.5 All tax authorities assess the risk of tax losses from the hidden economy by focusing on particular sectors of the economy. They use different methods to assess the risks but have identified similar sectors on which to target their efforts. For example some tax authorities use previous tax audits and their experience or analyse internal and external data

sources and/or take into account specific risk factors, such as the prevalence of cash transactions or rely on information received from others such as industry organisations on the prevalence of the hidden economy in their sectors.³⁶ **Figure 9 overleaf** shows that the construction industry features as a high risk sector in all countries, followed by the hospitality industry, taxi firms and hairdressing. E-commerce (the buying and selling of products or services over electronic systems) is an emerging risk sector which is increasingly targeted in Belgium, Sweden and the UK.

2.6 Academic research has identified the following characteristics of those likely to be operating in the hidden economy³⁷:

- businesses with low value retail transactions;
- people engaged in high value household services;
- family run businesses;
- people who own rental businesses and rental properties;
- people who have been in business for a number of years; and
- businesses providing auditors with incomplete records.

2.7 Examples of some of the methods used by tax authorities to assess risks include:

- In the **UK**, HM Revenue & Customs is using the transforming compliance risk management project to improve how it assesses the risks from the hidden economy by bringing together data on taxpayers and information from other agencies and the private sector.³⁸
- In **Australia**, part of Taxation Office's strategy is based on the testing hypotheses of likely hidden economy activities (see Appendix B).

9 Tax authorities broadly target similar risk sectors

Australia ¹	Belgium ²	Canada ³	Sweden ⁴	The United Kingdom ⁵	The United States ⁶
Building and construction	Construction and real estate	Construction and home renovations	Construction	Building work	Automotive sales industry
Taxis	Gambling and gaming	Hospitality sector	Restaurants	Catering/hospitality	Construction industry
Cafes, restaurants and takeaway food outlets	E-commerce	Agriculture	Hairdressers	Hairdressers	Health care industry
Hairdressing and beauty salons	Second homes	Fishing	Taxi companies	Childminders	Medical professions
Cleaning services	Transport	Logging	Transport companies	Gardening services	Real estate fraud
Clothing and textiles	Telecommunications	Real estate agents	Trade in used metals	Mini cab drivers	Restaurant industry
Pubs, clubs and taverns	Car sales	Taxis	Staffing companies (labour providers)	Fashion industry	Return preparer fraud ⁷
Tobacco growing	Diamond Industry	Hairdressing	Service providers (companies helping others to evade taxes)	Fishing industry	
Liquor wholesaling and manufacturing	Dentists		E-commerce	Locum doctors	
Motor vehicle retailing	Heating oil distributors			Journalists	
Gold bullion	Cash holding companies			Actuaries	
Art and antique dealing				Barristers	
Adult industry				Internet traders	
Tourism and hospitality industry				Buy-to-let	
				Offshore accounts	

Source: RAND Europe

NOTES

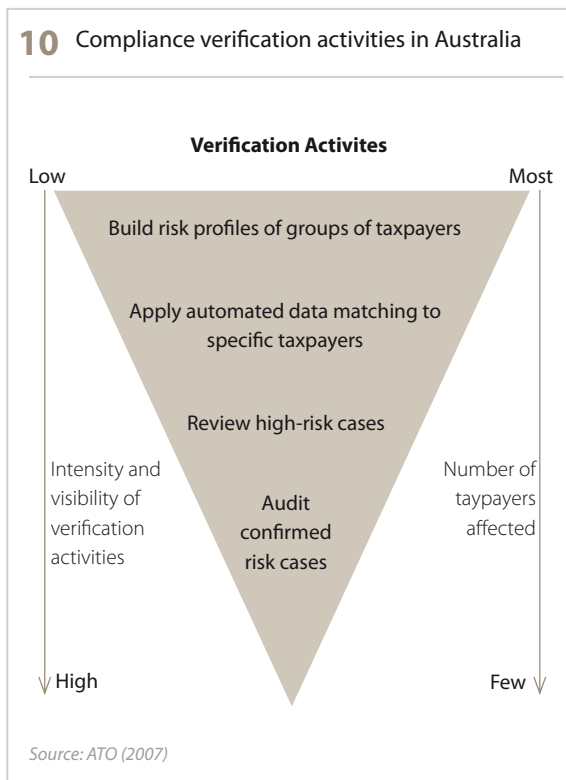
- 1 Australian Tax Office (2007), *How we combat tax evasion*, <http://www.ato.gov.au/print.asp?doc-/content/30337.htm> (accessed August 2007).
- 2 FODF (2007), *De Modernisering van FOD Financien en de Strijd tegen de Fiscale Fraude: Nieuwigheden*, p.15.
- 3 CRA, (2007) *The underground economy*, <http://www.cra-arc.gc.ca/agency/alert/underground-e.html>. (accessed September 2007).
- 4 Personal communication with Skatteverket official (survey response).
- 5 National Audit Office report on *HM Revenue & Customs: Tackling the hidden economy*.
- 6 IRS website, <http://www.irs.gov/compliance/enforcement/article/0,,id=163010,00.html> (accessed October 2007).
- 7 The IRS Criminal Investigation 'Return Preparer Program' focuses on protecting revenue by identifying, investigating and prosecuting abusive return preparers.

The Australian Taxation Office is piloting a number of new approaches to increase awareness in the community that it is tackling areas considered the least acceptable elements of the cash economy. Two specific projects are targeting people³⁹:

- with conspicuous lifestyles as exhibited by their purchases of goods and services such as luxury cars, boats, properties, and exotic holidays and which are not supported by their declared income.
- who are non-compliant with more than one government obligation (e.g. taxation, fair trading practices, industrial relations, immigration, welfare support, pensions, insurance, etc).
- In **Canada**, the Revenue Agency identified two sectors as high risk – construction and home renovations and the hospitality sector – partly on the information provided by trade associations.⁴⁰
- In **Sweden**, high risk sectors were identified by systematically analysing the results of tax audits between 1995 and 2003. The results were weighted based on the overall economic importance of each industry sector. For example the fishing industry sector had the highest percentage of undeclared income but it is not one of the high risk sectors, as its overall economic importance is small.^{41,42}
- In **Belgium**, the tax authority is using data mining techniques to identify high risk groups, which will be targeted with sector specific campaigns.⁴³ Data mining enabled the tax authority to systematically scan the results of previous tax audits and identify patterns in the profile of those committing fraud, the characteristics of the fraud, and the behaviour of those committing it.

- In the **United States**, the results of tax audits by the Internal Revenue Service show that sole proprietors who own unincorporated businesses have a relatively high rate of tax non compliance and account for a significant proportion of the tax gap. The Internal Revenue Service estimated that sole proprietors misreported 57 per cent of their business income in 2001 and that \$68 billion of the tax gap (out of a total of \$345 billion) is attributable to sole proprietors underreporting such income. The low level of compliance is because sole proprietors are not subject to withholding tax, and only a portion of their net business income is reported to the IRS by third parties. The Government Accountability Office produced a report looking at the various options for reducing sole proprietor non compliance.⁴⁴

2.8 The way tax authorities assess the risks from the hidden economy sit within a wider approach to assessing the risks across taxes. The Australian Taxation Office provides a good example of an approach to assessing the risks to tax revenue (**Figure 10 overleaf**). The compliance model links the level of risk to the verification methods and the intensity and visibility of the enforcement activities. The Taxation Office believe it is important to maintain the public's trust in the tax system by communicating its enforcement activities to them – particularly by demonstrating that offenders will be detected and punished.



2.9 The Australian Taxation Office approach consists of:

- Building risk profiles – identifying risk characteristics among groups of taxpayers by analysing information collected in returns and from third parties (e.g. financial institutions, government agencies, auditors of self managed superannuation funds) and surveys.
- Data matching and applying risk profiles to taxpayers (identifying inconsistencies, unreported transactions and other risks) by automatically checking returns (activity statements and other reports) against taxpayers past behaviour and third-party data.
- Reviewing taxpayers' returns where inconsistencies or other risks are identified.
- Contact with the taxpayer which depends on the nature and complexity of the risk – it typically starts with letters and phone calls seeking more information or clarification and extends to field visits and audits where required.
- Auditing taxpayers where reviews confirm that there is a risk to the tax revenue.

Most tax authorities have central coordinating units but no dedicated staff for detecting those in the hidden economy

2.10 Some tax authorities have strategic units responsible for directing and/or coordinating hidden economy work across the organisation. Several use their general tax compliance staff to detect those in the hidden economy. The general tax compliance staff are usually tasked with undertaking projects to tackle specific sectors of the economy or particular client groups likely to be operating in the hidden economy. The Canada Revenue Agency and HM Revenue & Customs have dedicated teams for tackling the hidden economy. In addition HM Revenue & Customs uses other dedicated project teams such as a team which is responsible for tackling the failure of individuals to declare income from offshore bank accounts and general tax compliance staff to tackle aspects of the hidden economy. As a consequence it is difficult to identify precisely the resources each tax authority allocates to tackling the hidden economy work. **Figure 11** sets out some broad estimates of the resources allocated which are not comparable since they reflect each tax authority's definition of the hidden economy.

2.11 Examples of how tax authorities are organised include:

- In **Australia** – the high level Cash Economy Steering Committee provides advice and oversight and helps coordinate the Taxation Office's cash economy and compliance activities.⁴⁵
- In **Belgium** – responsibilities for tackling the hidden economy have been elevated to the political level by the appointment of a Secretary of State as the coordinator for the government's efforts to combat fiscal fraud.⁴⁶ In 2006, a specialised anti-fraud unit was created, which coordinates the hidden economy activities of the main working units.

11 It is difficult to compare resources allocated by each tax authority to tackling the hidden economy

	Australia	Belgium	Canada	Sweden	The United Kingdom	The United States
Resources	Cash Economy: 470 staff ¹	Not available	Underground economy: 1,000 to 1,250 ²	Tax gap: 2,500 FTE ³ Black work: 722 ⁴	Hidden economy: 1,270 staff	Not available

Source: RAND Europe compilation

NOTES

1 Interview with senior official in Australian Taxation Office, October 2007.

2 CRA, *The underground economy*, <http://www.cra-arc.gc.ca/agency/alert/underground-e.html>. (accessed: September 2007).

3 Skatteverket, *Årsredovisning 2006*, Stockholm: Skatteverket, 2007.

4 Interview conducted with Skatteverket official, October 2007.

- In **Canada** – the High Risk Compliance Strategy Division at Headquarters is responsible for developing and evaluating the impact of comprehensive compliance strategies including tackling the underground economy.⁴⁷ Tax compliance units including underground economy teams are responsible for implementing the strategies.
- In **Sweden** – the head office oversees all strategic tasks, including tackling the hidden economy. Regional offices are responsible for undertaking the tasks.⁴⁸
- In the **United States**, the National Taxpayer Advocate has suggested that the Internal Revenue Service should establish a Cash Economy Program Office, which would be responsible for an overall strategy addressing the cash economy, coordinating the use of tools for identifying the underreporting of income and nonfilers, and promoting a research agenda that addresses the unique issues associated with the cash economy.⁴⁹

Tax authorities work jointly with other government agencies and the private sector to tackle the hidden economy

2.12 Tax authorities work with other public sector organisations and the private sector to improve compliance in particular sectors and detect those operating in the hidden economy. From the available information it is difficult to identify the type of relationships that work well in practice and whether joint working overall produces worthwhile results. The following provides some examples of the extent to which tax authorities work with others.

2.13 The Australian Taxation Office works collaboratively with other agencies through a range of cross-agency support services and information to deliver “whole-of-government” initiatives. The Taxation Office usually enters into a memorandum of understanding setting out the nature of the relationship and the work to be undertaken, as well as the expectations of all parties. The support they provide to other agencies seeks to:

- Provide better accessibility to services for taxpayers;
- Increase knowledge sharing between agencies; and
- Implement government initiatives and improve compliance with programs.

2.14 The Australian Taxation Office also works closely with industry, and tax and accounting professional bodies to help increase compliance in the cash economy. These include developing ideas on cash economy compliance messages and ways to convey them through professional associations' activities and seeking their input in designing information products and services. The Taxation Office also cooperates with them in alerting businesses to risky practices.⁵⁰

2.15 Joint working is one of the main levers used by the Belgian tax authority (FODF) to improve compliance. In some sectors such as construction, FODF places responsibility squarely on the industry sector to increase awareness and in some cases to provide data on companies. To facilitate cooperation, FODF has signed a number of agreements with:

- The accountancy professions to assist with the simplification of regulations and support the modernisation of the administration;
- Notaries (in Belgium notaries are responsible for inheritance and real estate transactions);
- Car distributors;
- Oil distributors; and
- The gaming and gambling sector.

2.16 Partnerships with industry sector organisations are an essential part of the Swedish Tax Agency's national programmes targeted at the hidden economy, in particular its projects tackling non compliance in the construction, the restaurant and the taxi sectors. In the construction industry sector, the Swedish Tax Agency works closely with employers and unions to tackle black work.⁵¹ Under the "ID 06" scheme, every company has to notify in advance which workers will be on a construction site and each worker has to register when entering or leaving a site.⁵² At present, this system is run on a voluntary basis by the members of the sector organisations. The Swedish Tax Agency is working on an internal policy to structure its relationships with industry sector organisations which it perceives to be of increasing importance in tackling the hidden economy.⁵³

Conclusions

2.17 Despite different definitions, tax authorities have similar objectives, and strategies for tackling the hidden economy. They use different techniques to assess the risks to tax from the hidden economy but have identified similar industry sectors as high risk. Tax authorities use similar measures to tackle the hidden economy. National context seems most relevant in the way tax authorities organise themselves to tackle the hidden economy.

Encouraging people into the formal economy

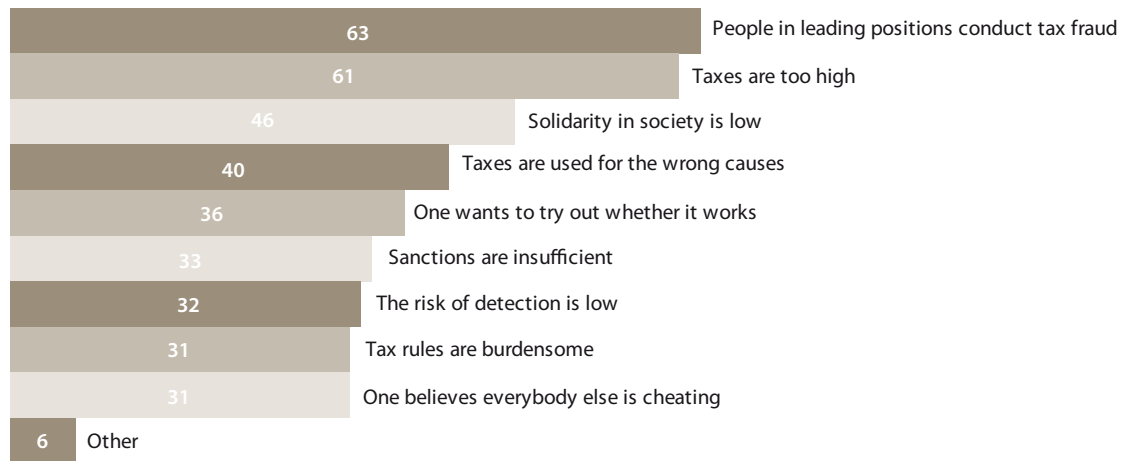
3.1 This chapter covers the motivations of people in the hidden economy and the measures used by tax authorities to encourage them into the formal economy.

It can be important to track changes in the motivations of those in the hidden economy

3.2 Understanding the motivations of those in the hidden economy can help tax authorities design appropriate measures to encourage people and businesses into the formal economy. Tracking changes in people's motivations can also help tax authorities assess whether attitudes are changing or whether new motivations are emerging which need to be tackled. Tax authorities conduct varying amounts of research into the motivations of those in the hidden economy. The Swedish Tax Agency and the Australian Taxation Office (ATO) are good examples of tax authorities conducting regular surveys to track changes in attitudes with the results used to inform their strategies to improve compliance.

3.3 The Swedish Tax Agency recently conducted two studies into the causes of and strategies for dealing with tax evasion and black work. *Right from the Start*⁵⁴ is an extensive review of the literature and evidence base for combating tax evasion. It also examines the motivations of those in the hidden economy. A major study into those who carry out undeclared work and those who purchase services from the hidden economy⁵⁵ has helped the tax authority to develop a strategy for tackling the "black economy". The findings show that people's decisions to undertake or purchase illicit work is dependent on a number of interrelated factors. Earlier research conducted by the Swedish National Office and used by the Swedish Tax Agency has differentiated between structural and individual causes for participating in the hidden economy.⁵⁶

3.4 Every two years the Swedish Tax Agency surveys the general public and businesses on their views on tax evasion, black work and the performance of the tax authority. This information is used to assess the impact of information campaigns and identify areas which require further action. For example in 2004, the Swedish Tax Agency responded to a change in the attitude of young people to tax by focusing information campaigns on this group. In 2006, the Swedish Tax Agency included a question in its regular survey on the reasons for tax fraud which showed that the perceived fairness of the tax system was an important issue (**Figure 12 overleaf**).⁵⁷

12 Reasons for tax fraud in Sweden, share of people agreeing with given reasons, 2006

Source: Swedish Tax Agency (2007)

3.5 The Australian Taxation Office also conducts regular research to understand taxpayers' views on compliance issues. Since May 2004 the Taxation Office has conducted several industry and community surveys (such as the 'Blue Moon' Research)⁵⁸ to obtain information on how peoples' behaviours are affected by the cash economy. It also conducts six-monthly surveys on business and community perceptions, which includes questions on the cash economy. Research by the Taxation Office in 2004 found that many people were tolerant of the hidden economy. The general public were concerned with a minority who "abused the system to the detriment of society in general" such as those who were also wrongly claiming welfare benefits.⁵⁹ The 2007 Community Perception Survey highlights that 73 per cent of Australians think it is unfair to use cash to evade taxes. In addition, 41 per cent of people thought that the Taxation Office was doing a good job in informing people about their initiatives to tackle the cash economy. A similar percentage thought that the Taxation Office was effective in dealing with people who do not declare all their cash earnings.⁶⁰ Academic research has also explored the variables that could play a key role in influencing people to become involved in Australia's cash economy.⁶¹

3.6 The European Commission's recent Eurobarometer survey on *Undeclared work in the European Union*⁶² provides extensive information on the motivations of those working in the hidden economy and those who purchase goods and services from it.

Motivations for participating in the hidden economy can be structural and individual

3.7 There is a large amount of academic research on the motivations of those in the hidden economy. The results from this work show that the motivations for participating in the hidden economy can be grouped into structural and individual causes⁶³ (**Figure 13**).

Structural reasons

Social norms

3.8 Social norms can encourage people into or can help to prevent people from participating in the hidden economy. For example close social networks in rural areas may increase the risk of detection, but at the same time these networks also provide local knowledge on who would be interested in carrying out illicit work. In Belgium strong social networks have been identified as an important factor affecting the size of the hidden economy.⁶⁴

13 Examples of structural and individual causes of participation in the hidden economy

Structural

- Social norms
- Institutional factors
- Labour market
- Cultural factors
- Strong competition

Individual

- Norms, values and the distance between the individual and state
- Perceived risk of detection
- The desire to earn extra income
- Skill base

Source: RAND Europe

Institutional factors

3.9 High tax rates, the total amount of the tax take and the complexity of the tax system can be factors that determine the size of the hidden economy.⁶⁵ Some 13 per cent of respondents to the European Commission's Eurobarometer survey stated that high taxes and contributions were a motive for undertaking undeclared work. Around eight per cent were put off by the bureaucracy they would face in declaring their income.⁶⁶

3.10 Other research shows that:

- *The amount of taxes* are key factors driving the hidden economy in Australia, Belgium, Canada, and the US.^{67,68,69,70,71}
- *The stacking effect of taxes* is also a likely driver of the underground economy. In Canada, the federal and provincial governments can increase revenue through direct and indirect taxes.⁷² The implementation of Goods and Services Tax has probably received most attention for increasing the size the underground economy.

In Belgium, which has some of the highest tax rates in Europe, studies have pointed to the relatively high tax burden on employment (compared to other taxes such as capital gains tax) providing an incentive to work in the hidden economy.⁷³

- *The complexity of the tax system* such as in Canada and the US is a factor driving people into the hidden economy.^{74,75} For example, it is estimated that on average it takes a person 14 hours to complete the standard US tax return including the time spent keeping proper records. The Swedish Tax Agency has also found that the complexity of the tax system is a key factor in determining whether people are likely to purchase or undertake illicit work.⁷⁶

Labour market

3.11 People can be attracted to the hidden economy if they have difficulties finding a job in the formal economy and they can earn a reasonable income from informal work.⁷⁷ Some academics see Belgium as a case that confirms the relationship between high labour costs and the size of the hidden economy.⁷⁸ Further, the rigidity of labour laws and the complexity of regulations have been cited as putting people off registering for and paying tax.⁷⁹ In Canada the growth in self employment has been cited as an indicator of the hidden economy since this group generally has more opportunities to evade taxes than employees. Studies have also found that the average worker in the underground economy also holds a regular job in the formal economy.⁸⁰

Cultural factors

3.12 Cultural factors, shared by society or regional subgroups influence the social acceptance of illicit work. If certain traditional activities, e.g. helping out the neighbour in building a house, are suddenly declared "black work", people might still stay with traditional patterns of social behaviour.⁸¹

Competition

3.13 Strong competition in a market such as restaurants or hairdressing may lead businesses to employ illicit labour or under declare their income to gain an advantage. Where such behaviour is common in a sector, it can push “honest” businesses into doing the same to remain competitive.⁸²

Individual reasons

Norms, values and the distance between the individual and the state

3.14 The strength of people’s moral convictions, based on norms and values (what is acceptable behaviour and what is not) play an important role in their decision whether to participate in the hidden economy or not. In addition, the (perceived) distance between the person and the state can explain part of their willingness to undertake work in the hidden economy.⁸³

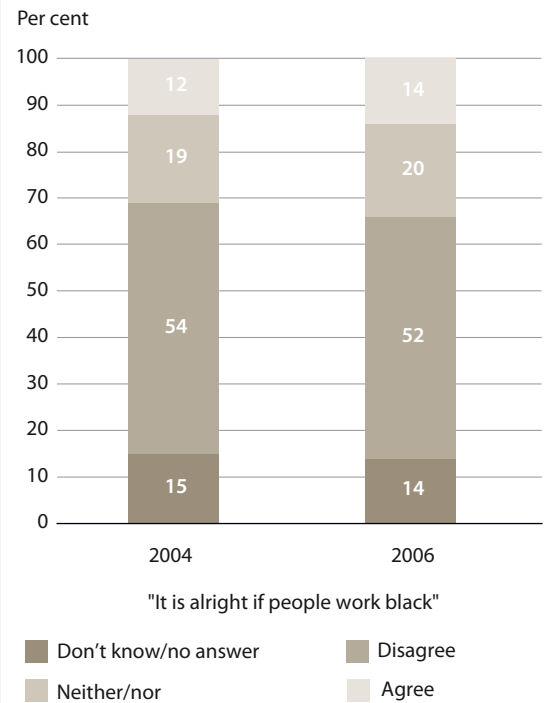
3.15 For example:

- In the **UK**, peoples’ fear of dealing with government departments has been cited as a reason for entering the hidden economy.⁸⁴
- In **Canada** the results of surveys suggest that less than one quarter of Canadians could be categorised as tax compliant citizens. Half of respondents were categorised as “upset and envious” or “tax anarchists”. A television network poll in 1994 indicated that 58 per cent of Canadians would purchase goods and services from the underground economy.⁸⁵
- In **Sweden** the results from the tax authority’s surveys show that only slightly more than half of the population disapprove of black work (**Figure 14**).⁸⁶

Skill base

3.16 To undertake work in the hidden economy people may need appropriate contacts, skills, materials and equipment. All of these factors are also closely related to jobs in the formal economy, which may explain the under representation of unemployed people in the hidden economy.⁸⁷

14 Attitudes towards black work and tax fraud



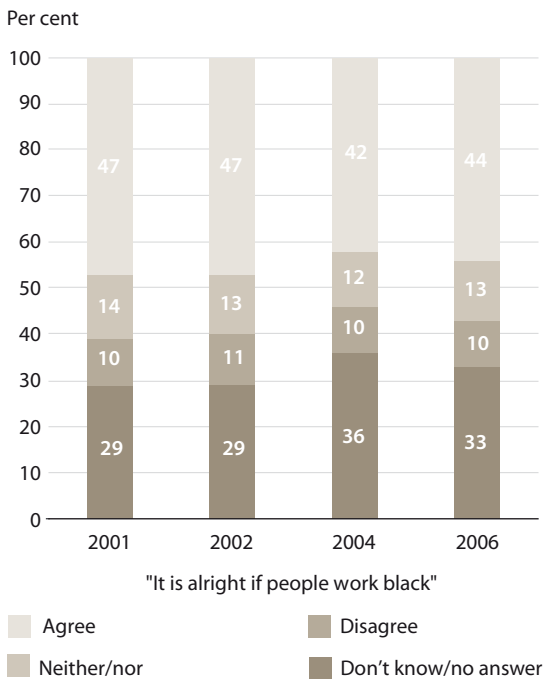
Source: Swedish Tax Agency (2006)

The perceived risk of detection

3.17 The perceived risk of detection can influence a person’s decision on whether to undertake work in the hidden economy. If they perceive the risk to be high the person may be less likely to undertake work in the hidden economy.

- In **Sweden**, the Swedish National Audit Office’s research shows that people who have never undertaken illicit work perceive the risk of detection to be higher than people who were involved in illegal activities.⁸⁸ The results from the Swedish Tax Agency’s surveys show that the general public and businesses consider that the risk of detection is declining (**Figure 15**).

15 The general public's views on the perceived risk of detection in Sweden

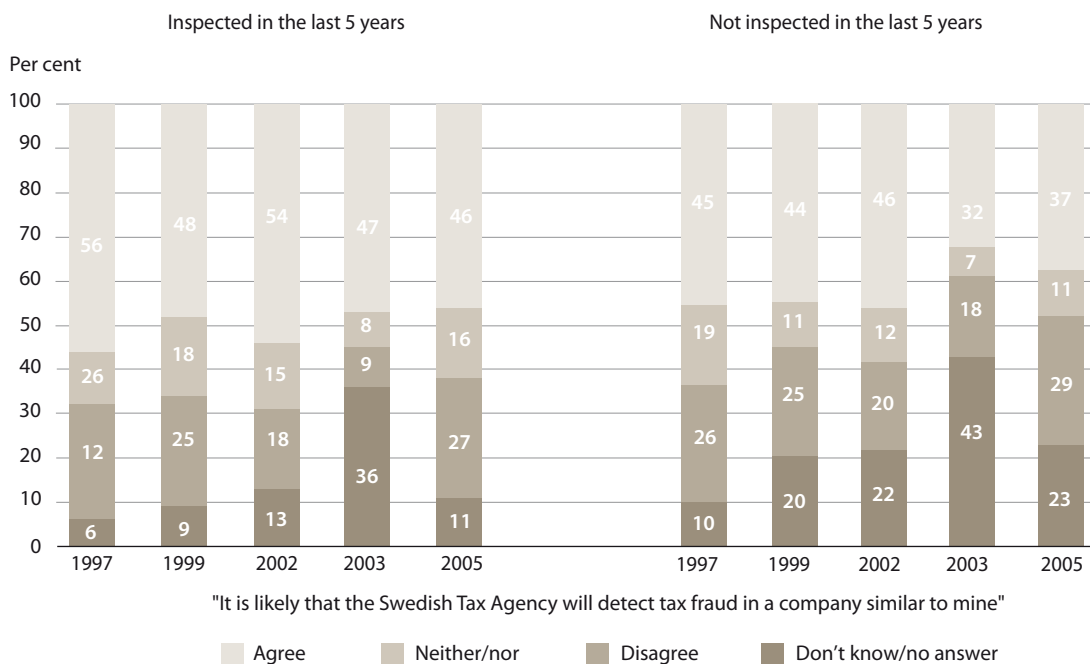


Source: Swedish Tax Agency (2006)

- In **Australia** the results of a survey showed that the "chances of getting caught" had a statistically significant influence on whether people undertook work in the hidden economy and on those who purchase services from the hidden economy.⁸⁹

3.18 In the Eurobarometer survey on "undeclared work in the European Union," more than half of the general public (55 per cent) across all 27 countries estimated that the risk of being detected doing undeclared work is fairly or very small.⁹⁰ One third thought the risk was fairly high or very high. There were certain regional differences. In the UK, people considered the risk of detection to be high. In contrast, in Belgium and Sweden an above EU average percentage of respondents considered the risk of detection to be low. The survey also found that when undeclared work is detected, people expect that all taxes and social security contributions will have to be paid as well as a fine.

16 Perceived risk of detection in Sweden among companies which had/had not been audited within the last five years



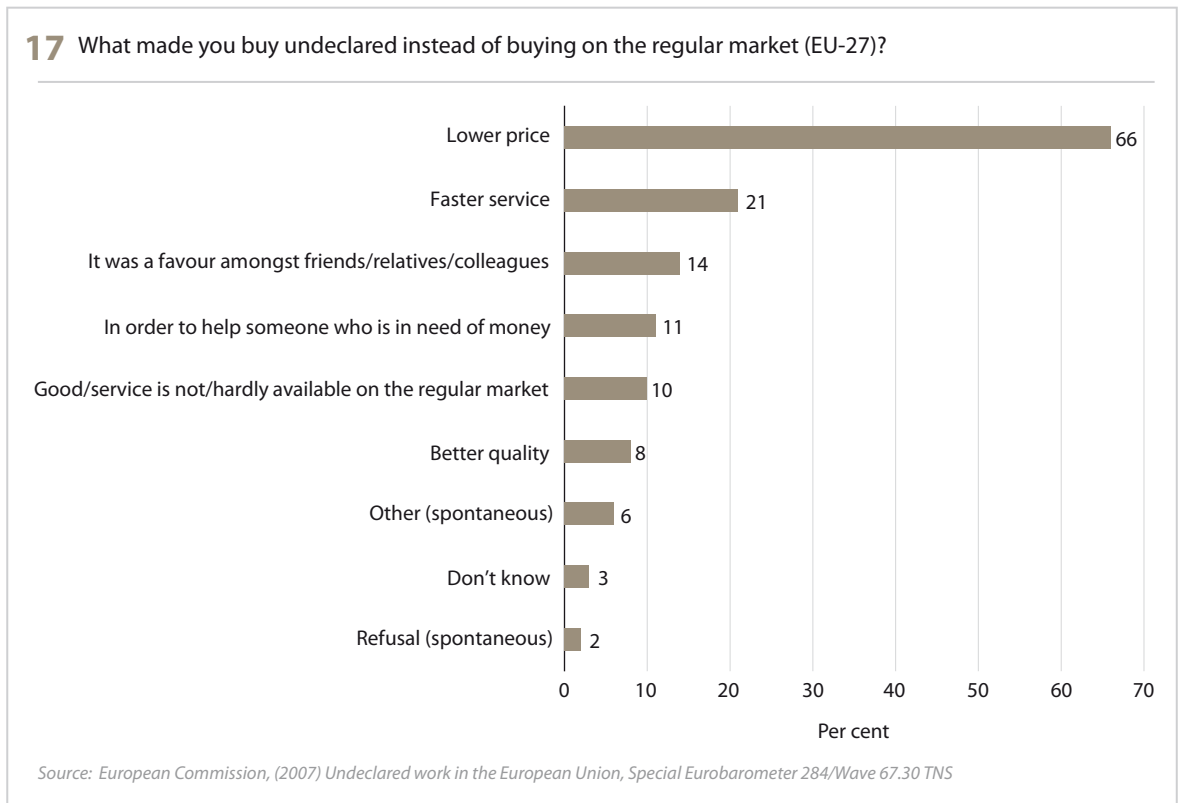
Source: Swedish Tax Agency (2006)

The desire to earn extra income

3.19 Earning an extra income is a factor encouraging people to work in the hidden economy. In Sweden, some people consider it unfair that they have to pay taxes above a certain level, or that other businesses get subsidised and they do not, and thus they consider that working in the hidden economy is justified.⁹¹ Some people in the UK work in the hidden economy to make more money. Others work in the hidden economy to hide their income from debt agencies and minimise payments to them or to avoid making child support payments. Some feel that working in the hidden economy is a necessity as it is the only way to make enough money to pay for essentials such as mortgage payments. Working in the hidden economy may also allow them to conceal their income to obtain welfare benefits fraudulently.⁹²

- The vast majority (66 per cent) of those who buy goods and services do so because prices are lower (**Figure 17**).
- Almost half (47 per cent) said it was because both parties (the buyer and the seller) benefited from it. This view was especially widespread in the Nordic countries.
- About a quarter (23 per cent) said that the work was only seasonal and not worth declaring.⁹³
- About a fifth (21 per cent) said that the work was undertaken more quickly (Figure 17).⁹⁴

3.20 The recent Eurobarometer survey on *Undeclared work in the European Union* asked respondents for the reasons they undertake undeclared work or purchase services from those in the hidden economy. The results show that:



There is no typical socio-demographic profile of people participating in the hidden economy

3.21 People's willingness to participate in the hidden economy can be examined from the demand side (i.e. those people who buy undeclared goods and services) and the supply side (i.e. those people doing undeclared work). The results from the Eurobarometer survey did not reveal any particular profile for the "typical purchaser" although there are some groups who are more likely to purchase services than others including men, people aged between 25 and 54 years, professional groups with above average incomes, the self employed, and people with a higher education.⁹⁵ In Australia cash economy activity occurs across all occupational groups.⁹⁶

3.22 Research into those who work in the hidden economy shows consistent results:

- Men are more likely to work in the hidden economy than women (Eurobarometer survey and studies in Australia).
- They are also likely to be in the age range 15–24 years, especially in Continental Europe and Nordic countries.⁹⁷ Studies in Australia have also found that as people get older they are less likely to work in the hidden economy.⁹⁸
- Unemployed and self employed are more likely to work in the hidden economy in some countries (Eurobarometer survey, studies in Australia, Sweden for self employed people and the UK.^{99, 100, 101, 102, 103, 104} In cooperation with the Swedish National Council for Crime Prevention, the Swedish Tax Agency carried out an in-depth study of black work by people receiving unemployment benefits in 2006. The results of this work indicate that these people, especially those unemployed for a long period are less likely than the average Swede to participate in the black economy.¹⁰⁵

Most tax authorities use targeted education and information campaigns to improve compliance

3.23 Most tax authorities use educational and information campaigns to target specific activities in the hidden economy or to provide specific advice such as to the self-employed on their tax obligations or to raise general awareness. There is little information however on the effectiveness of the campaigns making comparisons between countries difficult.¹⁰⁶ Where evaluations exist they rely on estimates of the increase in the number self employed people registering for tax (UK) or by examining the results of tax audits (Australia). Information campaigns can help to change the public's attitudes to the hidden economy and possibly reduce its size. Sweden and Australia conduct regular surveys of the general public to understand their attitudes to tax and use the results to change them. The results of the surveys over time provide some measure of how attitudes have changed and the success of information campaigns.¹⁰⁷

3.24 Various information campaigns undertaken by tax authorities include:

- In **Sweden**, the Tax Agency runs extensive information campaigns targeting specific groups of taxpayers. For example those paying tax for the first time are sent information packs explaining their responsibilities for filing a tax return and on how to complete one. The tax authority uses national media campaigns such as those focused on the construction sector to help improve compliance.¹⁰⁸
- In **Australia**, the Taxation Office educates small businesses about their obligations such as their responsibilities for keeping proper financial records. It provides: a record keeping evaluation tool (available on its website); the *Record keeping for small business* booklet; industry-specific record keeping fact sheets; free *e-Record* record keeping software; a register of software products that are commercially available and meet the Taxation Office's requirements (available on its website),

and free record keeping workshops. The Taxation Office has found that when businesses are provided with information on their responsibilities 90 per cent keep reasonable records afterwards. The Taxation Office provides regular feedback in newsletters to the general public on the results of information provided to it on suspected tax evasion – *Tax evasion and the community – recent results*. These newsletters cover what the community have been telling the Taxation Office; recently reported topics; a “Did you know” section (e.g. how the general public can use the hotline to report on suspected tax evasion cases); what the Taxation Office has observed in the community and information on tax evaders who were recently caught.

- In **Canada**, the Revenue Agency uses various ways to educate people and businesses about their tax obligations ranging from community visits to debunking tax myths on its website. In November 2005 the Agency launched a Tax Alert initiative to provide taxpayers with a central repository of information about the underground economy and the Agency’s enforcement activities, as well as informing taxpayers about avoidance and evasion schemes. It also alerts taxpayers to the risks they are exposed to by employing contractors who work in the underground economy.¹⁰⁹ The Agency has worked in partnership with the Canadian Home Builders’ Association on the “Get it in Writing” campaign to inform people of the risks of paying cash “under the table” to home maintenance and repair contractors.¹¹⁰
- In the **UK**, HM Revenue & Customs has run a number of advertising campaigns to raise awareness among the self-employed to register for tax and to advertise a new hotline for the general public to report those suspected of operating in the hidden economy. A series of campaigns ran from June 2005 to March 2007 advertising that self-employed people needed to register for tax. An estimated 8,300 additional people used the helpline to register. It is estimated that this will generate £38 million in tax receipts over a three year period.¹¹¹

Tax authorities have used disclosure schemes successfully to increase tax revenues

3.25 Tax authorities have used disclosure schemes to encourage people to declare income from the hidden economy (**Figure 18 on page 36**).¹¹²

The main differences between the schemes are in the sectors the tax authorities have targeted and the type of incentives provided. Some schemes do not impose a fine such as the initiatives in Canada and Ireland. In other countries such as Belgium, Germany, and France, a fine is imposed in place of the tax owed. The fine can be lower than the amount of tax that would be normally due. In other countries, such as the United Kingdom, the United States, and Australia the fine is on top of the tax owed on the non-declared income. Some schemes are quite general and little action is taken by the tax authority to increase the take up of the scheme or target the specific groups. Other schemes include letter writing campaigns using intermediaries such as financial institutions to make potential target groups aware of the scheme and explain their responsibilities as a taxpayer.

3.26 Disclosure schemes appear effective. For relatively low expenditure, large amounts of tax revenue are recovered such as in Belgium, the United States, and the United Kingdom (HM Revenue & Customs estimates a return of £67 for every £1 spent).¹¹³ International studies show however that tax revenue can fall short of expectations¹¹⁴ raising questions as to whether such schemes are worthwhile. Disclosure and/or amnesty schemes can also lead to lower compliance rates among taxpayers in the future.¹¹⁵ The schemes can create a ‘moral hazard’, where the government undermines the integrity of the tax system by giving incentives to people who have failed to declare their income. Disclosure schemes can be successful where they are not offered too often.¹¹⁶ Once they become regular, taxpayers may anticipate them and adjust their compliance behaviour. The schemes should respect the integrity of the tax system. Generous incentives may be effective in recovering tax revenue

in the short term, but may be more damaging in the long-term as they may impact on wider taxpayer compliance. Most of the countries studied including the United Kingdom use or are moving towards schemes (in the case of Belgium **see Figure 19 on page 38**) that respect the underlying tax rates and levy penalties on top of the tax owed. People may be more likely to come forward if the scheme is combined with reform of the tax system to make it easier to comply.^{117,118}

Some countries have used innovative policy initiatives to encourage people into the formal economy

3.27 Some countries have used innovative policy initiatives to encourage people into the formal economy. These initiatives aim to displace the hidden economy or seek to strengthen compliance or provide tools to industry to improve compliance.

3.28 Belgium offers a good example of a scheme aimed at displacing the hidden economy. It introduced service vouchers to subsidise the cost of household services. A household buys vouchers which pays for an hour of work from certified companies, who employ people who were previously unemployed. The company can employ people on a part-time temporary basis. After six months however, the company has to offer them a permanent employment contract for at least half-time employment if the person was formerly registered as officially unemployed. The employee can do the following activities: housecleaning; washing and ironing; sewing; running errands; and preparing meals. The household can pay for the cost of the work using the vouchers. The federal government pays the value of the voucher to the company. The households can recover 30 per cent of the price of the vouchers in their tax return.

3.29 The Belgian government planned to create 25,000 jobs by the end of 2005. According to an evaluation (Gevers et al, 2005), by the end of 2005 some 28,933 people had been employed through the service voucher scheme. These people were employed by 792 companies, of which 41 per cent were temporary employment agencies, one quarter were private not-for-profit enterprises and 18 per cent were public companies. Most people (90 per cent) were employed in part-time jobs, although most worked more than half-time. The 28,933 people in jobs represent 17,360 full-time equivalent jobs. Nearly one half already had a job before joining the service voucher scheme. The net effect on job creation therefore was some 9,000 jobs. By the end of 2005, two-thirds were employed on permanent contracts.

3.30 During the two and a half years the scheme has been in operation, almost 200,000 households have used vouchers to pay for services. Early studies found that customers previously sourced some 44 per cent of the work from the hidden economy (de Sutter, 2000). The most recent evaluation found that the figure was only 25 per cent. Both studies suggest that the scheme has transferred some hidden work into the formal economy.

18 Tax authorities have used different types of disclosure scheme

Country/year	Australia ¹	Canada ²	Belgium (2004) ⁴
Type of scheme	Offshore Disclosure Scheme The ATO has been working with some Australian financial institutions to encourage them to write to their overseas customers	Initiative to allow taxpayers to come forward and correct inaccurate information	General disclosure scheme, <i>Eenmalige Bevrijdende Aangifte</i> (EBA)
Fines	Additional taxable income <AU\$20,000 (£8,574)- Nil. >AU\$20,000 - Five per cent of additional liability	No fines or prosecution above tax payable	Six per cent of the total amount where the assets were reinvested in Belgium for a minimum of three years and nine per cent in other cases No tax payable aside from fines
Target group	Offshore account holders	General taxpayer population	Offshore account holders and self employed
Financial target	Not found	Not found	€850 million (£586.5 million) in penalties in 2004
Performance	Not found	Over 8,244 disclosures in 2006-07 resulting in C\$527 million in assessed taxes, up from 557 disclosures in 1993-94 ³	€5.7 billion (£3.9 billion) back in the tax system and levied fines of €496 million (about £342 million) About €10 billion (£6.9 billion) came into the system outside of the scheme

Source: RAND Europe compilation on the basis of academic literature

NOTES

1 Australian Tax Office. *Offshore voluntary disclosure*. Online at: <http://www.ato.gov.au/individuals/content.asp?doc=/content/87082.htm> (accessed October 2007).

2 Revenue Canada – *Underground Economy Initiative* (1999, Chapter 2). Online at: <http://www.oag-bvg.gc.ca/domino/reports.nsf/html/0112ce.html> (accessed October 2007).

3 CRA (2007), Annual Report to Parliament 2006-07.

4 Taken from Pacolet J., Coudron V. and Van De Putte I. (2006), *Zonder Pardon: Fiscale Amnestie Eenmalig en Andermaal*, Gids op Maatschappelijk Gebied, January 2006.

5 GAO (2004), *Taxpayer Information: Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions, Testimony Before the Committee on Finance*, US Senate, GAO-04-972; IRS (2004) *IRS, States Move Forward in Fight Against Abusive Tax Avoidance*, <http://www.irs.gov/newsroom/article/0,,id=120343,00.html>.

Belgium (2005)	The United States (2003)	The United States (2000)	The United Kingdom (2007)
General disclosure scheme	Offshore Voluntary Compliance Initiative (OVCI)	Offshore Credit Card Program (OCCP) using judicial summonses for information requests Rolling programme	Offshore Disclosure Scheme Department encouraged intermediaries to write to people with offshore accounts. It followed this up with letters setting out its suspicions.
No fines above tax payable	Reduced penalties payable above tax payable	Reduced penalties payable above tax payable	10 per cent penalty on tax owed No penalties under £2,500
Offshore account holders and self employed	Offshore account holders	Offshore account holders	Offshore account holders
€400 million (£276 million) in 2006	Not found (estimated 1 million account holders)	Not found	£400 million declared so far or nearly £9,000 per case
Closer to €70 million (£48.3 million) up to end of period	861 taxpayers came forward with \$200 million (about £100 million) in unpaid taxes, penalties, and interest ⁵ ; Programme cost about \$3 million (£1.5 million)	In 2003 about 2,800 tax returns are under audit, about \$3 million (£1.5 million) in taxes was recovered	64,000 notifications and 45,000 disclosures by account holders. Cost is about £6 million

19 The use of disclosure schemes in Belgium

Belgium has used two disclosure schemes to collect tax on income earned overseas and which has not been declared. The reasons for introducing the schemes were to comply with the European savings directive and increase tax receipts and stimulate the economy. The first scheme in 2004, *de Eenmalige Bevrijdende Aangifte* (EBA), applied to individuals and the self-employed. It was estimated that up to €160 billion (£110 billion) was outside of the tax system. The government hoped to collect €850 million (£586.5 million) through the scheme. The fines were six per cent of the total amount in cases where the assets were reinvested in Belgium for a minimum of three years and nine per cent of the total amount in other normal cases.

The government brought €5.7 billion (£3.9 billion) back into the tax system and levied fines of €496 million (about £342 million). This was below expectations and could have been lower as the amount was bolstered by a rush of late filers. However, the government estimates that outside of the EBA about €10 billion (£6.9 billion) was brought back into Belgium.

In 2005, the Belgian government announced a second scheme. However, the penalties were increased. Individuals would have to pay the actual tax rates on their income. The government estimated that it would collect €400 million (£276 million) in 2006 but collected €70 million (£48.3 million).

Source: RAND Europe

3.31 Gross costs for the service voucher schemes were estimated at €303.2 million. The additional jobs generated returns for the government, because of savings in unemployment benefits, as well as an increase in social contributions and personal income tax. These returns are estimated at €93.1 million, which brings the net costs to €210 million in 2005. Every full-time equivalent job created has cost some €12,500.

3.32 In other countries, the success of voucher schemes is mixed. France had a similar experience to Belgium, while in Finland the uptake of vouchers was disappointing. Observers point out that the effectiveness of vouchers is closely related to the extent of the subsidy.¹¹⁹

3.33 Another innovative policy of displacing the hidden economy as piloted in Germany is 'mini jobs'. This is where certain types of work up to a certain income level, and with a weekly time limit, are exempt from most taxes and social security contributions. In April 2003, there were about 5.5 million mini jobs mostly in the catering and cleaning sectors. Many of the jobs may have been transferred from the hidden economy to the formal economy.¹²⁰

3.34 To displace work in the hidden economy, the European Commission has allowed Member States to reduce the rate of VAT on certain labour intensive services. Several Member States have reduced the rate of VAT on building renovation and maintenance work. The Commission has noted however that there is limited evidence to show the effects of the reduced rate of VAT on the level of undeclared work in these countries (although the evidence is somewhat more robust for France).

3.35 Sweden and Canada provide examples of initiatives to strengthen compliance. In Sweden, as part of its 2006 research project, the Tax Agency proposed a set of legislative and regulatory measures to reduce tax evasion. These changes included for example:¹²¹

- Income from work under SKR 1,000 (£73) is free from tax if the employer is a business, and income of SKR 3,000 (£219) is free from tax if the employer is a private person.
- Businesses are required to give receipts to all customers and customers are obliged to take the receipt. Businesses should display their tax registration number.
- A business purchasing work from a subcontractor should have records showing their names and details of the work carried out. If they do not, they could be liable for the taxes the subcontractor has failed to pay.

3.36 Canada designed a more specific initiative, the Contract Payment Reporting System¹²², similar to the Construction Industry Scheme in the UK.¹²³ It aims to improve compliance in the industry (and the home renovation sector) by requiring construction businesses to record payments made to subcontractors, and to report these to the Revenue Agency. The system was originally introduced in 1996 on a voluntary basis but take up was too low to be effective and the system became mandatory in 1998. The Agency has conducted on-site visits to help companies implement the Contract Payment Reporting System. The scheme has collected over CA\$650 million (£321.1 million) in tax over the four years, 2001-2005.

Conclusions

3.37 Understanding the motivations of those in the hidden economy appears an important aspect of an effective strategy to tackle the hidden economy. The tracking of motivations can help in targeting the strategy and assess the risks to the integrity of the tax system. In addition, such tracking can also help to assess the impact of wider initiatives such as media campaigns (prevention), and disclosure schemes, in terms of behavioural changes. Australia and Sweden appear at the forefront of developments in designing ways of tracking the motivations of those in the hidden economy and in working with the wider academic community to understand the complex array of motivations. The United Kingdom appears to be at forefront in using effective disclosure schemes. Tax authorities use targeted educational campaigns and a number of policy initiatives to encourage individuals into the formal economy.

Detection

4.1 This chapter outlines some of the ways tax authorities detect people and businesses in the hidden economy focusing on two main methods – hotlines and data matching.

Tax authorities use general hotlines to enable the public to report suspected tax evasion but little information is available on their effectiveness

4.2 Hotlines allow members of the public to provide information in confidence by telephone or by completing a form either paper-based or online on those they suspect of evading tax. There is little information available on the comparative effectiveness of hotlines and on the merits of particular ways of organising them. Examples of the ways tax authorities use hotlines are (**Figure 20**).

- In the **UK**, HM Revenue & Customs (HMRC) has used advertising to encourage the general public to provide information to the telephone hotline on those suspected of operating in the hidden economy. They can provide information on other types of suspected tax evasion cases as well.
- In **Australia**, the Taxation Office operates two telephone lines. The Tax Evasion hotline (or “dobbing line”) is based at the Tax Evasion Referral Centre. In 2007 the Taxation Office also started the Tax Practitioner Integrity Service initiative where tax practitioners can telephone and report clients or former clients that they think may be

worthy of closer investigation. The Tax Evasion Referral Centre received about 19,000 contacts about suspected tax evasion in 2004-05. Just over one quarter related to businesses suspected of operating in the cash economy and not declaring tax on their income. The main industries reported to the hotline were building and construction, retail trade and cafes and restaurants. The top 500 cases completed in 2004-05 resulted in additional revenue of approximately AU\$29.7 million (£12.7 million).

- In **Belgium**, the general public can use a general helpline number to alert the tax authority to cases that may be of interest.
- In **Canada**, there are several hotlines operated at the local level but the Revenue Agency plans to set up a single number regionally
- The **United States** has a large number of tax helplines aimed at improving compliance, but the Internal Revenue Service does not have a dedicated hotline. The general public can complete a form (Form 3494 A) to provide information on those they suspect of operating in the hidden economy which can be posted or faxed to the Internal Revenue Service.

20 Several tax authorities have a tax evasion hotline

	Australia	Belgium	Canada	Sweden	The United Kingdom	The United States
Type of Hotline	No dedicated hidden economy hotline but a general tax evasion hotline (28 percent of calls relate to the cash economy)	No dedicated hidden economy hotline but a general helpline available	Local tax office number resulting in 25,000 calls a year Canada may regionalise the provision of hotline services	No hotline	HMRC launched a new hotline in November 2006, advertising that it can be used to report people evading tax, including those operating in the hidden economy	No dedicated hotline but helpline numbers available
Effectiveness	The top 500 cases completed in 2004-05 resulted in additional revenue of AU\$29.7 million (£12.7m)	Not found	No evaluation of hotline ¹	Not applicable	120,000 additional calls in first 12 months since then average of 7,000 calls a month	Not applicable

Source: RAND Europe compilation

NOTE

1 Interview with senior official in the Canada Revenue Agency, October 2007.

Tax authorities are making more use of data matching to detect those in the hidden economy

4.3 Tax authorities increasingly use data matching to analyse the main risks to tax revenue and to select cases for further investigation. Data matching exercises can focus on tax streams, specific tax evasion issues and sectors. In terms of assessing the risks to tax revenue, data matching allows the tax authority to undertake a more systematic review of large volumes of taxpayer data. Tax records can be matched with external sources of information to detect cases of people/businesses operating in the hidden economy. In a report, the Australian National Audit Office noted that “external data sources are more likely to be effective in identifying cases than (internally) cross-checking information on activity statements and tax returns.”¹²⁴

4.4 Some examples of data matching by tax authorities show that:

- In **Sweden** the widespread use of the personal number (social security number) allows data about people from different sources to be easily compared, such as information from banks. The “ROT” initiative allowed taxpayers to reduce their tax by submitting invoices where they employed someone for household services. The invoices submitted by taxpayers with their tax return enabled the tax authority to identify people working in the hidden economy.

- In **Canada**, the Revenue Agency (CRA) reported in 1999 that over the previous five years it had obtained more than 70 databases from other federal departments, provincial and municipal governments and private sector sources and matched them against their own databases.¹²⁵ The Ontario Workplace Safety and Insurance Board and the Revenue Agency recently agreed to exchange information to identify people and businesses registered with one government agency but not the other. The Agency also obtained private sector databases of payments made to city construction contractors. When a sample of payments was matched with contractors' tax returns around 40 per cent had not reported all of their income.
- In **Australia**, the Taxation Office during 2005-06 automatically matched the information on income tax returns with large volumes of external information from companies, financial institutions, government agencies e.g. Australian Transaction Report and Analysis Centre (AUSTRAC), Australian Bureau of Statistics and various state and territory authorities, employers and private health funds. The Taxation Office is specifically targeting business-to-consumer transactions including matching businesses appointment and quote books to invoices; tracing owner-builder transactions using local council records; matching information from trade suppliers to domestic service businesses; and analysing local advertisements.¹²⁶ The Taxation Office is developing industry benchmarks for some trades and industries where there is a high volume of cash transactions. Where the Taxation Office identifies taxpayers who do not fit within the benchmarks that relate to them, it will take a closer look at their activities to see whether there is non compliance. This approach will provide an opportunity for taxpayers who are outside benchmarks to adjust their behaviour, where necessary.¹²⁷
- In the United States, the Internal Revenue Service (IRS) intends making greater use of data matching to detect those who may be underreporting their taxes.¹²⁸ It receives and handles a growing number of information returns from third parties; around 1.7 billion for tax year 2006. The IRS pursues millions of discrepancies between the individual taxpayers' tax returns and the information returns, including both under-reporting of income and a failure to file tax.¹²⁹ The National Taxpayer Advocate has suggested that the IRS should also explore creating a database combining all information sources into a single system that would allow the IRS to develop new techniques for identifying potential under-reporting. The Advocate has also suggested that the IRS could develop industry ratios on the average share of sales from cash and payment cards. It could use any unexplained deviations from these ratios in combination with other criteria to select returns for audit.¹³⁰

There is little information available on the effectiveness of specific measures

4.5 There is very little publicly available information on the performance of tax authorities in tackling the hidden economy, the results achieved from using various measures to tackle the hidden economy or their cost effectiveness. Where performance information is available it is mainly output based such as number of detections and the amount of tax recovered. There is no link between the resources allocated (e.g. staff) and the outcomes (reduction in the tax gap). For example Australia and Canada report on the number of cases per compliance activity or market segment (e.g. micro-businesses).

4.6 A report by the Australian National Audit Office in 2005-06 suggested that the Taxation Office should assess the impact of its work on tackling the cash economy by measuring:

- The underlying changes in the tax collected from sectors of the cash economy targeted by the Taxation Office;
- Changes in the attitudes of industry participants and consumers over a period of time; and
- Comparing the amount of tax paid by those in the cash economy sectors receiving some sort of intervention from the Taxation Office such as education with those who have not.

Conclusions

4.7 Some tax authorities have a hotline allowing the public to report suspected cases of tax evasion including their suspicions about those working in the hidden economy. The general nature of these hotlines makes it difficult to assess their effectiveness in helping tax authorities detect cases in the hidden economy. In terms of data matching, the comparative analysis shows that targeted approaches to sectors, tax streams, and taxpayer groups might be more effective than general approaches that mostly match internal tax administration data. The use of external data sources seems to have a positive effect on detection rates. There is no information publicly available on the trade-offs between using a hotline and expanding the investment in data matching. There is also little information on the cost effectiveness of detection methods in general.

Sanctions

5.1 This chapter covers the extent to which tax authorities impose sanctions. These sanctions are imposed to improve the future compliance behaviour of a person/business and provide a deterrent to others.

The amount of financial penalties varies widely

5.2 Financial penalties can consist of an administrative penalty and/ or a tax surcharge. Administrative penalties are usually for a fixed amount and can vary considerably. Tax surcharges are another way of imposing a fine on taxpayers. They are usually a percentage of the amount of tax owed. Financial penalties are more likely to be used by tax authorities than prosecution. **Figure 21** sets out the penalties that tax authorities can impose.

21 Financial penalties are widely used

	Australia	Belgium (2002)	Canada (2006-2007)	USA (2006)	Sweden (2005)	United Kingdom (2006-07)
Key types of administrative sanction	Interest on the amount owed	Administrative fine up to €2,250	Penalties can range from 5 per cent to 50 per cent	Depends on specific offence	Delay surcharges up to £365	Interest on the amount owed
	Penalties up to 110%	Tax surcharge up to 200 per cent			Tax surcharge up to 40 per cent	Penalty up to 100 per cent of the tax owed
Number	Not available	2,503	3,243 files (income tax and GST) in which penalties were applied in 2006-07	36,204,000	Delay charges: 236,000 Tax surcharges: 205,000	Around one half of cases detected had a penalty or surcharge
Amounts Collected	Penalties and interest: \$AU 1,333 million (around £580 million)	€4.2 million (around £3 million)	C\$36 million (around £18 million) of tax assessed (exclusively on underground activities)	Civil penalties \$27 billion (around £13.5 billion)	Delay charges £20 million Tax surcharges £80 million	Penalties/surcharges around £5 million. Interest around £4.3 million

Source: RAND Europe compilation on the basis of annual reports published and information provided by tax authorities

5.3 The amount of money tax authorities collect from penalties is small compared to the overall amount of taxes collected. For example:

- In **Belgium**, in 2002 a total of €4.22 million was collected from 2,503 administrative penalties.¹³¹
- In **Sweden**, delay charges were imposed on 66,000 income tax returns in 2005 and 170,000 were imposed on monthly VAT, payroll and PAYE returns. The total value of the delay charges amounted to £20 million and 205,000 tax surcharges were made, totalling £80 million.
- In the **United States**, civil penalties are also a widely used. In the fiscal year 2006 a total of 36 million administrative penalties were assessed, worth \$27 billion.

5.4 Tax authorities do not always impose penalties to the fullest extent and take account of mitigation factors to reduce the amount of the penalty. For example a review of penalties by the Swedish Tax Agency in 2002 found that in many cases the tax surcharges are reduced or not imposed at all.¹³²

5.5 The Government Accountability Office (GAO) in the US found that fixed amount penalties are not updated for inflation over long time periods and as a result could lose their deterrent effect. The GAO estimated that for 2005 an extra \$60.3 million could have been collected if penalties had been adjusted.¹³³ Similar concerns have been voiced in Belgium, where penalty rates have only been adjusted once since 1994.¹³⁴

5.6 The Canadian Revenue Agency recently conducted a study to examine whether imposing a gross negligence penalty for underreporting income affects taxpayers future compliance behaviour. It found no strong correlation and after a three year period taxpayers tended to regress but not to the extent of their previous compliance behaviour.¹³⁵

The number of prosecutions is relatively low

5.7 Criminal prosecution tends to be used for more serious cases such as repeat offenders mainly because of the costs involved in bringing prosecutions. The wider deterrent effect on other taxpayers is also an important consideration in deciding whether to prosecute. The number of cases prosecuted by tax authorities is relatively small (**Figure 22**).

5.8 Those prosecuted may face a prison sentence and a fine. In Canada courts impose a penalty of up to C\$ 25,000 for failing to file a tax return. The courts may also impose a fine of 50 per cent to 200 per cent of the tax evaded and a jail term of up to two years. When followed by indictment, the court may fine 100 per cent to 200 per cent of the tax evaded and sentence an individual to a jail term of up to five years.¹³⁶ In Belgium, those prosecuted of intentional violations of the VAT code, can face prison sentences ranging from eight days to two years in prison and fines from €250 to €125,000.¹³⁷ To increase the deterrent effect, details of prison sentences are included in the Swedish Tax Agency's annual report as well as in press releases.¹³⁸

22 The number of criminal prosecutions for tax offences is small in most countries

	Belgium (2002)	USA (2006)	Sweden	Canada	Australia (2005-06)	United Kingdom (2006-07)
Number of criminal prosecutions	4,385	2,019	609	245	178	1,392 ¹

Source: RAND Europe compilation of available data

NOTE

- 1 Of these 69 were for hidden economy offences.

There is little information available on the cost effectiveness of sanctions

5.9 Little data are available on the cost effectiveness of sanctions. Most tax authorities publish only output data, such as the number of convictions or the tax collected, without linking this information to the resources involved.

5.10 There is little information available on the extent of the deterrent effect created by the use of different sanctions. The Swedish Tax Agency monitors attitudes to the tax system on a regular basis, including in surveys questions on tax control and enforcement. The results suggest that the general public's perceived risk of detection has slightly decreased but the perception of the consequences of detection has remained fairly stable since 2001. Such a tool may be valuable with evaluating future changes in sanctions policy and assessing whether the changes increase or reduce the deterrent effect. The academic community is divided on whether penalties improve compliance.¹³⁹

Conclusions

5.11 Tax authorities are most likely to impose a financial penalty on those they detect in the hidden economy. The amount of the penalty imposed varies widely between tax authorities. Tax authorities only prosecute individuals/ businesses in a relatively small number of cases because of the costs involved. They tend to prosecute the more serious cases and where a wider deterrent message is needed. From the available information it is not possible to determine the cost effectiveness of sanctions including the extent of their deterrent effect.

Methodology

In the **first stage** of the proposed project the NAO study team and the RAND Europe project team agreed on the template of questions to be used for the country reviews and on the selection of the five countries to be reviewed. We did this by conducting a joint kick-off meeting.

The template closely followed the categories set out in the Invitation to Tender (ITT) and included:

- General description of the revenue system and organisation of each country;
- Definition and measurement of the hidden economy;
- Strategy of tax authority;
- Key initiatives used by the tax authority; and
- Results of initiatives.

In the kick-off meeting, we also discussed the selection of the case studies with the NAO study team. We selected Australia, Canada, Belgium, Sweden, the United States. The selection criteria were:

- Similar demographics to UK;
- Similar size of economy (GDP per capita);
- Similarities in the set-up of the tax authority;
- The availability of data and information/research on the hidden economy and initiatives of tax authorities in a specific country. Given the short timeframe and budget constraints of this

research, we felt that the study should focus on cases where data and information is more readily available from publications and web resources;

- Variance of hidden economy indicators in specific countries (some countries with a larger hidden economy, some with similar levels as the UK, and others with a lower level); and
- Evidence of interesting or innovative practices.

We undertook an initial scan before the kick-off meeting to inform the selection of case studies. The RAND Europe study team also identified government and academic contacts in these countries, which could help bridge particular information and data gaps.

In the **second stage** the RAND Europe team, were assigned countries according to their nationality, relevant experience and language skills. The team undertook an **initial search** to collate easily identifiable information through desk-based research, to identify potential sources and establish the contacts for less easily available information. Sources included:

- Government, tax agency and policy publications in respective countries;
- Documents from international organisations such as the OECD and IMF;
- Documents from international Supreme Audit Institutions;
- Documents from supra-national organisations such as the European Union;

- Publications from institutes involved in tax authority reform, such as the Taxation Institute of Australia and the Institute of Fiscal Studies in the United Kingdom; and
- Other academic databases accessible through the RAND library such as JSTOR and SSSR.

At this stage, we also identified potential contacts in the countries to be studied to bridge any data and information gaps. The assistance of the NAO study team and its international affairs department in setting up contacts was helpful given potential sensitivities in asking government sources in other countries for help in a study for the UK NAO. For this second stage, each analyst was allocated four days per country.

Stage three consisted of **mid-term meeting**.

These meetings provided the RAND Europe team and the NAO study team with the opportunity to share findings, identify difficult areas, draw out emerging themes for overarching analysis, compare understanding of the questions in the template and identify areas for further investigation.

Stage four consisted of the **refinement of the case studies**.

On the basis of the common understanding and agreement achieved through the workshop, the RAND Europe team completed the case studies in a further three days per country. Team members refined their investigation through further document analysis and through personal contact with informants in the countries selected. The interaction with the contacts ranged from phone calls to sending e-mail requests for verification or additional information.

Stage five was the synthesis and **analysis and presentation of the final report**. The RAND Europe project team in this phase synthesised the research and prepared the final deliverable consisting of a thematic comparative overview of the evidence found in countries.

Hypotheses tested by the Australian Taxation Office in 2007-08

Non-reporting of income by closely held entities

Closely held family entities may be a characteristic of a cash economy population, because there is often no separation of ownership and stewardship. As these businesses are privately held with direct control of the business exercised by the owner, the external checks and accountability faced by larger public entities does not exist.

Participants in a supply chain

Where one part of the supply chain participates in the cash economy then there may be an increased likelihood that other parts of the supply chain also participate.

Participants in under and oversupply conditions

Changes in the economy that result in demand exceeding supply (in times of an economic boom or natural disaster) or supply exceeding demand (in times of economic downturn) influence levels of cash economy participation.

Low documentation loans

Recourse to low documentation lending is an indicator of cash economy participation and the non-reporting of income.

Impact of virtual worlds on omitting cash income

There is the potential for non-reporting of cash transactions to occur in the context of internet gaming involving virtual worlds and virtual cash (online commerce).

Taxpayers reporting unrealistic income

Taxpayers reporting unrealistically low business income are potential cash economy participants.

Employer obligation reporting discrepancies

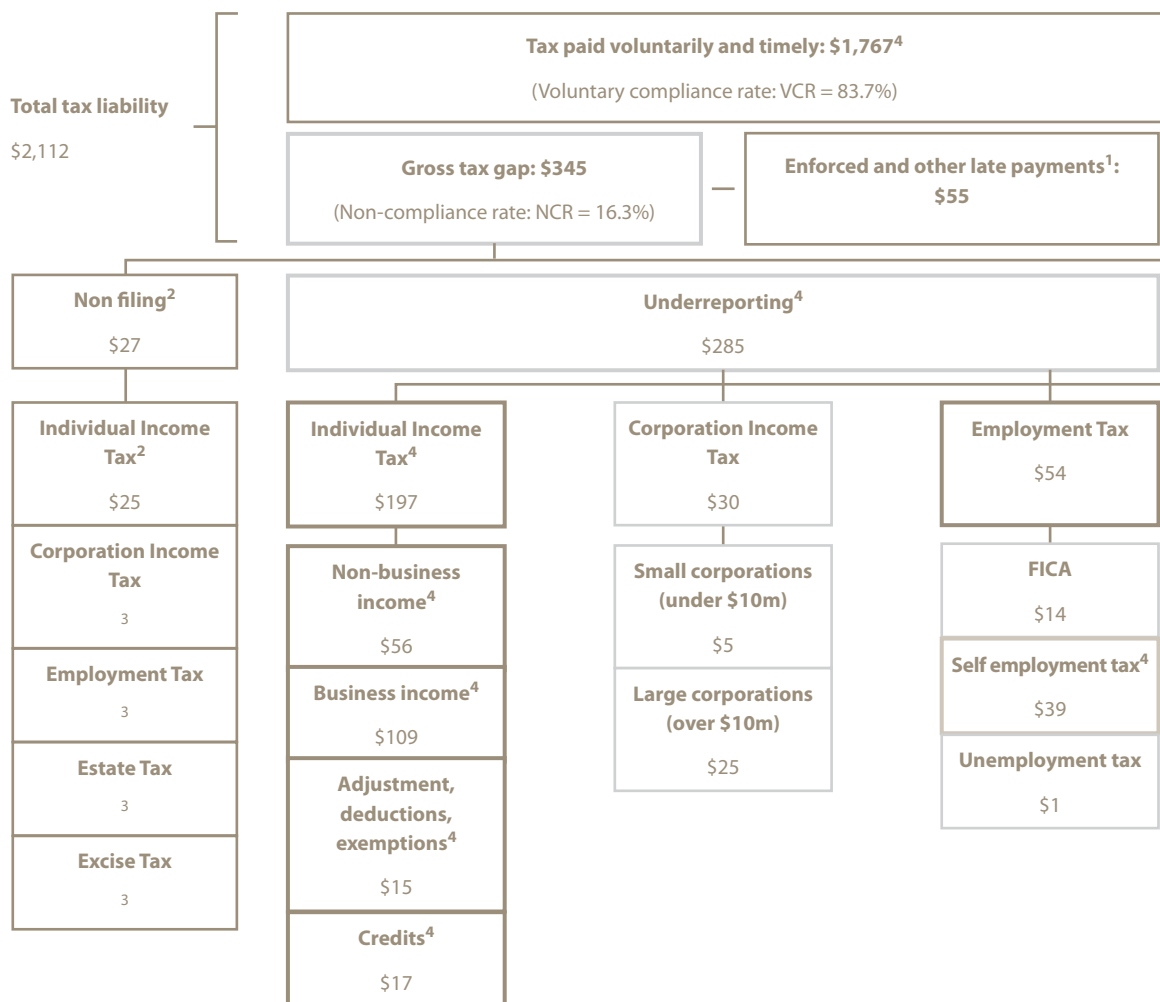
Indicators of employer obligation non compliance are also indicators of cash economy participation.

Superannuation contributions

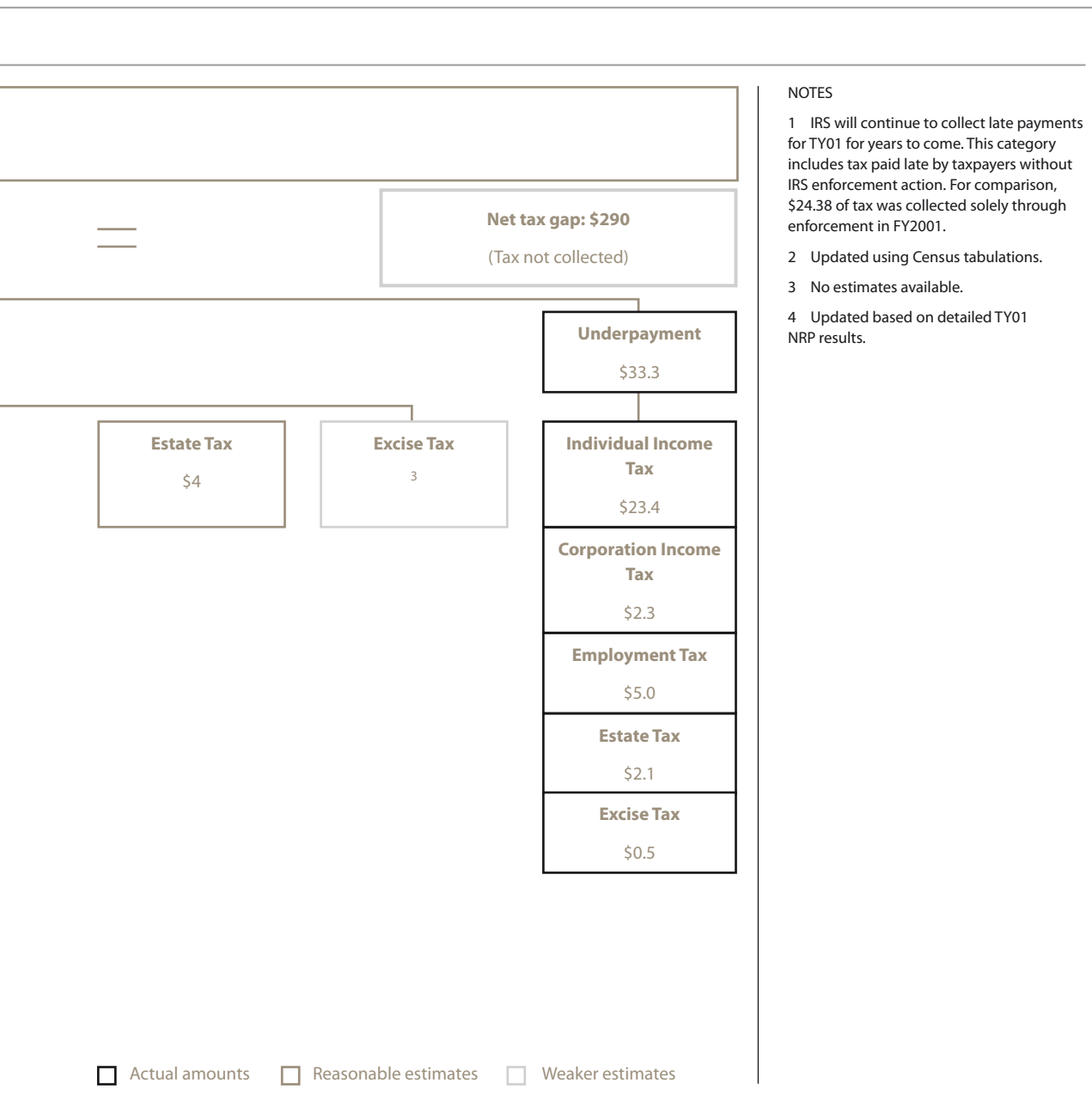
Where the source of significant superannuation contributions cannot be linked to an identifiable source, it is a potential indicator of cash economy participation.

United States Internal Revenue Service's estimates of the tax gap

23 Tax gap map for tax year 2001, in \$ billion



Source: Inland Revenue Service, February 2007



NOTES

- 1 IRS will continue to collect late payments for TY01 for years to come. This category includes tax paid late by taxpayers without IRS enforcement action. For comparison, \$24.38 of tax was collected solely through enforcement in FY2001.
- 2 Updated using Census tabulations.
- 3 No estimates available.
- 4 Updated based on detailed TY01 NRP results.

24 Tax year 2001 gross tax gap by type of tax and type of non-compliance (in \$ billion)

Type of tax	Type of non-compliance			Total	
	Non-filing gap \$ billion	Underreporting gap \$ billion	Underpayment gap ¹ \$ billion	Amount \$ billion	Percent
Individual Income Tax	25	197	23	245	71.2
Corporation Income Tax	- ²	30	2	32	9.3
Employment Tax	- ²	54	5	59	17.0
Estate and Gift Tax	2	4	2	8	2.4
Excise Tax	- ²	- ²	1	1	0.1
Total	27	285	33	345	
Percent distribution	7.8	82.5	9.7	100.0	100.0

Source: Inland Revenue Service February 2007

NOTES

- 1 Since the underpayment gap figures are generally actual amounts rather than estimates, they are presented here to the closest \$0.1 billion.
- 2 No estimates are available for these components.
- 3 Amounts may not add to totals due to rounding. See Figure 23 regarding the reliability of estimates.

Endnotes

- 1** RAND Europe is an independent not-for-profit policy research organisation that aims to serve the public interest by improving policy making and informing public debate. Its clients are European governments, institutions and firms with a need for rigorous, impartial, multidisciplinary analysis.
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- 4** The Australian Bureau of Statistics has produced some estimates on the size of the hidden economy in Australia in 2001.
- 5** See for instance, Pacolet J., Coudron V. and Van De Putte I. (2004), *Zonder Pardon: Spaarfiscaliteit, Vermogensbelasting, Fiscale Amnestie*, HIVA, Antwerp.
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