

## Underground Economy and Tax Administration

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### Kayıt Dışı Ekonomi ve Vergi İdaresi

#### Abstract

Around the world economies, underground economy is a fiscal problem peculiar to the developing countries. But almost all countries, independent of whether developed, developing or transition, face a remarkably large size of the underground economy. Underground economy has two main disadvantages: Not only it cut downs the tax revenues but also it causes the tax equity to worse off and threatens the legitimacy of the tax system. So, it emerges for government interventions like tax policy, direct regulations or institutional arrangements. In this paper, we expand the analysis of underground economy one step further to put forward a remedy for the underground economy: Some efforts must be made to increase tax compliance such as, establishing the simplicity of the tax system, encouraging the compliant motives of the taxpayers, powering different behaviour patterns with respect to different income levels and stipulating efficient administration of the reforms.

**Key Words** : Underground Economy, Tax Administration, Tax Compliance.

**JEL Classification Codes** : H20, H83, O17.

#### Özet

Küresel ölçekte ele alındığında yeraltı ekonomisi, gelişmekte olan ülkelere özgü mali bir problem olarak görülmektedir. Ancak, ister geçiş ister gelişmiş ya da gelişmekte olan ekonomileri olsun, neredeyse tüm ülkeler kayda değer bir yeraltı ekonomisi büyüklüğü ile karşı karşıyadır. Yeraltı ekonomisi sadece vergi hasılatının azalmasına değil aynı zamanda vergi adaletinin bozulmasına ve vergi sisteminin meşruluğunun tehdit edilmesine neden olmak suretiyle iki temel dezavantajı beraberinde getirerek vergi politikası, doğrudan müdahaleler ve kurumsal düzenlemeler gibi kamusal araçları gerektirir. Bu çalışmada yeraltı ekonomisine yönelik analiz bir adım öteye götürülmüş, çözüm olarak vergi mükelleflerinin gönüllü uyumları arttıracak, vergi sisteminin sadeliğinin sağlanması, farklı gelir düzeylerine göre farklı davranış kalıplarının geliştirilmesi ve reformların etkin yönetiminin taahhüt edilmesini içeren politikaların hedeflenmesi gerektiği vurgulanmıştır.

**Anahtar Sözcükler** : Kayıt Dışı Ekonomi, Vergi İdaresi, Gönüllü Uyum.

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## 1. Introduction

A recent study by Schneider (2004), calculated the size and development of the underground economies of 145 countries by employing currency demand and DYMIMIC (dynamic multiple- indicators multiple-causes) approaches. The findings suggest that unweighted averages of the absolute values of the shadow economy (in % of GDP) for the years 2002-2003 is %43.2 for the African countries, %30.8 for the Asian countries, %43.6 for the South American countries, %40.1 for the East and Central European and Former Soviet Union countries, %16.3 for the highly developed 21 OECD countries, %33.4 for the South West Pacific Islands, %21.8 for the Communist countries.

These results bring a very important insight: Almost all countries, independent of whether developed, developing or transition, face a remarkably large size of the underground economy. Considering tax gap and social security tax revenue loss resulted from illegal working and especially unjustified gains derived from illegal activities, one can say that underground economy is unfavourable (Özsoylu, 1996: 54).

The linkage between tax administration and underground economies is supported by the findings of several studies like Tanzi and Tsibouris (2000), Schneider and Enste (2000). We can say that the large size of the underground economy emerges for government interventions like tax policy, direct regulations or institutional arrangements.

In this paper, as we offer tax administration proposal for the underground economy, we will extensively dwell on tax compliance. It is well known fact that the difference between the tax that taxpayers should pay and what they actually pay on a timely basis is tax gap. But we must state the fact that eliminating tax gap and increasing tax compliance to deal with underground economy requires comprehensive, coordinated plans and long-term gradual policies.

## 2. Underground Economy

In the literature there is no consensus for defining underground economy. Moreover the distinction between the terms “underground economy”, “informal economy” and “shadow economy” is not clear<sup>1</sup>.

As stated in figure 1, underground economic activities involve legal activities, illegal activities, both monetary and non-monetary transactions.

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<sup>1</sup> For an extensive research to explain terminological differences see: Gyls (2005).

**Table: 1**  
**Types of Underground Economic Activities**

Type of Activities	Monetary Transactions	Non-Monetary Transactions		
<b>Illegal Activities</b>	Trade with stolen goods, drug dealing and manufacturing, prostitution, gambling, smuggling, fraud etc.	Barter of drugs, stolen goods, smuggling etc. Produce or growing drugs for own use. Theft for own use.		
	Tax Evasion	Tax Avoidance	Tax Evasion	Tax Avoidance
<b>Legal Activities</b>	Unreported income from selfemployment; Wages, salaries and assets from unreported work related to legal services and goods	Employee discounts, fringe benefits	Barter of legal services and goods	All do-it-yourself work and neighbor help

Source: Schneider (2004: 5)

Smith (1994) defines underground economy as “market based production of goods and services, whether legal or illegal that escapes from the detection in the official estimates of GDP”.

Brooks (2001), defines a connection between underground economy and tax administration and explains the growth of the underground economy with the factors like “increase burden of taxes and government regulation, increase in means-tested transfers, stagnating real incomes and increases in unemployment, increase in self-employment, shift to services, changing demographics, forces of globalization and decline in tax morality”.

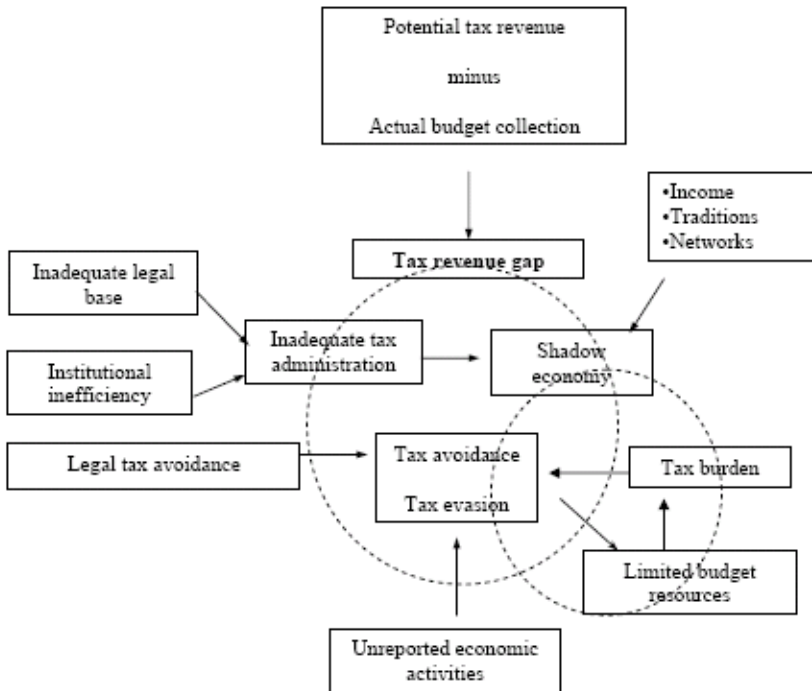
Constrained by the object of this study, we will follow Brooks (2001) to define underground economy: “Value of the economic activity that would be taxable was it reported to the tax authorities”.

From a tax administration framework, it is appropriate to define the underground economy in terms of *tax gap*. The tax gap measures the extent to which taxpayers do not file their tax returns and pay the correct tax 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 the amount due by the payment due date. (IRS, 2005: 1).

From figure 1, it can be inferred that many factors cause the underground economy. Circles on the figure connect blocks, the activities on which are interrelated of independent. At the center of the problem, tax gap plays an important role: The difference between potential tax revenue and realized tax revenue. Tax evasion, tax arrears, misunderstanding of the tax laws causes non-compliance of the of the taxpayers therefore increasing tax gap. We can also see that, the magnitude of the tax gap depends on

inadequate tax administration and underground activities like tax avoidance and evasion. It is also kept in mind that economical, political, historical, and cultural environment plays a big role here. From this context, comprehensive and understandable legislative basis, strong legal foundations, institutional arrangements are necessary to fill the tax gap. Here, tax administration plays a big role.

**Figure: 1**  
**Tax Administration and Underground Economy**



Source: *Trasberg (2004: 5)*

### 3. Tax Administration: A Remedy for the Underground Economy

Recent experiences in the world economy indicate that preventing underground economy cannot be established without sweeping changes or reforms in the tax administration, modernizing and increasing the efficiency of the tax administration.

Considering underground economy, a convenient tax administration reform requires an extensive evaluation of the magnitude of the tax gap and noncompliance. In the economies where the tax gap is small, the nature of the reforms need preserving high compliance motivation of the taxpayers while the economies where the tax gap is large some radical reforms become necessary.

The promotion of voluntary compliance should be primary object of revenue authorities (OECD, 2001: 3). In a framework of tax administration, education and to some extent enforcement to increase tax compliance become convenient policy tools.

Using tax administration to deal with underground economy, the objectives below must be the starting point (CCRA, 2002: 9):

- Encouraging voluntary compliance through activities such as community visits to business establishments and public education;
- Working co-operatively with the provinces, other government departments and key interest groups to encourage and find ways to exchange information;
- Strengthening programs to identify non-filers and non-registrants through the matching of databases to identify areas of potential non-compliance and increasing enforcement for verification purposes;
- Enhancing effectiveness by refining audit techniques or developing legislative proposals to address non-compliance;
- Focusing on high non-compliance sectors through improved workload development and identification of high-risk sectors;
- Publicizing tax evasion convictions to serve as a deterrent to non-compliance;
- Conducting compliance research to support and analyze the effectiveness of compliance efforts.

The basic problems of the tax administration must be also stated. These problems are the inadequacy of the material and financial resources, poor quality and staff on education, inefficient procedures, and the abortion for implementation of measures reducing tax compliance, inefficient taxpayer services, and the high turnover of the technical and administrative staff.

Briefly, from a tax administration framework, basic approaches to deal with the underground economy require establishing the simplicity of the tax system, encouraging the compliant motives of the taxpayers, powering different behaviour patterns with respect to different income levels and stipulating efficient administration of the reforms.

The required strategies forming with respect to the magnitude of the underground economy include:

- Reconstruction of the structure of the tax departments in order to establish better taxpayer services and low operational costs;
- Forming or redesigning distinctive processes to gain from the advantages of the new technologies;
- Encouraging the activities enable to control off-record small or medium sized taxpayers;
- Expanding the usage area of the technology;
- Investing in physical and human capital resources of the tax administration;
- Successing the regular implementation of the tax laws;
- Forming national tax services for tax collecting activities of the central government;
- Reorganizing tax offices with respect to basic functions of the tax administration (taxpayer data, accounting, data processing, increase the strength of the tax collecting, auditing taxpayers);
- Increasing the responsibility and self assessment;
- Increasing taxpayer information programs;
- Encouraging forming out of government tax agencies, the institutions helping taxpayers to accomplish the tax responsibilities;
- Ensuring computer support systems for tax administration activities;
- Step by step test of the reform measures by employing tax administration pilot projects.

Considering modernization of the tax administration, data processing deserves a special attention. Tax administration, in order to pursue its function efficiently, must follow data processing activities in principal economic sectors like banking, commerce and communication. Tax collecting depends on banking system, convenient income calculation and taxpayer control system, and the accommodation of the tax administration with the daily computer records of the banks. Reformers must be define the levels and scale of this process such as this process must support modern tax administration's activities and also an evaluation for the resource, personnel and computerization must be done.

Around the world, tax evasion is about the volume between %20 and %40 (Silvani and Baer: 1997). This value corresponds to taxpayers who don't fill the declaration. The high volume can be explained by the following factors:

- The taxpayers' records are not updated.
- The faults about the identity of the taxpayers.
- The tax administration cannot follow systematically the taxpayers who don't declare.

The first two problems above reflect deficiencies during the declaration and recording process and can be solved by updating the records and pre-giving identity numbers to taxpayers. To solve the third problem, the tax administration should pursue some strategies like aligning taxpayers with respect to their scales and business activities.

Tax audits deserve special attention in the framework of tax administration. The taxpayers' perceptions about probability to audit cause them to increase their compliance rate. So, the tax administration's line of vision to tax audit will highly determine the tax administration's ability to improve compliance of the taxpayers. Many countries couldn't accomplish the mission of tax audit to control tax revenues. As a result of modernization, in the short run, comparing to recent periods, remarkable increases in tax collections has been occurred. But, no permanent increases have been gone on.

The sanction and punish system can be thought as an important tax administration tool to increase tax compliance. The efficiency of the sanction and punish system strengths the taxpayers' compliance motives. The starting point here is forming a legal structure enables to specify taxpayers' furtive rapidly and to prevent the motive of taxpayers' tax payment postpones.

The most important elements of the tax compliance efforts are good and efficient taxpayer services and well designed human relationships campaigns. Tax administration should provide consistent, fair, kind and fast services to taxpayers. Efficient taxpayer services involve obviously powering of the forms and required documents and forming centers to contact with the taxpayers.

In order to achieve permanent tax administration reforms, a strong management team is required. Moreover, to implement reforms, tax administration should work as an organization. The basic problem here is the way that how the administration organizes. Reformers establish procedural changes to modernizing tax administration only by organizing. Before making substantial changes in organization structure some important issues must be examined (Varquez and Timofeev, 2005):

- The degree of autonomy,
- The responsibilities related to tax collection,
- The organization structure.



The organizational and procedural changes required by tax administration to increase tax compliance, can be done by the autonomy of the tax administration: If reformers have the autonomy (independently decide the changes for the organization structure, personnel, wages, and procedures, renting or buying), the tax administration becomes more successful.

Considering organizational structure of the tax administration, the responsibility between central, regional and local tax offices must be clearly distinguished. Generally, the efficiency of the tax administration becomes worse off if the coordination between independent tax administrations can't occur. Coordination and sharing the knowledge and information (both horizontal and vertical) increase the efficiency of the tax administration and facilitate tax compliance. Sharing the information, in this context, involves the operations below:

- Coordinating both national and regional tax records to develop business and facilitate administrative knowledge and information sharing.
- Using only one taxpayer identity number.
- Sharing tax audit.
- The co-implementation of taxpayer services.
- The coordination of central and regional tax collections.

#### **4. Conclusion**

In this study, it is proposed that the tax administration reforms increase tax compliance and therefore reduce the magnitude of the underground economy. We define underground economy from a tax administration framework, in terms of tax gap. Eliminating the tax gap, the difference between the tax that taxpayers should pay and what they actually pay on a timely basis and increasing tax compliance to deal with underground economy requires comprehensive, coordinated plans and long-term gradual policies.

Inadequacy of the material and financial resources, poor quality and staff on education, inefficient procedures, the abortion for implementation of measures reducing tax compliance, inefficient taxpayer services, the high turnover of the technical and administrative staff are the problems of the tax administration. Combining the efforts of dealing with the underground economy require establishing the simplicity of the tax system, encouraging the compliant motives of the taxpayers, powering different behaviour patterns with respect to different income levels and stipulating efficient administration of the reforms.

As a result, from a tax administration-underground economy framework, the required associated reforms are divided to six basic classes.

- Tax administration, in order to pursue its function efficiently, must follow data processing activities in principal economic sectors like banking, commerce and communication.
- Strategies like aligning taxpayers with respect to their scales and business activities to reduce tax evasion.
- Tax auditing to the taxpayers' perceptions about probability to audit, causing them to increase their compliance rate.
- The sanction and punish system and forming a legal structure enable to specify taxpayers' furtive rapidly and to prevent the motive of taxpayers' tax payment postpones.
- Combining Taxpayer services and well designed human relationships campaigns.
- Forming a strong management team, coordination and sharing the knowledge and information.

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