TECHNICAL NOTES AND MANUALS

Revenue Administration: Managing the Shadow Economy

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Fiscal Affairs Department

INTERNATIONAL MONETARY FUND

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Authorized for distribution by Carlo Cottarelli

June 2010

JEL Classification Numbers:	PLEASE PROVIDE
Keywords:	PLEASE PROVIDE, please provide
Authors' E-Mail Addresses:	please provide

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Revenue Administration: Managing the Shadow Economy

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- This technical note addresses the following main questions:
- What is the shadow economy?
- What is the size of the shadow economy?
- What action should revenue agencies take to manage the shadow economy?
- What are the most recent initiatives to manage the shadow economy?

I. What is the shadow economy?[1]

In most countries, tax revenue foregone as a result of the "shadow economy" represents a very significant component of the total tax gap (i.e., the difference between actual and potential tax revenues). Definitions of the "shadow economy" vary widely, but it may generally be taken to describe a situation where businesses operating outside the tax system and registered businesses conceal transactions to avoid paying taxes or social security charges, or to avoid the costs associated with legislation on safe working conditions or protection of consumers' rights. Sometimes the transactions are only partly concealed and maybe reported to the revenue agency or to the government statistical office at lower than true values so as to reduce rather than entirely eliminate taxes. In other cases, there will be no record of the transaction at all, and in such cases the payment may be made in cash which helps hide it from taxation.

II. What is the size of the shadow economy?

While the shadow economy is acknowledged by all G20 countries as a major and enduring revenue risk, by its very nature the size of the shadow economy is difficult to measure. Sweden, however, estimates that at least half of its total tax gap is attributable to the shadow

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[1]Also variously referred to as the black, grey, underground, cash, non-observed, or informal economy.

economy, with around two-thirds of the revenue loss centered in the micro business taxpayer segment.[2] Given the endemic nature of this risk, revenue agencies should continue to work with statistical authorities to refine measurement methodologies over time. This will both enhance the ability of governments to make accurate revenue forecasts and help ensure that the most appropriate policy and administrative responses are developed to manage the revenue risks posed by the shadow economy. The OECD has published a guide to assist government statistical offices to improve their measurement of the extent of the shadow economy and the broader non-observed economy.[3]

Table 1: Estimated size of the shadow economy for G20 countries as a percentage of official GDP

Country	2002	2003	2004	2005	2006	2007	Country average
USA	8.6	8.7	8.8	8.9	8.9	9.0	8.8
Japan	11.1	11.2	11.5	11.7	12.0	12.1	11.4
UK	12.8	12.9	13.0	13.0	13.1	13.2	12.9
China	13.3	13.4	13.6	13.7	14.0	14.3	13.5
Australia	14.4	14.7	14.8	14.8	14.9	15.0	14.6
France	15.3	15,4	15.5	15.6	15.6	15.7	15.4
Germany	16.0	15.8	15.9	16.0	16.4	16.7	16.0
Canada	16.2	16.3	16.4	16.5	16.6	16.6	16.3
Saudi Arabia	17.5	18.5	19.1	19.4	19.5	20.0	18.7
Indonesia	19.5	19.7	20.0	20.2	20.5	20.9	19.9
India	23.6	24.0	24.2	24.5	25.0	25.6	24.0
Argentina	23.3	24.4	25.3	26.1	27.0	27.8	25.5
Italy	27.4	27.2	27.2	27.1	27.3	27.4	27.2
Korea	28.1	28.2	28.5	28.7	29.0	29.4	28.2
South Africa	28.8	29.0	29.7	30.4	30.0	31.7	29.5
Mexico	29.9	29.7	30.1	30.3	31.0	31.3	30.2
Turkey	31.8	32.4	33.2	34.2	34.7	35.2	33.0
Brazil	39.7	40.0	40.9	41.1	41.8	43.0	40.5
Russia	47.8	48.8	49.5	50.1	50.8	52.0	48.6

Source: Schneider ibid.

Current methodologies for measuring the size of the shadow economy are best viewed as an indicator of the order of magnitude of the problem. They have most utility when used as a tool to identify trends over time rather than as an absolute measure. For example, using a 'multiple indicators multiple causes' (MIMIC) modeling approach, Schneider

[2]See: Tax Gap Map for Sweden Report 2008, Swedish National Tax Agency, February 2008.

[3]See Measuring the non-observed economy – A Handbook, OECD 2002

has estimated the size of the shadow economies for a wide range of countries (including developing, emerging, and high income OECD countries) over several years.[4] This analysis shows that the average size of the shadow economy (as a percent of 'official' GDP) in developing countries and transition countries is around double that of high income OECD countries. The study also shows a very significant variation across G20 countries (see table 1), indicating strong potential for revenue gains if poorer performing countries could reduce the size of the shadow economy in line with the top performing countries (USA, Japan and the UK).

III. What action should revenue agencies take to manage the risk of the shadow economy?

The challenge of reducing the shadow economy, and the potential revenue gain from doing so, is clearly much greater in developing and emerging countries. Studies have found that the extent of the shadow economy in any particular country is influenced by a wide range of factors, including: the overall tax and social security contribution burden; the complexity of the tax system; the cost of formalizing a business; the prevailing social welfare environment; the effectiveness of the tax administration; and attitudes to government authority and government spending. Typically, many developing and transition countries have overly complex tax laws and procedures. For example, the World Bank Doing Business 2010 report shows that, on average, the cost of key business processes such as registration and paying taxes is significantly higher in developing and transition countries than in OECD countries (see table 2).

Table 2: Average time required to complete key business processes

	PAYING TAXES		STARTING A BUSINESS	
	Number of payments required per year	Time required to comply (hours per year)	Number of procedures required	Time required to comply (days)
East Asia & Pacific	24.6	227.2	8.1	41.0
Eastern Europe & Central Asia	46.3	336.3	6.7	17.4
Latin America & Caribbean	33.2	385.2	9.5	61.7
Middle East & North Africa	22.9	204.2	7.9	20.7
OECD	12.8	194.1	5.7	13.0
South Asia	31.3	284.5	7.3	28.1
Sub-Saharan Africa	37.7	306.0	9.4	45.6

Source: World Bank Doing Business 2010 Report

[4] Shadow Economies All Over the World: New Estimates for 1999-2007, Schneider, Buehn and Montenegro, 2009.

At the *tax policy* level, these countries should focus on: simplifying tax laws; reducing taxes on micro and small businesses; reducing barriers to entry into the formal economy such as costs, time, and procedures; allowing more flexible hiring and firing of workers (e.g., through temporary contracts); and improving and expanding the coverage of social services and health programs.

At the tax *administration* level, priority should be given to developing integrated compliance management strategies that address the underlying causes of non-compliance and reflect an appropriate balance of assistance, encouragement, and enforcement activities.The shadow economy is largely centred in the micro and small business sectors, and the large number of potential participants means that it is not logistically feasible for revenue agencies to rely on audit as the sole compliance improvement lever. The shadow economy manifests in a range of non-compliant behaviors which are driven by a variety of underlying causes. Revenue agencies should therefore develop mitigation strategies that respond to the most serious of these behaviors through a balanced set of measures aimed at engaging with the community to: (a) reduce community tolerance for the shadow economy; (b) provide targeted assistance to promote voluntary compliance; (c) encourage self regulation; and (d) demonstrate a visible and credible detection and enforcement capability.

A. Reduce community tolerance of the shadow economy

Community attitudes to the shadow economy are an important factor in influencing voluntary compliance. For example, in many developing countries, taxpayers have limited experience of a free market and a tax system based primarily on self assessment. Perceptions of the overall 'fairness' of the tax system in achieving social equity and providing essential public services and infrastructure may be low, leading to widespread disengagement and higher levels of non-compliance. Even in advanced economies, dissatisfaction and disengagement will result where taxpayers perceive that weak tax administration results in unfair competition —*"Why should I do the right thing when I know my competitors are cheating?"*

A comprehensive communication strategy that addresses these issues at a range of levels is required. The communication strategy should:

- ***Raise community understanding of the role played by taxes in achieving social equity objectives and providing essential public services and infrastructure.*** This message is really about the important role of taxation in good government and should therefore be undertaken at the whole of government level rather than by revenue agencies. This will require a sustained medium-term campaign aimed at explaining in simple terms the overall program of taxes and transfer payments, rather than to try to market the benefits of any single tax or transfer mechanism. The key theme of this campaign is that "taxes are the price we pay for a civilized society". Strong discipline around expenditure decisions is also important in securing community support for the overall tax regime.

- ***Promote a voluntary compliance culture.*** Many countries have recognized the importance of the school-based education system in promoting a better understanding of the tax system and the importance of voluntary compliance among the next generations of taxpayers. They have developed broad-based education campaigns in schools ranging from basic "story telling" type activities for very young school children to more structured approaches that embed technical tax topics into secondary and tertiary education curricula. The aim is to promote a culture in which voluntary compliance with tax obligations is widely regarded as a hallmark of good citizenship. These education programs are delivered through the school system with strong sponsorship and logistical support from the revenue agency. By its nature, cultural change is a long-term process and this strategy therefore requires a sustained commitment on the part of revenue agencies.
- ***Raise awareness of the dangers of dealing with shadow economy operators.*** This element of the communication strategy aims at highlighting the risk of poor quality of workmanship, lack of effective warranty arrangements, and health and safety issues associated with dealing with business operators and tradespersons who fail to meet their basic legal obligations. This campaign is often most effective when delivered in partnership with reputable business, trade and professional associations who have a shared interest in ensuring that their legitimate members can compete on a level playing field.
- ***Educate small business operators about the non-tax risks of understating income*** which may, for example, result in reduced insurance pay-outs (i.e., claims will be limited to the level of disclosed income), compromise their ability to sell the business, or compromise the collection of debts.
- ***Engage the community in identifying and rejecting shadow economy operators.*** Studies show that the community is less tolerant of shadow economy operators who contribute little or nothing in the way of taxes, but at the same time claim government benefits, or live an extravagant lifestyle; do a sub-standard job; or negatively impact the welfare of others (e.g., legitimate business competitors). This campaign should encourage taxpayers to avoid such operators, and inform them as to how they can report such activities to the revenue agency with a guarantee of confidentiality.
- ***Inform the community of the tax agency's increasing capability to detect and deal with shadow economy activities.*** This element of the communication strategy has two main objectives. First, it is aimed at raising community confidence in the effectiveness of the revenue agency's administration of the tax system by demonstrating that tax evaders are identified and brought to account. Secondly,

it represents an important deterrent to others who may be contemplating engaging in non-compliance. The campaign should widely publicize the anti-avoidance actions taken by the revenue agency and, importantly, report the results of such actions including successful prosecutions that flow from these activities. Where privacy laws restrict the publication of detailed taxpayer information, sanitized case studies are an effective means of communicating results.

B. Provide targeted assistance

Non-compliance often arises from a lack of understanding and low skill levels rather than any deliberate intention not to comply. This is particularly the case with small business operators who cannot afford professional advice. The revenue agency should therefore provide a range of assistance measures targeted to small businesses to promote voluntary compliance. It should not be assumed that small taxpayers will necessarily contact the revenue agency to avail themselves of these services as they are usually "time poor" due to the demands of running a small business, and are often fearful of authority. The assistance measures must accordingly comprise a balanced program of reactive services and outreach programs. Typical assistance activities include:

- High quality taxpayer enquiry services (telephone, email, letters, one-stop-shop service centers etc);
- Free seminars conducted in conjunction with other key government agencies to help small businesses understand their obligations and entitlements;
- Outbound telephone calls to check if the small business operator is experiencing any problems and to offer help and advice;
- Optional free advisory visits at the taxpayer's premises to resolve any problems that may have emerged;
- Targeted advisory visits (non-optional) to the premises of small businesses which are considered high risk and have not requested an advisory visit;
- Simple information products that explain key obligations (especially record keeping requirements) and inform the taxpayer of how they can seek help from the tax office;
- Provision of on-line self help tools, e.g., on-line calculators and decision support systems;
- Proactive reminders of approaching obligations (e.g., letters, emails, text messages and telephone calls) timed to promote on-time compliance with key filing, reporting and payment obligations.

Genuine new businesses should be managed as a discrete group. This approach can lay the foundations for an ongoing and cooperative relationship between the revenue agency and new taxpayers. The aim is to prevent compliance issues from arising, rather than treat them after they emerge. Hallmarks of a well managed approach to encouraging new businesses to be compliant include early identification of first-time business operators; ongoing monitoring of the business in its early stages, and timely and proactive provision of assistance when a potential problem is identified.

Particular attention should be paid to businesses that become an employer for the first time. The transition to employer status introduces many new obligations and complexities for taxpayers. New employers are a key leverage point for embedding good compliance behavior from the start around obligations to withhold income tax from employees' wages and to make social security payments on their behalf. Early contact and targeted assistance programs are essential for this group.

C. Encourage self-regulation

Voluntary compliance should be encouraged through a range of incentives that recognize and reward good compliance behaviour. Incentives may include:

- Remission guidelines for penalties and interest that recognize a good compliance record;
- Less-onerous reporting requirements, and easier access to extended filing periods and payment instalment arrangements for taxpayers with a record of good compliance;
- On-line self-help tools to promote accurate reporting of complex obligations e.g., a decision support system for determining the employment status of workers (i.e., are they employees or contractors?);
- Pre-filling of tax returns with data obtained from third parties – e.g., income from salaries and wages; interest; dividends; social service payments; credits for tax payments withheld from salaries and wages or other payments; and credits or offsets from other transactions.

Self-regulation can also be promoted through effective liaison with key intermediaries and other external stakeholders in the tax system including tax agents and other tax practitioners, banks and other financial institutions, industry, business and professional associations, and business service providers.

Tax agents and other practitioners play a key role in ensuring the integrity of the tax system. Business operators often prefer to get advice from their tax practitioner and in many countries the majority of tax returns are actually prepared and filed by tax agents. A specific strategy adopted in Australia has been to provide tax practitioners with a premium service including dedicated telephone enquiry teams, direct access to expert tax interpretation officers, and tailored seminars aimed at keeping tax agents up to date with changes in the tax laws and their correct interpretation. Tax practitioners can also represent a valuable source of intelligence on the extent of the shadow economy and the underlying drivers of non-compliant behavior. The increased service provided to tax agents needs to be balanced with an effective approach to monitoring compliance by tax agents, as a single rogue tax agent can do serious damage to the revenue.

Banks and other financial institutions are another integral element of the tax system. Effective liaison arrangements should be in place to ensure that banks and other financial institutions understand and meet their obligations to support collection enforcement policies (garnishee notices, withholding arrangements, reporting of financial transactions etc).

Industry, business and professional associations are another useful leverage point for influencing compliance behavior. The formation of cooperative "partnership" arrangements with key industry and business associations has proven very effective in New Zealand, Australia, and many other countries as a conduit for identifying compliance problems (e.g., ambiguous or impractical law, overly complex forms and procedures, unreasonable time limits, onerous reporting requirements etc.) and for the development of workable solutions. Open dialogue, and co-design of approaches with broadly-based representative associations demonstrates transparency in tax administration and promotes ownership of the solutions within the user groups. These associations share the revenue agency's objective of eliminating unscrupulous operators from the system and can therefore represent another valuable source of intelligence on what is happening on the ground within an industry, trade, or profession.

Revenue agencies should work cooperatively with associations to develop 'industry benchmarks' for high risk industries in which "business-to-consumer" transactions represent a major proportion of total business income. These benchmarks reflect the expected relationship between inputs and outputs for a particular business activity based on industry standards. The focus is on those trades where there is a strong correlation between only a few inputs and total business income. Where the benchmarks are developed in partnership with the relevant industry or business association and are jointly endorsed by these associations and the revenue agency they have a very strong credibility base both in the marketplace and in any dispute resolution processes. These benchmarks should be well publicized throughout the target industry (again in partnership with the relevant industry association) as a self-checking mechanism to enable taxpayers to compare their own business performance with industry standards and to assist trade participants to voluntarily comply. This encouragement should be backed-up by a strong message that any taxpayer filing returns that are outside the benchmark limits will be closely examined by the revenue agency. All returns filed by taxpayers in those industries should then be automatically checked against the benchmarks and outliers reported to the risk assessment area for further review.

Business service providers such as manufacturers of accounting software packages and payroll service providers are another important leverage point for improving compliance by small business. Close liaison with these entities can ensure that the software marketed or used by them accurately captures and reports all tax obligations, including new requirements that may be introduced from time to time.

D. Demonstrate a highly visible and credible detection and enforcement capability

To complete the shadow economy strategy, tax agencies need to complement the education, assistance and encouragement activities with a highly visible and credible program to detect and deal with non-compliance. This requires the development of effective intelligence gathering, risk identification and analysis, and case selection capabilities - and a skilled compliance workforce. The enforcement program should aim to:

Identify people operating outside the system. Revenue agencies should develop an effective detection program to identify shadow economy operators who attempt to avoid regulation of their activities by staying completely under the government's radar. This program will typically include:

- conducting regular unannounced on-site visits to locations such as industrial estates, shopping districts, markets and fairs, restaurant precincts, taxi ranks, etc. to check that operators are registered in the system;
- matching the revenue agency's active taxpayer register against third party data bases for trades and professional associations (e.g. architects, lawyers, entertainers, and professional sportsmen) to identify unregistered operators.
- test-checking the validity of tax invoices to ensure the supplier is registered;
- introducing reporting arrangements for business-to-business transactions under which a business must report any purchases from a supplier who does not quote a valid tax identification number. This arrangement can be complemented by a withholding requirement.[5]

Monitor compliance by new registrations. New registrations represent a critical control point for both shadow economy and fraud prevention purposes. In the context of the shadow economy, revenue agencies should implement a range of filtering mechanisms to distinguish between operators that are genuinely first-time businesses (i.e., have no previous experience in operating a business) and new start-ups which are controlled by experienced operators. Revenue agencies should:

- ***Develop a registrations risk engine capable of matching data*** from all new registration applications against: known operators with a poor compliance record; known addresses from which such people have operated; known contact numbers connected to such people; and known high risk advisors. The risk engine should also check for common names, addresses, and contact numbers across multiple

[5] In Australia, the purchaser must also withhold an amount equal to the highest marginal PIT rate and remit this amount to the tax office, or pay an administrative penalty equal to that amount.

registrations as this can be another strong indicator of risk. With the advent of modern data warehouse facilities, the capacity of such risk engines can be greatly enhanced by the introduction of enhanced fuzzy search capabilities that can compensate for variations in spelling of names and addresses to prevent operators from escaping detection by the simple process of deliberately misspelling a name or a street address to circumvent the data matching process.

- ***Physically verify the bona fides of the highest risk cases*** and refuse/cancel registrations where appropriate;
- ***Closely monitor the compliance of suspect registrations*** where it is not possible to refuse/cancel registration;
- ***Telephone all genuine first-time business operators to determine through interview their understanding of their obligations and entitlements*** and advise them of where they can go to get assistance from the tax agency;
- ***Conduct follow-up on-site advisory visits to those first-time businesses which fail to demonstrate a reasonable grasp of their obligations*** through the telephone interview;
- ***Contact by telephone, or make on-site visits to, selected new businesses that fail to meet their filing and/or payment obligations*** to ensure they understand what is required.

Improve record keeping practices. Good record keeping is a critical enabler of voluntary compliance. To complement the range of assistance measures promoting better record keeping by small businesses discussed earlier in this note, revenue agencies should conduct a regular program of record keeping reviews. These are short on-site verification visits to micro and small businesses to ensure that appropriate records are maintained. Where gaps in record keeping are identified the taxpayer should be given guidance and a reasonable time to self-correct the situation. Failure to self-correct should result in an audit and/or the imposition of an administrative penalty. Australia has introduced on-the-spot administrative penalties for failure to keep adequate records. The quantum of the penalty is proportionate to the size of the business and the penalties escalate for each period that the taxpayer fails to self-correct. The penalty is imposed under a stand-alone provision and does not require any separate assessment of liability to tax.

Identify businesses regularly declaring losses or unrealistically low income. Business operators who understate income and contribute little or nothing in the way of taxes gain an unfair advantage over competitors. It is important that revenue agencies take visible and effective action to detect and deal with these cases. Revenue agencies should identify such cases using data matching and data mining capabilities. In industries for which performance benchmarks have been established, taxpayers falling outside the benchmark limits should also be selected for review. It will not be cost effective to audit every case, so revenue agencies should adopt a differentiated response depending on the level of risk assessed. The aim is to "touch" as many taxpayers in the risk pool as possible. Revenue agencies should:

- Select the high risk cases for audit verification;[6]
- Issue customized letters to the medium risk cases explaining how the suspected tax gap has been identified, and direct the taxpayer to review its transactions for the relevant period and either file an amended return or explain the gap. It is important that revenue agencies follow up on any taxpayers that fail to respond in an acceptable fashion;
- Issue warning letters to the low risk cases explaining why they have been contacted and warning that they may be subject to audit if future returns fail to reflect realistic income levels.

Focus on high risk industries and activities. Some industries or trades have entrenched shadow economy practices that require stronger and concerted effort to improve compliance. Revenue agencies should select the highest risk trades and industries for targeted project work. The project should develop an understanding of the nature of the non-compliance and its underlying causes, and then engage the business, trade and professional associations in a joint effort to improve compliance using an appropriate mix of education, assistance, and verification activities. Box 1 outlines a typical example of an industry project approach.

Introduce tailored reporting arrangements for trades or industries in which tax avoidance practices are endemic (e.g., building and construction, IT service providers). This approach has been adopted in a number of countries to manage the risks related to sub-contractors in the construction industry and is supported by the OECD. An example is the Contract Payments Reporting System introduced in Canada in 1999. Under this reporting system all entities, including government departments and agencies, are required to report the total amount paid to each contractor on an annual basis. Canada then matches the information reported against income tax records to identify: contractors who are not registered; contractors who have not filed returns; contractors who have under reported income; and taxpayers who have received government benefit payments to which they were not entitled.

Detect instances of 'conspicuous consumption'. Community confidence in the revenue agency is damaged where individuals enjoy a lavish lifestyle incommensurate with the tax they pay. These people are often very visible in the community because of their lifestyle. Revenue agencies should match data from motor vehicle, boat, aircraft, and property registers against income tax returns filed to identify persons whose declared income does not match the assets owned. A similar risk-based differentiated verification approach to that described above should then be undertaken.

[6] It is critical that auditors are vested with the authority to apply indirect audit methods for reconstructing income and are trained in these methods.

Box 1. Sample shadow economy industry project approach

Where an industry or trade is identified as high risk, the revenue agency should:

Engage with the relevant industry or businesses associations to explain why it is seen as high risk and to ensure that the revenue agency has an accurate understanding of how the industry operates.

Publicize the revenue agency's intention to conduct a verification program of the industry and seek the support of the associations in informing their members.

Identify tax practitioners who have a significant client base in the targeted industry, alert them to the issues and request that they inform their clients of the intention to conduct a verification program.

Conduct a sample audit program to confirm the most serious areas of non-compliance and to quantify the amount of tax at risk across the industry.

Engage with the industry association and the tax practitioners to prepare advice to industry participants on the areas of non-compliance identified through the sample audit program.

Send letters to taxpayers in the industry and/or communicate with taxpayers through the industry association and practitioners advising them of the specific areas of non-compliance and requesting that they review their returns and make any necessary self-corrections. Highlight that voluntary disclosures will attract lenient penalties, and that further audits are planned under which taxpayers who have not self-corrected will be subject to full penalties.

Offer free seminars and advisory visits for taxpayers who are unsure of their obligations (these seminars should ideally be conducted jointly with the industry association).

Ensure that the revenue agency's enquiry staff is aware of the compliance improvement program and has scripted answers for enquiries received from taxpayers about the program, including how to make a voluntary disclosure, attend a seminar or request an advisory visit.

Ensure that the collection enforcement staff is aware of the program and applies the reduced penalties and more flexible payment arrangements to taxpayers who voluntarily self-correct.

Conduct a follow-up audit program of the industry with wider coverage and targeting taxpayers who have failed to self-correct and are assessed as high risk; and prosecute the worst offenders.

Publicize results of audits and prosecutions highlighting how data matching and other new approaches facilitated detection of high risk taxpayers, and using representative case studies to show how informal economy participants were identified and dealt with.

Measure the effectiveness of the project e.g., by tracking the number of voluntary disclosures received and the overall change in tax paid by taxpayers in the target industry, and surveying the industry and practitioners to test for changes in observed compliance behavior.

Detect cases where taxpayers have illegally claimed government benefits by hiding their real income. This is another behavior for which the community has low tolerance. Tax agencies should match data on government benefit payments with other data from third parties and data from tax returns to identify people who have claimed government benefit payments to which they are not entitled. These cases are usually straight forward and can be resolved by cessation of benefits and a letter requiring restitution. Prosecution should be considered in the most serious cases.

IV. Recent Initiatives in Managing Shadow Economy Risks

Even high income OECD countries acknowledge that the shadow economy continues to represent a major revenue threat and that the global economic crisis has almost certainly increased the level of participation in shadow economy activities. Most of these countries have already addressed the major structural and policy issues and have implemented comprehensive compliance improvement strategies targeted specifically at the shadow economy. Further enhancements to existing compliance programs are therefore likely to have only a marginal impact and revenue agencies must therefore continually develop more innovative mitigation strategies to keep shadow economy risks reasonably under control. Some examples of more recent initiatives are illustrated in Box 2.

Efforts might also be made to reduce the incidence of cash transactions in the marketplace. Despite the widespread adoption of new payment methods including card, telephone and on-line transactions, cash remains a very significant means of payment accounting even in advanced economies. A recent central bank study in Australia revealed that cash still accounted for 70 percent of all payments. The study also showed that these payments represented 38 percent of the total value of transactions, indicating that cash remains the primary instrument for low-value purchases.[7] Cash transactions are intrinsically the most difficult for revenue agencies to identify and monitor, and revenue agencies should therefore consider working closely with banks and other financial institutions to develop and promote alternative payment mechanisms and reduce the community's demand for cash.

V. Key Points for Tax Administration Design

The shadow economy represents an endemic tax compliance risk in all countries, and requires long-term targeted compliance risk management strategies which should target the underlying causes of non-compliance and comprise an appropriate mix of education, assistance, encouragement, and enforcement activities. Close cooperation with other government agencies (e.g., Social Security and Immigration), and with non-government intermediaries in the tax system (such as tax agents and banks) should be pursued.

[7] Reserve Bank of Australia Research Discussion Paper: Price Incentives and Consumer Payment Behavior (RDP 2009-04).

Box 2. Recent initiatives in the fight against the shadow economy

- *Increased application of withholding/reporting arrangements* in high risk industries (Canada, Sweden, United Kingdom and United States, and strongly supported by the OECD).
- *Extensive use of third party data matching* to detect instances of 'conspicuous consumption' (Australia).
- *Publication of the names of serious tax evaders*—"naming and shaming" (Korea, United Kingdom)
- *Development of "industry benchmarks"* for high risk industries which reflect the expected relationship between inputs and outputs for a particular business activity based on industry standards (Australia).
- *Increased reporting requirements* for identified tax evaders (United Kingdom).
- *Mandatory use of certified cash registers* in high risk industries which have a high incidence of relatively small value cash sales (e.g., restaurants). Business operators are required to use cash registers that have been certified by the manufacturer that they are connected to a tamper proof control unit (or 'black box') and it is mandatory for the business operator to provide receipts to customers for all purchases (Sweden, Canada, Greece).
- *Mandatory staff registers* for industries with a high incidence of informal employees (e.g., restaurants and hairdressers) - business operators are required to maintain an up to date register showing the name of the business, the employees' names and birthdates and their working hours (Sweden).
- *New 'failure to notify' penalties* for taxpayers who have a history of operating in the shadow economy and fail to notify the revenue agency that they: are liable to register for and pay a particular tax; intend to carry out taxable activities; or that their circumstances in relation to a particular tax have changed (United Kingdom).
- *Re-contact programs for previously audited taxpayers* to check how things are going and to provide assistance if needed (Australia).

The objective cannot be to eliminate the shadow economy entirely but to limit it over time to a level that is tolerable to the government and to the community. Attempting to go further will not represent a cost-effective use of scarce resources and may cause an undesirable increase in unemployment, particularly in developing countries where large numbers of self employed workers live an economically precarious existence. The scale of the response to the risks represented by the shadow economy needs to be proportionate to the magnitude of the problem. Revenue agencies should not lose sight of the fact that other issues may represent equal or greater revenue risks.

While measurement of the shadow economy is inherently difficult, revenue agencies should continue to work with statistical authorities to refine the measures over time. This will both enhance the ability of the government to make accurate revenue forecasts and help ensure that the most appropriate policy and administrative responses are developed to manage the revenue risks posed by the shadow economy.

TNM/10/14

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