Improving tax governance in EU Member States: Criteria for successful policies

Jonas Jensen and Florian Wöhlbier
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By Jonas Jensen and Florian Wöhlbier
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EXECUTIVE SUMMARY

An efficient and effective tax collection is a prerequisite for financing European welfare states. Particularly at the current conjuncture, at which many Member States face high consolidation challenges, efforts should be increased to achieve a low tax compliance gap, i.e. a small difference between the taxes collected and the theoretical tax due. Achieving higher revenues via higher compliance is clearly preferable to doing so via tax raising measures. While aiming at high compliance, tax administrations also have to pay due attention to their tax collection costs and the costs businesses and individuals face when paying taxes.

There are several criteria that characterise efficient tax administrations: They successfully implement an overall compliance strategy and focus audit efforts on the largest revenue risks. They divide taxpayers into co-players and opponents and distinguish between providing a service and education to those who voluntarily comply and control for those who don't. They use third-party information comprehensively, provide pre-filled tax returns to taxpayers and use IT systems as far as possible to both make it easy to pay taxes and at the same time limit the taxpayers' ability to evade. As regards their organisational structure, they often apply a function-based organisational approach. Moreover, it is important that tax systems are simple and stable and that tax arrears are efficiently collected. All these measures underpin tax morale and contribute to achieving a high share of voluntary compliance among taxpayers which allows the tax administration to concentrate its efforts on those taxpayers who try to evade taxes.

To successfully fight the shadow economy it has proven important to increase the tax morale in a country and to benefit from electronic means of payments, with tracking possibilities for audit purposes. On the contrary, the success of deterrence through punishment and the provision of monetary incentives to declare work are rather limited. Criminalising the purchaser of shadow economy activities appears to be fruitful.

A few special topics also need particular attention. Tax amnesties should certainly be avoided despite the temporary and short run increase in revenues. A particular focus should be put on fighting VAT evasion, both at the national level and EU level, with large amount of revenue being at stake. Tax evasion by placing financial wealth in tax havens also remains a major concern in the EU.
1. INTRODUCTION

An efficient and effective tax collection is a prerequisite for financing European welfare states with a relatively high level of public service and a redistributive tax and transfer system. It is of particular importance at the current juncture where Member States face severe consolidation challenges. Tax avoidance and evasion undermine the revenue raising and redistributive objectives of the tax system. Tax evasion also leads to redistribution from those who do respect the rules to those who do not. These issues feature very high on the European policy agenda, as seen in the Commission Communication 'on concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries (1) and the Annual Growth Survey 2012. (2)

A significant number of Member States face the challenge of improving the efficiency of their tax collection and of better preventing tax evasion. In order to identify the challenges in the area of the effectiveness of tax collection several indicators are available. (3) All indicate that there are significant differences in the performance of the tax authorities in different Member States and the challenges they face.

Undeclared work and other forms of underreporting of income in tax returns are lack of tax compliance, i.e., tax evasion (see Box 1.1 for definitions). While cheating with the reporting of income can be detected and prevented administratively through audits, combatting the shadow economy often requires other methods. Tax compliance can be defined as a "...taxpayer's willingness to comply with tax laws, declare the correct income, claim the correct deductions, relief and rebates and pay all taxes on time." (Palil and Mustapha, 2011)

There are three revenue-reducing behavioural effects of taxation:

- **A genuine behavioural effect, which reduces the tax base, because people and companies reduce their economic activity.** For instance, they choose to work less and enjoy more leisure due to a taxation of labour income or to consume less of a product on which an excise duty is levied.

- **Tax avoidance (legal) in the form of a re-arrangement of income, which is in principle legal but not the intent of legislation.** This includes transformation of income, e.g., remuneration in the form of dividend income, as this is typically lower taxed than wage income, transformation of expenses into tax deductible expenses or the placement of savings in assets for which the return is taxed lower.

- **Tax evasion (illegal), where income, consumption or production are not (or under) declared for taxation,** despite the fact that they are taxable, e.g., by not reporting the full income to the tax authorities or by carrying out undeclared work.

Put in a general way, a compliance gap, i.e. a gap between the taxes collected and the theoretical tax due, can result from the following factors:

- Lack of knowledge of tax obligations by individuals and businesses,

- Difficulty to understand the tax code and high costs of declaring income,

- Unwillingness to declare income,

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(2) COM(2011)815 final, VOL. 1/5.
Unwillingness to pay taxes or pay taxes on time,

Ability to cheat/underreport.

The goal for revenue authorities is to collect the full amount of taxes and duties payable in accordance with the law. From a compliance perspective, tax authorities should aim at reducing the tax gap while at the same time having low costs of collecting taxes for the government and of paying taxes for taxpayers (businesses and individuals) (see Graph 1.1). To achieve these objectives, governments may rely on a variety of tax administration policies.

Tax administration policy can be defined as a set of measures, procedures and tools, which a tax authority uses to collect the full amount of taxes payable in accordance with the law in the most effective way and at the lowest administrative costs. This covers policies to facilitate and stimulate voluntary compliance, to prevent and deter evasion, to detect and combat tax fraud, to enforce compliance, as well as to effectively collect the taxes due. These policies are interlinked: facilitating voluntary compliance decreases the need for enforcement, while an effective enforcement policy will contribute to more voluntary compliance. In general, policies aiming at enhancing voluntary compliance, e.g. through the provision of high quality taxpayer services, will result in greater trade facilitation, while enforcement policies will entail a further increase in administrative burdens on businesses. However, a tax administration policy needs to include both and the challenge is to find a proper balance between the two elements.

This paper presents operational criteria to assess the adequacy of policy responses in the area of tax governance, following the approach developed in the EPC's Lisbon Working Group (LIME). (*) LIME worked to develop operational criteria to assess the adequacy of policy responses. This was done on the basis of a literature survey which sought to develop general criteria for successful reforms to make work pay as well as criteria for success at the level of policy instruments.

Box 1.1: Tax evasion, the tax gap, the shadow economy and undeclared work

In the literature, different definitions of the terms tax evasion, shadow economy and undeclared work are used interchangeably. (*) In this note, the following definitions are used.

Tax evasion represents the general concept that individuals and companies underreport taxable activities (and over-report deductible expenses). Taxpayers illegally conceal or misreport (otherwise legal) economic activity in an attempt to reduce the amount of taxes they pay. Tax evasion gives rise to a tax gap – the monetary difference between the revenue that tax authorities would collect if all taxpayers complied with the tax code and other forms of regulation and the actual revenue that is collected.

The shadow economy can be defined as legitimate productive activities in which a payment or a quid pro quo barter is taxable but the seller – often in common understanding with the buyer – neglects to pay taxes (including social security contributions and excise duties). Activity in the shadow economy includes both undeclared work and underreporting of income of cash-based businesses sale of goods. The shadow economy measures the value on the black market of the production not reported to the tax authorities; i.e. not the amount of taxes evaded.

Tax evasion is not always linked to shadow economic activity. It also includes 'pure' tax evasion which is not linked to any production of goods or services and which does not create an added value. This kind of tax evasion involves transactions that have the only objective to conceal income or over reporting of deductible expenses. Examples of this include hiding money in tax shelters, use of manipulated transfer prices and fraud related to VAT refunds.

(*) See, e.g., Schneider (2011a) and Pedersen (2003) for a discussion and further literature references.
1. Introduction

recommended distinguishing between ‘dimensions to watch’ for in order to achieve success and ‘conditions for success’, which are of prescriptive and normative nature. The former requires considering specific aspects although they do not give concrete recommendations in favour of a predetermined policy stance. The latter (conditions) recommends a specific and concrete policy design.

The paper is structured as follows: Chapter 2 presents data on tax compliance costs and the costs of tax collection. Chapter 3 discusses how the efficiency of the tax administration can be improved and Chapter 4 analyses specific ways to combat tax evasion and the shadow economy. Finally, Chapter 5 addresses three special topics, namely why tax amnesties are counterproductive, which special measures could be put in place to combat VAT fraud and tax evasion by placing financial wealth in tax havens.

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**Graph 1.1: Tax revenue, tax gap and costs of collecting taxes**

![Graph showing tax revenue, tax gap, and costs of collecting taxes](image)

*Source: Commission services.*
2. TAX COMPLIANCE AND COSTS OF TAX COLLECTION: SOME FIGURES

The size of the shadow economy gives a first idea of the extent of tax non-compliance. Several researchers have worked on measuring the size of the shadow economy, and on analysing its consequences for the formal economy. According to Dell’Anno (2003), the shadow economy includes those economic activities and the income derived thereof that circumvent or avoid government regulation or taxation. A large share of the shadow economy in official GDP can, therefore, be due to the avoidance of tax and social security contribution (SSC) payments, but also due to the avoidance of labour protection legislation and consumer rights protection laws.

By definition, the size of the shadow economy is difficult to ascertain. Reflecting these difficulties, different studies come to rather different results for some Member States. Therefore, available results only provide an indication of the magnitude of the problem and the development over time rather than precise estimates.

Shadow economic activity varies considerably across EU Member States. According to Schneider (2011a), the size of the shadow economy increased steadily between 2008 and 2010, but dropped again in 2011. In 2011, Bulgaria is estimated to have the largest shadow economy in the EU, equivalent to 32.3% of its GDP, followed by Romania (29.6%), Lithuania (29.0%), and Estonia (28.8%) (see Table 2.1). Another important source is the European Employment Observatory, which collected national data in 2004 and 2007 for the share of undeclared work. Depending on availability, these figures are either based on micro surveys, labour force survey studies, macro studies or a combination or even a guesstimate. The estimated size of undeclared work is usually significantly lower in the reported national data. The picture is, nevertheless, rather similar for many Member States. However, it is noticeable that Estonia is estimated in the latter to have a share of undeclared work well below the European average.

The estimated size of the shadow economy is usually significantly lower in micro surveys than in macro studies. In micro surveys individuals are asked if they have performed (or acquired) activities in the shadow economy during the previous year. One reason for the lower results is that micro surveys usually apply a more narrow definition of the shadow economy, focusing on households' supply of black labour, whereas the macro studies tend to encompass also other types of tax evasion. Another possible reason might be biased reporting. Nevertheless, it is likely that the size of the shadow economy is overestimated, at least for some countries, in macro estimations like Schneider (2011a) and that the truth lies somewhere between the results from macro studies and micro surveys. Results for the latter are only available for a few Member States (see right column of Table 2.1 for examples).

Despite cross-country disparities, there seem to be some common characteristics of the prevalence of undeclared work. Undeclared work is most prevalent among men, singles, people with short or craft education and workers employed in the construction sector and in the hospitality sector. It is more common in sparsely populated areas.

Only few studies are available that measure the size of the tax gap. The most well-known study is the study of the ‘VAT compliance gap’ carried out by Reckon LLP (2009). It aims at measuring the gap between actual VAT revenues and what they would have been with full compliance. It estimated an average gap of 11% of liabilities in 2006 for EU as a whole (see also Section 5.2). Apart from this, mainly studies for single Member States exist. Studies carried out by national tax administrations in many cases do not get published.

(1) A further discussion of the different methods used to measure the shadow economy is available in Slemrod and Yitzhaki (2002).
The impact of the tax level on avoidance and evasion is not clear, while the ability to cheat in combination with tax morale seems to be the crucial factor. The ability to misreport and the will to exploit opportunities to do so – the tax morale – appear to be decisive explanatory variables for the size of the shadow economy and the total amount of tax evasion. This is confirmed by the depiction of the estimated size of the shadow economy compared to the overall tax-to-GDP ratio or the marginal tax rate on labour for the EU Member States in Graph 2.1. Increased taxes will increase the value of evading if the penalty for evading is only dependent on the evaded income. If in contrast, the penalty is directly related to the evaded tax, the tax rate typically has less or no importance for tax evasion, as the change in the potential gain and the potential costs nets out. The fact that there is no clear relationship between the level of taxation and the size of the shadow economy underlines that the tax morale of the inhabitants and the tax governance of the state is what matters for the size of the shadow economy. The tendency that the size of the shadow economy is smaller the higher the overall tax-to-GDP ratio could reflect other factors, e.g. the fact that a high tax-to-GDP ratio is often associated with a high level of economic development, which is again linked with lower activity in the shadow economy. The share of self-employed and people employed in small enterprises can have a large impact on the share of taxpayers who is able to cheat and, therefore, on tax governance. High shares can, e.g., be due to special regulations in sectors which prevent

Table 2.1: Size of the shadow economy and undeclared work in the EU

<table>
<thead>
<tr>
<th>Country</th>
<th>Size of shadow economy (in % of GDP), Schneider (2011a)</th>
<th>Undeclared work (share of GDP or employment, 1995-2006)</th>
<th>Undeclared work working hours in % of hours in formal economy, Pedersen (2003)/RFRU (1997-2004)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AT</td>
<td>10.3</td>
<td>8.1</td>
<td>8.7</td>
</tr>
<tr>
<td>BE</td>
<td>20.1</td>
<td>17.5</td>
<td>17.9</td>
</tr>
<tr>
<td>BG</td>
<td>34.4</td>
<td>32.1</td>
<td>32.9</td>
</tr>
<tr>
<td>CY</td>
<td>28.1</td>
<td>26.0</td>
<td>26.8</td>
</tr>
<tr>
<td>CZ</td>
<td>18.5</td>
<td>16.6</td>
<td>17.2</td>
</tr>
<tr>
<td>DK</td>
<td>16.5</td>
<td>13.9</td>
<td>14.4</td>
</tr>
<tr>
<td>EE</td>
<td>30.2</td>
<td>29.0</td>
<td>29.9</td>
</tr>
<tr>
<td>FI</td>
<td>16.6</td>
<td>13.8</td>
<td>14.3</td>
</tr>
<tr>
<td>FR</td>
<td>13.8</td>
<td>11.1</td>
<td>11.7</td>
</tr>
<tr>
<td>DE</td>
<td>15.4</td>
<td>14.2</td>
<td>14.7</td>
</tr>
<tr>
<td>EL</td>
<td>27.6</td>
<td>24.3</td>
<td>25.2</td>
</tr>
<tr>
<td>HU</td>
<td>24.5</td>
<td>23.0</td>
<td>23.8</td>
</tr>
<tr>
<td>IE</td>
<td>14.8</td>
<td>12.2</td>
<td>13.2</td>
</tr>
<tr>
<td>IT</td>
<td>24.4</td>
<td>21.4</td>
<td>22.2</td>
</tr>
<tr>
<td>LV</td>
<td>29.5</td>
<td>26.5</td>
<td>27.3</td>
</tr>
<tr>
<td>LT</td>
<td>31.1</td>
<td>29.1</td>
<td>30.0</td>
</tr>
<tr>
<td>LU</td>
<td>9.9</td>
<td>8.5</td>
<td>8.8</td>
</tr>
<tr>
<td>MT</td>
<td>26.9</td>
<td>25.8</td>
<td>26.0</td>
</tr>
<tr>
<td>NL</td>
<td>12.0</td>
<td>9.6</td>
<td>10.3</td>
</tr>
<tr>
<td>PL</td>
<td>27.1</td>
<td>25.3</td>
<td>26.1</td>
</tr>
<tr>
<td>PT</td>
<td>21.2</td>
<td>18.7</td>
<td>19.7</td>
</tr>
<tr>
<td>RO</td>
<td>32.2</td>
<td>29.4</td>
<td>30.2</td>
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<tr>
<td>SK</td>
<td>17.6</td>
<td>16.0</td>
<td>17.3</td>
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<tr>
<td>SI</td>
<td>26.0</td>
<td>24.0</td>
<td>25.0</td>
</tr>
<tr>
<td>ES</td>
<td>21.3</td>
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<td>19.8</td>
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<tr>
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<td>17.5</td>
<td>14.9</td>
<td>15.6</td>
</tr>
<tr>
<td>UK</td>
<td>12.0</td>
<td>10.1</td>
<td>11.1</td>
</tr>
<tr>
<td>EU-27</td>
<td>17.4</td>
<td>15.1</td>
<td>15.9</td>
</tr>
<tr>
<td>EA-17</td>
<td>17.6</td>
<td>15.3</td>
<td>16.0</td>
</tr>
</tbody>
</table>

Note: The size and development of the shadow economy is calculated with the MIMIC (Multiple Indicators and Multiple Courses) estimation procedure. The currency demand approach was used for Austria, Germany and Poland. Averages are GDP-weighted. Source: Schneider (2011a), national data collected by European Employment Observatory, Spring Review 2004 & 2007 (figures for BE, IT and LT are based on the articles on undeclared work from national SYSDEM correspondents) and Pedersen (2003).

The impact of the tax level on avoidance and evasion is not clear, while the ability to cheat in combination with tax morale seems to be the crucial factor. The ability to misreport and the will to exploit opportunities to do so – the tax morale – appear to be decisive explanatory variables for the size of the shadow economy and the total amount of tax evasion. This is confirmed by the depiction of the estimated size of the shadow economy compared to the overall tax-to-GDP ratio or the marginal tax rate on labour for the EU Member States in Graph 2.1. Increased taxes will increase the value of evading if the penalty for evading is only dependent on the evaded income. If in contrast, the penalty is directly related to the evaded tax, the tax rate typically has less or no importance for tax evasion, as the change in the potential gain and the potential costs nets out. The fact that there is no clear relationship between the level of taxation and the size of the shadow economy underlines that the tax morale of the inhabitants and the tax governance of the state is what matters for the size of the shadow economy. The tendency that the size of the shadow economy is smaller the higher the overall tax-to-GDP ratio could reflect other factors, e.g. the fact that a high tax-to-GDP ratio is often associated with a high level of economic development, which is again linked with lower activity in the shadow economy. The share of self-employed and people employed in small enterprises can have a large impact on the share of taxpayers who is able to cheat and, therefore, on tax governance. High shares can, e.g., be due to special regulations in sectors which prevent

\(^{1}\) See, e.g., Alm (2000) for references to estimates of the effect of tax rates on taxpayer compliance. See also Thießen (2010) for an estimation of factors influencing the size of the shadow economy.
Compliance costs are an important variable often associated with non-compliance. A widely used indicator for the measurement of tax compliance costs for small and medium-sized enterprises is the ‘paying taxes’ indicator (7). It measures the time to prepare, file and pay (or withhold) corporate income tax, value added or sales tax and labour taxes, including payroll taxes and SSC for a case study company. In 2011, in particular the Czech Republic and Bulgaria but also Poland, Latvia, Italy, Hungary and Portugal show high tax compliance costs as compared to the EU average of 189 hours (see Graph 2.2). A topical case is Italy, which is of particular relevance due to the size of its economy in Europe. Compliance costs in Italy amount to 285 hours, the second highest amongst euro-area Member States. The high Italian value is mainly due to compliance with labour tax provisions (214 hours of 285). Overall, compliance costs have been on a downward trend in the EU in recent years (2005 average: 212 hours).

Moreover, it is important to analyse how costly tax collection is for the revenue administration. According to OECD (2011), the average costs of tax collection in the EU Member States amounted to 1.1 (costs per 100 units of revenue, see Graph 2.2). No clear trend is discernible for the period 2005-2009. In 2009, Poland, Czech Republic, Portugal, Belgium and France were characterised by rather high costs of tax collection. (8) Slovakia had high costs in 2007, the latest year for which data are available.

Expectations for revenue improvements from an augmented fight against the shadow economy should be cautious. Even if the shadow economy could be completely removed, revenue gains would be significantly lower than the figures reported in Table 2.1 times the tax rate. Many activities carried out in the shadow economy would disappear because there would be no demand for such services at formal market prices. As a rule of thumb based on anecdotal evidence of country examples, around 1/3 of the work carried out in the shadow economy could be transferred to the formal economy and thus lead to additional tax revenues. Other activities wouldn't be demanded any longer or be carried out by the customers themselves, i.e. move to household production. If the shadow economy amounts to, say, 10%
of GDP and the average effective marginal tax rate including VAT is 50%, revenue would increase by 1.7% of GDP if the shadow economy could be completely removed.

Graph 2.2: Administrative burden of tax systems for a medium-sized company (2011) and administrative cost per net revenue (costs per 100 units of revenue, 2007 to 2009)

Note: Administrative burden includes total hours to comply across the EU include: corporate income tax time, labour income tax time, and consumption tax time. Data for Malta are not available. For the administrative cost, no data available for Greece is available. Data for Slovakia are limited to year 2007. Data for Cyprus is currently under revision by the OECD following a request by the Cypriot authorities.

Source: PwC et al. (2011) and OECD (2011).
3. POLICIES TO RAISE THE EFFICIENCY OF TAX ADMINISTRATION

Different policy instruments can be used to increase tax compliance. The effectiveness of each measure depends on the underlying cause of non-compliance.

Reform priorities to improve tax compliance differ across Member States, reflecting variations in tax systems, in stages of development, in the administrative capacity, and in the extent and type of tax evasion. Reforms, therefore, need to be tailored to each Member State’s circumstances. The relatively wider tax gaps and lower revenue productivity of the less developed Member States generally suggest potential for bigger revenue yields from compliance improvement initiatives. For these countries, getting the fundamentals of revenue administration in place (especially taxpayer service operations and effective audit and enforcement) should be the first step.

3.1. DEVELOPMENT OF A COMPLIANCE STRATEGY AND TARGETING EFFORTS AGAINST TAX EVASION

Developing an overall compliance strategy is critical for the tax authorities’ ability to improve taxpayer compliance and to enhance revenue collection. The purpose of a taxpayer compliance programme is to identify and respond to the most significant risks in the tax collection system through a range of measures aimed at the underlying causes of the noncompliant behaviour. Its ultimate objective is to achieve the widest possible impact on voluntary compliance across the taxpayer population.

A close monitoring of the tax gap or other tax compliance indicators is important in order to be able to react quickly in case of an increase in the tax gap. As part of a compliance programme tax administrations should improve revenue analysis capabilities and develop (further) indicators for tax compliance in the different tax categories. A taxpayer compliance programme should be authorised at a high level, describe and prioritise resources for the most significant compliance risks and set out the detailed response by tax administration to those risks. The compliance programme does not cover every aspect of a revenue agency’s operational activities, but focuses on special areas of high risk and importance for revenues. Compliance programmes are structured around major taxpayer segments (e.g., large businesses, medium-size enterprises, small and micro enterprises, and high income individuals) or types of taxes with a high risk of fraud (e.g. corporate income tax, vehicle taxation, VAT, deductions for commuting expenses in personal income taxation) and address compliance risks relevant to these segments. Box 3.2 lists the features of a typical taxpayer compliance programme.

As an overarching plan, a taxpayer compliance programme should carefully target efforts against tax evasion. Governments’ resources to collect taxes and combat tax evasion are limited. Therefore, it is essential that the resources are targeted to achieve the best possible outcome.

Taxpayers should be viewed as clients and the tax administration should move from a control to a service approach. Most taxpayers – whether individuals or businesses – comply voluntarily with the tax laws and pay their taxes without any intervention from the authorities. Therefore, most revenue agencies have moved away from administrative assessment systems under which all or most tax returns are subjected to examination prior to the issue of final tax returns to taxpayers, to a system which relies on most taxpayers voluntarily complying with their obligations to register, keep proper records, file correct returns and pay tax on time without the intervention of a tax official. Successful self-assessment systems are underpinned by an administrative approach which recognizes that voluntary compliance will be optimized through an appropriate balance of taxpayer education and assistance that help taxpayers and their advisors understand their obligations and entitlements, simple laws and procedures, and risk-based

(11) See, e.g. Russell (2010a) for a discussion of taxpayer compliance programs.
verification programmes (see European Commission, 2010). Tools like one-stop shops and single tax web portals for all taxes and taxpayers can make it easier for taxpayers to comply with their tax obligations. (12)

Risk-based verification programmes segmenting taxpayers into co-players and opponents have proved efficient. Segmenting taxpayers improves compliance behaviour by detecting and deterring non-compliance through the use of risk management approaches. Taxpayers are more likely to comply if they perceive the likelihood of detection as high and see blatant non-compliers being brought to account. The compliance level can be shown in the shape of a triangle, the compliance pyramid (see Graph 3.1).

Tax authorities could perform detailed analysis of random audit data to segment individual taxpayers into co-players and opponents according to the four groups in the compliance pyramid. The segmentation can then be revised according to the track record of the particular taxpayer. Once the taxpayers are segmented, the approach towards the taxpayer can be separated between service and control. The compliance pyramid as a basis for segmentation applies to both individuals and businesses. The segmenting of taxpayers into the four compliance categories will depend, among other factors, on the coverage of third-party information. Taxpayers with income and deductions extensively covered by third-party information will typically be categorised as "compliant". For self-employed and business, parameters such as size and sector will be influential, but the segmentation may rely more heavily on track record.

Graph 3.1: The compliance pyramid

<table>
<thead>
<tr>
<th>Deliberate fraud</th>
<th>General non-compliant</th>
<th>Attempt to comply, but fail</th>
<th>Compliant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased use of control, increased audit probabilities</td>
<td>Increased use of precautionary measures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Range of measures:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Criminal investigation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Complete audit</td>
<td></td>
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<td></td>
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<tr>
<td>Partial audit</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Assistance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Information</td>
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</table>


Notifying high-risk taxpayers by letter may increase voluntary compliance. When a taxpayer is identified as a deliberate defaulter, notifying the taxpayer by letter that he/she will be under close scrutiny

may by itself increase compliance and could be a cost-efficient strategy. However, the thread of closer scrutiny needs to be credible.

Special attention should be paid to the segment of taxpayers who attempt to comply, but fail to comply fully with their obligations to register, file correct information and pay the correct amount of tax on time. his segment with information and education, when possible via standard electronic communication, can increase the number of taxpayers in the fully compliant segment at relatively low costs and thereby increase the share of revenues that ‘enters through the front door’.

Flag systems are an efficient tool and could be based on the segmentation of taxpayers. The four groups in the compliance pyramid can form the basis of a segmentation-oriented flag system. Flag systems will typically be more sophisticated and more targeted than the segmentation in the compliance pyramid.(13) Available data is used to point out for which tax returns of individuals and businesses it would be most beneficial to perform closer audits. The tax authorities cannot examine all tax returns and should, therefore, identify those that can be expected to have the largest deviations. Tax agencies could apply a computer-based examination of all tax returns that assigns a flag to a tax return if the income reported seems suspicious, or if the reported type of income is known to often suffer from evasion (e.g. self-employed income).(14) A flag would then increase the likelihood of a manual check. The flag system could build on data about sources of income, size of taxpayers' reported changes to the preliminary assessment of income, income levels, any mismatch between income and consumption levels, and perhaps also socio-economic factors.

(13) For instance in Denmark, taxpayers are allocated to the compliant segment unless their record (regarding errors in payment of taxes ranging from late payment to serious evasion) suggest otherwise. The flag system, on the other hand, is based on detailed data (in particular on the source of income and the taxpayer's potential ability to cheat) and targeted selection of taxpayers for auditing.

(14) Kleven et al. (2011) found that the presence of types of income difficult to detect (e.g. self-employed income and other income not reported by a third party) is the most important factor in predicting evasion whereas socio economic characteristics of the individual have little explanatory power.
A preferable treatment of self-employed as compared to employed people in the tax system should be avoided. As pointed out in the above (and discussed in more detail in Section 3.6), self-employed are much more likely to evade taxes than employees. This can lead to significant revenue losses and a higher workload for the tax administration due to a higher need for manual controls in the case of self-employed. Moreover, such incentives are also debatable from a general tax policy point of view as a tax system should not discriminate between different forms of employment.

Controls should complement the flag system in specific cases. Even if control costs on average outweigh the revenue gain for some categories of taxpayers (e.g. self-employed), they are important for the fairness of the tax system and thus tax morale. Moreover, controls should increase an audited taxpayer's compliance in the future and this need to be taken into account in the cost-benefit analysis when deciding on the level of audits.

The communication strategy of tax authorities could improve voluntary compliance. As part of the compliance strategy, tax authorities should consider using strategic communication of results. Strategic communication about results of control actions and detection of evaders can contribute to increasing the perceived detection probability and underpin tax morale at a low cost. Non-monetary sanctions such as "name and shame" methods which include the publication of the names and relevant information of delinquent taxpayers can be used to increase the cost of non-compliance in cases where monetary sanctions are not adequate to discourage taxpayers from non-compliance.

3.2. SIMPLE AND STABLE TAX SYSTEM

Simple and stable tax laws and procedures make it easier and less expensive for taxpayers to comply with their obligations and access their entitlements. Taxpayers are less likely to voluntarily comply if the tax system itself makes it too difficult or very expensive for them to meet their obligations. Furthermore, rate differentiations, exemptions and deductions complicate the system and create scope for avoidance. As a general rule, tax bases should, therefore, be broad and allow only limited possibility for deductions and exemptions and tax systems should tax substitutable types of income in a similar way.

Taxpayers are entitled to have up-to-date information on the operation of the tax system and the way in which their tax is assessed. They are also entitled to be informed of their rights, including their rights of appeal. All taxpayers can expect that the information provided to them reflects the complexity of the tax situation, thereby enabling them to understand better their tax affairs. The authorities may use a variety of means to fulfil this obligation: information leaflets, taxpayers' charters, telephone announcements, video guides, etc. The right of appeal against any decision of the tax authorities applies to all taxpayers, and to almost all decisions taken by the tax authorities, whether they concern the

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**Box 3.3: Policy criterion 2 (condition for success) “Segmentation of taxpayers into co-players and opponents and exploitation of databases to target audits to the most relevant taxpayers”**

Segmenting taxpayers into the four compliance categories in the compliance pyramid can assist tax authorities in differentiating the approach towards the taxpayer between service and control.

Building up databases with information on taxpayers’ income and assets can make the investigations of tax authorities better targeted, e.g. by means of a flag system, where a flag significantly increases the audit probability. The flag system should build on data on the sources of income of each taxpayer, the taxpayer's income level and the difference between the taxpayer's tax return and the preliminary assessment of income as well as the track record for previous years. This data may help to segment a given taxpayer into one of the four compliance categories.
application of the law or of administrative rulings and penalties, provided the taxpayer is directly concerned.

**Taxpayers also have a right to a high degree of predictability as to the tax consequences of their actions.** Firstly, this calls for a stable tax system over the years. Of course, certainty is not always possible. For example, taxpayers may not always know in advance the effect of rules that are dependent on the facts and circumstances in a particular case. However, it is clearly a goal that taxpayers should be able to anticipate the consequences of their ordinary personal and business affairs. Achieving this goal is often difficult because modern tax systems are complex and evolving. However, tax authorities may not be obligated to provide the taxpayer with certainty in relation to the application of anti-abuse provisions aimed at taxpayers seeking to circumvent the intent of the legislation.

A simple and stable tax system is also preferable from the tax administration viewpoint. It is easier to administer and can be applied better and at lower costs.

### 3.3. OPTIMAL SIZE, RESOURCES AND ORGANIZATION OF TAX ADMINISTRATION

There are vast differences in the size and organisation of tax administrations in EU Member States. Some of these differences can be attributed to the differences in organisation of the administration of SSC, customs, excises etc., which could be (or not) part of the tax agency. Overall, the total staffing of tax authorities appears rather low in Italy, Spain and Estonia. In the Netherlands and Latvia, total staffing on the other hand appears relatively high.

Tax administrations with more resources do not perform better than tax administrations with fewer resources. When total staffing of tax administrations per 1 million inhabitants is compared with the size of the shadow economy, only a very weak relationship emerges (see Graph 3.2). However, a cross country comparison does not take into account the wealth of other possible explanations. One important aspect is that the causality could be from the size of the shadow economy and the level of tax evasion to total staffing rather than the other way around, as there is a rationale for employing more staff to combat tax evasion if the shadow economy and tax evasion in other areas are large.

**Graph 3.2: Size of the shadow economy and the total staffing of tax authorities**

\[ y = -0.0027x + 22.703 \]

\[ R^2 = 0.0163 \]

*Source: Own calculations based on Schneider (2011a) and OECD (2011).*
Some country examples suggest that a limited amount of resources could be associated with efficient tax administration and small shadow economy. Looking at Member States like Finland, Austria, Sweden and the United Kingdom, it appears to be possible to run an efficient tax administration with a staffing of slightly above 1,000 per 1 million inhabitants (see Graph 3.3). The number of local and regional tax offices or branches also varies largely between Member States from 35 in the UK to 3,271 in France and 1,421 in Belgium. A relatively low number of local tax offices (below 10 per 1 million inhabitants) could support professional competency, ensure quality of the service and improve administrative cost effectiveness.

Not only the headcount but also the quality of human resources in the tax authority is essential. Adequate education and training of the staff must be ensured. Practices should be in place to build and maintain the required professional skills and ethical standards of the personnel. Furthermore, staff in tax authorities needs to be amply equipped with efficient IT tools.

To ensure cost efficiency and the specialisation of the officials, field offices should not be too widely dispersed geographically. A large country might also choose to organize its field offices into a smaller number of regions. In smaller Member States, local tax centres might not contain all different functions. Some specialised functions like corporate income tax, large corporations, frontier taxpayers (taxpayers who derive income in one Member State but reside in another), property taxation, and vehicle taxation etc. may be concentrated in one physical address.

Operation of an integrated tax and social security contribution collection agency could improve efficiency and effectiveness, and reduce the compliance burden for businesses. SSCs are the largest single source of government revenue in most Member States. However, in 14 Member States the collection of SSCs is administered through a separate social security agency, rather than by the main tax revenue body (see Annex 1). The majority of the revenue bodies are set up as unified semi-autonomous bodies responsible for both direct and indirect tax administration. Customs administration is most often administered by a separate entity, although some Member States have merged tax and customs administration. Twenty Member States have separate bodies for tax and customs administration; of these, nine have allocated the excise administration to the customs body and not to the revenue body. Running separate entities for similar tasks implies a duplication of fixed costs and means that taxpayers have to deal with several collection bodies.
There is a new trend towards integrating the collection of social security contributions with tax collection operations. The Czech Republic, Slovakia and Portugal (as part of the Memorandum of Understanding) consider integrating the collection of taxes and SSCs over the next few years. Tax administrations can be organised as a department within the Ministry of Finance, as a separate department of government or as is the case in some countries, an autonomous agency. The Minister of Finance usually has direction or oversight of the tax administration.

### 3.4. THE FUNCTION-BASED ORGANISATION OF TAX ADMINISTRATION

A function-based organization for tax administration is acknowledged as the most effective organisation to collect revenues, minimise the tax gap and service taxpayers.\(^{(15)}\) In essence, a function-based tax administration is organised in logical groupings of core functions that encompass all taxes, rather than separate units to deal with each different (type of) taxes. Such core functions where headquarters can be divided into separate divisions include (1) taxpayer service and education, including registration and de-registration; (2) tax returns processing and payment; (3) audit and investigations; (4) large corporations; (5) high net-wealth individuals (6) task force for transnational economic crime; (7) vehicle taxation; (8) recovery, enforced collections of tax arrears; (9) operation planning and results analysis; (10) maintenance and development of IT systems; and (11) objections and appeals.

A function based approach gives tax authorities a better picture of overall taxpayer compliance. It is also able to better leverage a number of synergies from the standardization of common work in the same unit.

The organizational structure of tax administrations should be based on a strong head office. The head office should be assigned with policy direction and monitoring, organized by key tax administration functions and separate from operational tasks. The headquarter develops strategies and priorities, develops and maintains the IT infrastructure, allocates operational results, sets goals and targets, measures the results and adjusts approaches as a consequence of those results.

The responsibility for the tax assessment, dispute resolution and for recovery tax arrears should be strictly separated between two different parts of the tax agency. If the tax official responsible for regulating the tax to be paid is the same as the official recovering tax arrears, this could give rise to suspicion of possible corruption. Likewise, the system for resolving disputes between taxpayers and tax authorities should be strictly separated to ensure independency and objectivity.

\(^{(15)}\) See Kidd (2010) for a more detailed analysis of functionally organised tax administrations.

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**Box 3.4: Policy criterion 3 (point to watch) "Basic organisation of revenue collection"**

The optimal size of tax authorities in terms of total number of employees depends on the scale of the challenges with tax evasion in the Member State. Member States with less than 1,000 employees per 1 million inhabitants might investigate whether increasing full-time equivalents would be worthwhile.

A high number of local tax offices (above 10-15 per 1 million inhabitants) appears not recommendable. Professional competency and administrative cost effectiveness could increase by reducing the number of local offices.

Member States could possibly lower administration costs by integrating the collection of SSC, excise duties and customs into the tax agency.
Field offices are usually structured in a similar manner to the functions established at headquarters. In this way, communication lines with headquarters are clearer, services are properly set up for taxpayers and staff efficiency can be maximized.

The organization of the tax administration should also recognize that both the needs and compliance challenges of large, medium and small taxpayers and other specific groups of taxpayers are quite different and tailor its programmes accordingly. Many administrations have created large taxpayer offices (LTOs) and sometimes even medium taxpayer offices as key components of their field network. Large corporate taxpayers pose a particular risk in terms of the tax gap as a limited number of companies account for a large share of revenues. Furthermore, a large taxpayer's tax assessment is often relatively complicated and involves transnational issues (e.g. transfer pricing and thin capitalization). Other groups of taxpayers that could justify the setting-up of special entities or units are High Wealth Individuals and High Income Self-Employed.\(^{(16)}\)

A comprehensive system of taxpayer registration is a critical feature in the arrangements of tax administrations. It is an important prerequisite for several of the different policies to improve the efficiency of tax administrations discussed in this chapter, such as for pre-filled tax returns and the use of third-party information.

### 3.5. Provision of Pre-Filled Tax Returns to Taxpayers and Utilisation of IT Systems

Pre-filling appears a successful formula to improve the efficiency of tax collection for the personal income tax. Pre-populated tax returns were first introduced by Denmark in 1988. Since then, pre-filling has evolved to become a significant (and for some, transformational) component of e-services and the e-government strategy by revenue bodies in many countries.

Pre-filling entails the use by revenue bodies of information already held by them (e.g. taxpayer identity information, elements of taxpayer history, and third-party reports of income and deductions etc.) to populate fields within tax returns etc. that are made available to taxpayers for examination. Depending on the degree of sophistication of the service (and the legislative framework in place), fully or partially-completed tax returns can be made available to taxpayers in electronic and/or as hardcopy form. In their most advanced form, tax return preparation has been fully automated for the vast majority of the taxpayer population. In the Nordic countries, tax administrations generate at the year-end a fully completed personal income tax return in electronic and/or hardcopy form for the majority of taxpayers required to file tax returns (Denmark: 84%, Finland: 94% and Sweden 60%), with the remaining share of taxpayers

\(^{(16)}\) For an analysis of organisation responses to dealing with High Net Worth Individuals and examples of Member States that have set-up special units to deal with this group of taxpayers, see OECD (2009).
3. Policies to raise the efficiency of tax administration

receiving a partly pre-filled tax return (see OECD, 2011). Substantial use of pre-filling to fully or partially complete tax returns for a significant share of taxpayers also takes place in Belgium, Estonia, France, Lithuania, the Netherlands, Portugal, Slovenia and Spain.

**Tax authorities can pre-fill tax returns based on third-party reports of labour and savings income.** This concerns wage data from employers, positive and negative interest income, dividends and return to shares and financial instruments as well as acquisition prices for shares and bonds etc. from financial institutions and deductible expense such as union fees from unions (see Section 3.6 for further details on third-party information). Other than third-party information, a pre-filled return may contain additional hard information that the tax agency possesses such as an estimated commuting allowance based on knowledge of the taxpayer's residence and work address. Where no third-party information exists, tax authorities could use the information of the previous year as a starting point. Upon receiving the pre-filled return, taxpayers have the option of making adjustments and of submitting a new return. The taxpayers' access to making adjustments to the final tax return should be limited (by locking fields on the tax return) to those types of income and deductions for which the tax authorities do not possess hard and reliable information from third parties.

**Pre-filled tax returns with third-party information make it easy for the taxpayer to comply and pay taxes.** However, third-party information cannot cover all taxpayers and all income types. In particular, companies and self-employed will to a large extend have to assess their own income and deductible expenses. For these taxpayers, it should be as easy as possible to fill in and file the tax return. While it cannot be avoided that the tax rules in some cases are complicated, the filing process should be made easy by appropriate IT solutions. As can be seen in Graph 3.4, the use of electronic filing varies widely across Member States.

**Box 3.6: Policy criterion 5 (condition for success) “Comprehensive use of electronic pre-filing”**

The use of electronic pre-filled tax returns lowers compliance costs, lowers costs of tax administration and increases compliance. Tax authorities should pre-file tax returns based on third-party reports of labour and savings income.

Pre-filled tax returns make it easy for tax authorities to select taxpayers for audit. This is particularly the case when taxpayers make significant downward adjustments to the pre-filled return.
The whole process of handling the tax returns should be made electronic to the mutual benefit of the taxpayer and the tax agency. For example, the administration of tax returns in Denmark is completely automated since 2008 and taxpayers can access online their tax return information and the related notice of assessment. Neither pre-filled tax returns nor a final tax assessment is sent to the taxpayer on paper unless requested.

A preliminary and pre-filled tax return should be sent to the taxpayers and their workplace before the beginning of the tax year. A preliminary and pre-filled tax return before the tax year ensures that a taxpayer pays the taxes on a continuous monthly basis while the income is earned. The preliminary tax return will vastly be based on information from the previous tax year.

3.6. USE OF THIRD-PARTY INFORMATION

Third-party reporting of income is an important element in an efficient tax administration. A very common example is that employers mandatorily report the taxable wages of their employees directly to the revenue authorities together with the payee details. The relevant fields on the tax return covered by third-party information can then be locked, so that the taxpayer is not able to change the information reported to the tax authorities. This is in contrast to self-declaring, where individual citizens are responsible for reporting their income and deductions themselves.

Third-party reporting makes tax evasion considerably more difficult. There is a clear negative correlation between the share of an income type reported by third parties, and the proportion of tax evasion for the income type. Tax evasion varies widely across different income types, as the possibilities to evade differ. This is primarily due to the feasibility of using third-party information for different income types. In a detailed study on Danish data, Kleven et al. (2011) found that while only 2% of all individuals who receive personal earnings (wages, transfers, etc.) reported too low incomes, and just over 4% of those with deductions do the same, tax evasion was discovered for almost 40% of individuals with self-employment income. This reflects the coverage of third-party information, as seen from Table 3.1. Over 90% of all personal income (wages, transfers, etc.) are reported via third parties. For self-employed taxpayers, the share of income reported by third parties, however, is only just under 10 per cent. The authors conclude that the extensive use of third-party information in Denmark makes Danes unable to cheat, and that this is very important for tax compliance. The negative correlation between third-party reporting and tax evasion is also identified in studies for the U.S. While there was a tax evasion on 1% of the required tax payments for wages reported by third parties for the tax year 2001, the same share was 57% for self-employed business income that cannot be verified using third-party reporting.\(^{(17)}\)

\(^{(17)}\) See Slemrod (2007).
Ten Member States already use third party information to pre-fill tax returns. An overview of the use of Third Party Information in the European Union by the Fiscalis Risk Management Platform (European Commission, 2012), shows that Third Party Information regarding individual income is widely available and include information received from other countries (within the EU, the Savings taxation Directive – see Box 5.3 - provides for automatic exchange of information on interest payments made in one Member State to any individual who is resident in another Member State). Ten Member States (Belgium, Denmark, Finland, Lithuania, Malta, Netherlands, Portugal, Romania, Spain, Sweden) use the information to pre-fill tax returns. Many Member States also use the information for audit or control and for assessment. The majority of countries uses the information for risk analysis. It is also often used as a source for debt collection. Details on sources and uses of third party information are included in Appendix 2.

In most Member States, employers are obliged to report to the tax authorities the taxable wages and royalties they pay their employees. Some Member States have expanded the obligation to conduct third-party reporting to financial institutions regarding each account holder’s interest payments (positive and negative), dividends and yields on bonds, as well as the purchase and selling prices of shares and bonds, whereby large parts of the taxpayer's capital income including capital gains can be automatically calculated by the tax authorities. (18)

<p>| Share of | Reported by | Share of taxpayers |</p>
<table>
<thead>
<tr>
<th>population</th>
<th>third party</th>
<th>who evaded</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive income</td>
<td>98</td>
<td>90</td>
</tr>
<tr>
<td>Negative income</td>
<td>79</td>
<td>75</td>
</tr>
<tr>
<td>Employee's wages and transfers</td>
<td>95</td>
<td>99</td>
</tr>
<tr>
<td>Deductions</td>
<td>60</td>
<td>63</td>
</tr>
<tr>
<td>Income from shares</td>
<td>22</td>
<td>64</td>
</tr>
<tr>
<td>self-employed income</td>
<td>8</td>
<td>10</td>
</tr>
<tr>
<td>Total</td>
<td>98</td>
<td>93</td>
</tr>
</tbody>
</table>

Note: Each person may have more types of income at the same time.
Source: Kleven et al. (2011) and Danish Economic Council (2011).

The better the coverage of third-party information, the more resources are freed up that can be targeted, e.g., to areas reliant on self-reporting and to combating the shadow economy. For third-party reporting to work, tax agencies need to be operating a certain level of IT-systems to handle the data and to feed it into the taxpayer's final tax return. It should, however, be kept in mind that in small companies with only a few employees, it could be relatively easy for the employee and employer to collaborate on under declaring, and thus third-party reporting conducted by small businesses should not be totally excluded from scrutiny.

3.7. EFFICIENT PROCEDURAL JUSTICE AND DISPUTE RESOLUTION SYSTEM

For an effectively functioning tax administration it is essential to have a credible procedural justice system in place. The main objective of such a functioning legal system – as the last step of the

(18) Some Member States also get information about non-monetary payments or benefits and withholding tax. And information on tax allowable deductions e.g. kindergarten fees, charities and upgrading to environmentally friendly equipment.
Box 3.8: Policy criterion 7 (condition for success) “Efficient procedural justice increasing voluntary compliance”

Efficient procedural justice is important as the last stage of the compliance management chain. An administrative complaint and tax dispute resolution system can often swiftly and fairly settle disputes between tax authorities and taxpayers. Sufficiently high interest payments for deferred payments are a strong incentive to achieve high rates of voluntary compliance.

compliance management process system – is to build trust in the tax system and encourage voluntary compliance.

**Tax legislation should provide procedural justice to the individual taxpayer.** Tax authorities should always inform taxpayers about their right to file a complaint about a decision, and they should reply and settle any case within an acceptable time span and always provide taxpayers with an explanation for their decision.

**Most Member States have set up specialised National Tax Courts for adjudicating disputes over direct and indirect taxes.** This helps ensure that tax disputes are dealt with by highly qualified professionals. Moreover, tax courts give an independent and objective ruling on tax disputes. They need to be sufficiently staffed and have proper IT systems in place to avoid unnecessary backlogs that hamper the enforcement of tax debts and reduce the credibility of the whole tax system in the citizens’ eyes.

**Any deferred payment of disputed taxes must be subject to interest payments of a sufficient level and taxpayers could be charged a fee for submitting complaints.** The charging of interests on any deferred tax payment is necessary to avoid that appeal mechanisms and the legal system are exploited for deferring tax payments as a means of financing their business, the interest rate should be set at a sufficient level, i.e. above the market rate. On the other hand, the interest rate should not be so high that it gives an incentive to use too high tax payments as a savings account. Where a fee for submitting a complaint exists, it could be recoverable in case the taxpayer wins the dispute.

**To avoid too high a burden for the jurisdiction, it is important to have a mandatory administrative appeal phase within the tax authority.** This should lead to a resolution of many cases while recovering the revenues required or releasing the undue amounts of tax in a timely manner. However, individual tax authority officials should not have discretionary power to decide the correct amount of taxes from the taxpayers they audit.

**Finally, it is important to ensure that court decisions are effectively enforced.** As far as possible, automated systems should be used to collect those tax debts once a final court decision has been taken against which no further appeal is possible. Moreover, to ensure payment the tax authorities should be allowed to ask for sufficient collateral from taxpayers that go to court.
4. SPECIFIC MEASURES TO COMBAT THE SHADOW ECONOMY

Raising the efficiency of tax administration will not be enough to combat the shadow economy. In most Member States, undeclared work constitutes the vast majority of the shadow economy, while undeclared or under declared sale of goods and services constitutes a minor part. Unlike for underreporting of income or "over reporting" of tax deductions, it is difficult for tax authorities to detect undeclared work in the process of audits of annual tax returns, as it is not possible to obtain third-party reports of income from moonlighting and the activity is typically concealed both by the person performing the work and the costumer. This means that detecting undeclared work through administrative actions can be costly.

Undeclared work involves a welfare loss. The lack of taxation makes the after-tax return of moonlighting disproportionately larger than comparable activities carried out in the formal economy. This implies that too many economic resources and skills are allocated to the black sector, while the productivity of undeclared work can be expected to be lower. (19) On the other hand, moonlighting reduces the distortions caused by taxation in the form of reduced labour supply and income transformation, as the tax wedge implies that some activities would not be carried out in the formal economy, if not performed in the shadow. Furthermore, undeclared work represents an undesirable redistribution from those who do not cheat, for people who cheat. The existence of undeclared work is thus in conflict with the horizontal equity principle, which dictates that people with equal incomes should be taxed equally. More commonly occurring moonlighting may make it more accepted in other people's eyes, which can induce them to supply or demand moonlighting themselves. Therefore, another cost of undeclared work is that it increases tax evasion in the future through deterioration of other taxpayers' tax morale.

A variety of measures is applied in different Member States to combat the shadow economy. These measures can be either of a deterrence nature or provide incentives to carry out the activities in the formal economy. Moreover, electronic payments can help reduce the shadow economy, while the tax morale deserves constant focus.

4.1. THE STICK: DETERRENCE

Several ways to deter people from using the shadow economy exist, but often prove to be costly and difficult to implement. These measures have in common that they aim at making the use of shadow economic activity riskier.

In principle, high penalties for undeclared work or other activity in the shadow economy could be a successful way to combat the shadow economy as they would have a deterrent effect. However, according to the principle of proportionality, there must be a reasonable relationship between the severance of a crime and the penalty. Therefore, this is in general not an effective and sufficient way forward.

A complimentary policy instrument to deter the shadow economy could be increased monitoring and auditing. Increasing the probability that working in the shadow economy will be discovered also reduces the expected gains from informality as would higher penalties. However, simply increasing control efforts in terms of full-time equivalents could prove relatively costly compared to the direct revenue gains.

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(19) Moonlighting enables less efficient producers to offer services at a lower price and displaces more efficient (and taxpaying) producers, and thus it leads to a poor allocation of resources (see, e.g., Palda, 1998).
A potentially powerful option would be to criminalize the purchase of undeclared work. Some studies have shown that the buyer of undeclared work reap a large part of the evaded taxes through a lower price. Thus, there is currently a lack of proportionality between the buyers' gain and their potential punishment. Therefore, the current penalty for the supply of undeclared work is complemented with an additional penalty placed on the buyer of moonlighting, which is not the case in most Member States today. It should, however, be taken into account that it could be difficult for the buyer of a service to ensure that the seller pays the statutory taxes. In Italy, purchase of undeclared work is illegal, but it is sufficient for the buyer to show a receipt for the work performed, to avoid criminal liability. This also applies to individuals purchasing services from private individuals. This system, however, creates an administrative cost for the buyer, who must keep track of receipts. An alternative solution is to require the purchaser to pay with electronic means in order to avoid criminal liability for purchases of undeclared services (such a system has, e.g., been implemented in Norway and is foreseen in Denmark) or to keep invoices for works carried out for them for some time (e.g. two years in Germany).

4.2. THE CARROT: MONETARY INCENTIVES

Introducing tax deductions for certain activities and sectors with a high prevalence of undeclared work, i.e. monetary incentives, could be effective but very costly at the same time. This route is likely to be very costly as it involves a high deadweight loss and implies an undermining of the vertical fairness of the tax system.

Several countries (e.g. Belgium, Denmark, Germany and Sweden) have introduced or experimented with tax deductions or subsidies for the purchaser of household services (such as cleaning, babysitting, and construction work on the taxpayers' home) in recent years with rather disappointing results. The argument used for such deductions is that they increase the formal market in specific sectors with a high prevalence of shadow economy and home production. To benefit from the tax deductions, the supply of the service normally has to be registered and in some cases the payment has to take place through a specific electronic system registering the purchase. Although such tax credits and subsidies may have a positive impact on employment in the formal economy, they tend to be expensive in terms of forgone revenue and the experienced results in terms of reduction of the shadow economy have not been convincing, in particular when compared to the cost of the measure. Moreover, these measures tend to introduce a 'trap' which might lock in people in this kind of household jobs.

4.3. THE BENEFIT OF ELECTRONIC PAYMENTS

A commonly used measure in the fight against the shadow economy is the use of mandatory electronic payments for purchases over a certain threshold. Such an obligation to pay purchases over a certain amount by electronic means exists, e.g., in Italy (€2,500) and Greece (€1,500). Electronic payments leave a trace that the tax authorities could possibly use for audits, which should have a deterrent effect on potential tax evaders. Of course, this requires that tax authorities have sufficient legal provisions

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(20) See Danish Economic Council (2011).
(21) For a description and assessment of different measures put in place in selected EU Member States, see Williams (2008).
specific measures to combat the shadow economy

4. Specific measures to combat the shadow economy

to access data of individuals' electronic payments or bank accounts. This is currently not the case in all Member States.

A related measure is to exploit data of an individual's electronic transactions and to compare them with the declared income of the individual to detect tax evaders. If individuals have low reported income and at the same time an elevated level of private consumption, it could be an indication that the taxpayer is worth a closer audit. Italy pursues this strategy rather systematically with the so-called 'income meter', a procedure by which a computed level of income based on expenses made by the taxpayer is compared with declared income to detect tax evaders. Also Denmark and Sweden are exploiting data on electronic purchases for audits of taxpayers.

4.4. IMPROVING TAX MORALE

Tax morale is considered a key factor and encompasses several dimensions. In the conventional view of economic models of taxpayer behaviour, taxpayers comply with tax laws if the expected penalty in case evasion is detected exceeds the tax to be paid. However, a host of other factors such as social values, public morality, and people’s perception about the public sector also matter in shaping attitudes to tax laws. Dell’Anno (2009) argues that aggregate tax evasion may be largely explained by the taxpayers' moral considerations and that tax morale is dependent on the taxpayers’ intrinsic attitudes to honesty and social stigma. These attitudes are influenced by the taxpayers’ perceptions of the size of tax evasion, that is how much everyone else evades, as well as by their perceptions of the policy maker's effectiveness and ability to act in the interests of citizens. According to Slemrod (2007), taxpayers' adherence to the law regarding tax payments depends on the taxpayers' perception about the fairness of the tax system and whether the governments spend tax revenues in a satisfactory way. The extent of tax evasion can thus be expected to decrease if the tax system is deemed to a greater extent as fair and just and if taxpayers believe that the government provides a good service for the taxes paid.

Low tax morale can be contagious. If the individual justifies his evasion by the fact that everyone else does it, existing tax evasion motivates further cheating. Therefore, it is important that governments protect and nurse the tax morale of the population. This can be done by highlighting the risk of being detected and securing. In combination with high actual detection probabilities, an active communication strategy about successful control actions and detection of evaders can contribute to this. Using strategic communication of successful detection and persecution of severe tax evasion could prove a cost effective way to both underpin tax morale and increase the perceived detection probability.

The importance of tax morale means that tax compliance may also be strengthened by influencing the taxpayers’ attitudes and norms. This could be done through attitude campaigns, e.g. explaining why one should comply and why it is unfair not to pay the required taxes. Attitude campaigns appeal to the conciseness of taxpayers and explain how costly moonlighting is to society by making examples of what could be achieved in terms of tax cuts or increased public spending for the revenue that would accrue in absence of moonlighting. This will remind the campaigned taxpayer, that it is unbenefficial to him and the
society that other taxpayers evade, and, therefore, make him aware that he should not evade himself. Especially young taxpayers are an important target group, as their tax morale is generally lower than for all taxpayers as a whole.

**Attitude campaigns have been used extensively in several Member States recently**, e.g. the "Tænk hvis alle arbejdede sort" in Denmark and the "Se tutti pagano le tasse, le tasse ripagano tutti" in Italy. However, as Slemrod (2007) points out, the effectiveness of such campaigns has not been compellingly demonstrated empirically.

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**Box 4.3: Policy criterion 10 (condition for success) “Attitude campaigns improve tax morale”**

Tax authorities may strengthen the taxpayers' tax morale through attitude campaigns explaining why one should pay the amount of taxes required and why it is unfair for other taxpayers if one does not pay the required taxes. Attitude campaigns may be targeted towards younger taxpayers, who generally have lower tax morale. Civic lessons at school could also help found a better tax morale.
5. SPECIAL TOPICS

5.1. TAX AMNESTIES: WHY ARE THEY COUNTERPRODUCTIVE?

Tax amnesties remain popular as an instrument aimed at raising revenue and increasing tax compliance. The common inducement offered in exchange for voluntary disclosure of past untaxed income is a significant but temporary reduction in tax liabilities including penalties. The argument for instituting tax amnesty programmes is usually to forgo the tax revenue that has proven to be difficult to enforce with the objective to secure a short term increase in tax revenue from that category of taxpayers.

In theory the costs of tax amnesty programmes are likely to exceed their benefits. The effectiveness of a tax amnesty would require (i) that the amnesty is a one-off and does not create expectations of repeated amnesties in the future and (ii) the existence of a real and credible threat of detection and punishment. These requirements are generally not fulfilled, and if (ii) is so, there might not be a need for a tax amnesty. Even with these requirements fulfilled, there are important costs of initiating a tax amnesty programme: (i) tax amnesties lead to vertical inequality as dishonest taxpayers are favoured over honest taxpayers, (ii) the reduction in perceived fairness of the system may adversely affect the compliance rates of otherwise honest taxpayers and (iii) initiation of a tax amnesty programme and especially repetitions thereof are likely to create expectations of future programmes. This leads to a perception among taxpayers that tax evasion could prove profitable.

The experience of tax amnesty programmes at country level is not encouraging. Several studies have provided evidence that additional tax amnesties are likely to produce decreasing yields and discourage future compliance. The VAT compliance gap is large. As discussed in Chapter 2, it is estimated at an average of 12% of liabilities in 2006 for the EU as a whole. The bulk of VAT evasion can be attributed to transactions in the shadow economy that are not reported, followed by underreporting of taxable sales or exaggerating claims for refunds of VAT paid on business inputs. Contrived insolvency fraud and carrousel fraud are particularly severe forms of VAT evasion, where few evaders can cause a significant revenue loss. Organised carrousel fraud becomes more attractive the higher is the VAT rate, whereas it is unlikely that shadow economy fraud will be reduced by applying lower rates to the transactions that are not reported, because it remains attractive to evade the associated income tax.

VAT rate differentiation creates scope for misclassification fraud where the VAT liability is reduced by exaggerating the proportion of sales in the lower-taxed categories. Moreover, sufficiently large rate

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(22) See, e.g., Baer and Le Borgne (2008).
(23) Not the entire VAT gap is due to outright fraud; it also includes non-payment arising from innocent error, legitimate tax avoidance measures or business failure.
differentials can also give rise to refund entitlements for some traders (those using inputs taxed at a high rate to produce outputs subject to a low VAT rate), which creates opportunities for abuse and extends the scope of the refund problem beyond exports. Furthermore, reduced VAT rates are an inferior instrument for distributional considerations compared to progressive income taxes and direct subsidies (see European Commission, 2011). This points towards the application of a uniform VAT rate with exemptions only based on the technical unfeasibility of taxation (for financial services for instance).

Abusive use of VAT refunding is difficult to control in real time. VAT is a tax on all commodity sales, whether to consumers or to other businesses. However, registered businesses are able to credit the VAT charged on their purchases ("input VAT") against the VAT due on their sales ("output VAT"). Any excess credits this creates are refunded to the taxpayer. According to the VAT Directive, commodities are taxed by the jurisdiction in which they are consumed by zero-rating exports and intra-community supplies and charging VAT on imports and intra-community acquisitions. Under the “invoice-credit” form, registered businesses charge tax on their sales and issue corresponding invoices to their customers, who, if they are also VAT registered businesses, can use these invoices to establish a right to credit or refund against their own output VAT liability. These features of the VAT system are a crucial prerequisite for the functioning of the internal market. However, they also leave the VAT system exposed to economic crime. See Box 5.2 for a short description of some common types of VAT fraud.(24)

As VAT is a harmonized tax and a large part of problems with fraud is cross-border, work is being done at EU level to combat fraud and evasion, notably through the use of administrative cooperation provisions financed by the Fiscalis Programme.(25) Furthermore, the EU VAT Information Exchange System (VIES) that enables traders to verify that their customer in another Member State is registered for VAT is used to track transactions and thus can signal possible fraud.

The scope for VAT fraud partly depends on the speed with which VAT refunds are paid, compared to VAT collections. Fraud that involves false refund claims by firms which subsequently disappear is more attractive when VAT is refunded rapidly, because this gives the authorities less time to detect and fight the fraud. However, traders should be able to rely on the right to obtain VAT refunds within a certain period of time in order not to transform VAT into a tax on production, and on exports in particular, rather than a tax on consumption. Whenever a new business is registered for VAT and immediately claims large VAT refunds over a certain level, the business should routinely be checked by the tax authorities to establish whether the business is genuine and its activities are legal. Alternatively, a requirement could be introduced for some transactions and risky VAT refund reclaims for a third-party processor to act as a clearer if a bank does not wish to perform this role.

Member States also use the reverse charge mechanism, placing VAT liability on the buyer rather than the seller (with the amount thus paid fully creditable against the purchaser’s liability on any subsequent sales), for business-to-business transactions in some sectors, to prevent VAT fraud (e.g. for mobile phones, computer chips, and other particular goods that have proved popular instruments for

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(24) See, e.g., Keen and Smith (2007) for a more detailed description of VAT fraud and possible measures to combat it.
5. Special topics

Box 5.2: Common forms of VAT fraud

“Acquisition fraud” (also called “contrived insolvency fraud” or “missing-trader fraud”) is a type of fraud in which the zero-rating of intra-community supplies is combined with the “deferred payment” mechanism for collecting VAT on acquired goods is exploited for economic crime by illegal claims of VAT refunds: A company (B) buys goods from a company (A) in another Member State (which export the goods without VAT) and sells the goods to a third company (C) (situated in the same Member State as company B) at a price including VAT. However, company B disappears before paying the liable VAT. In other types of fraud, a fake company simply claims VAT refunds based on fake invoices and then disappears. These types of fraud are typically carried out by organized criminals, moving between Member States to perpetrate the fraud.

“Carousel fraud” is another important type of fraud that exploits the zero-rating of intra-community supplies combined with the deferred payment of VAT on acquired goods: A company (B) buys goods from a company (A) in another Member State (which supplies the goods without VAT). Suppose the VAT-free unit price at which the goods are sold is €1000. Company (B) sells the goods to a buffer company (C) at a price shown as including VAT, say €1080 (€900 + €180 VAT) if the VAT rate is 20%. However, company (B) disappears before paying the liable VAT. The third company (C), which may be complying and know nothing of the fraud, is used to conceal the fraud. Company (C) sells the goods to a fourth company (D), say at a price of €1140 (€950 + €190 VAT), and pays the VAT of €10 (output VAT €190 – input VAT €180). The fourth company (D) pays this price including VAT on the purchase from the buffer company (C) and then supplies (ICS) the goods back to the original company (A) in the other Member State at a price of €980 (VAT exempt) and claims a refund for VAT on exported goods of €190; in effect it reclaims the VAT not paid by the disappeared company (B) (i.e. €190 – €10 = €180 which is 20% of the price company (B) had to pay on its sale to company (C)). In this example, all participants have a profit from the carousel arrangement. Every member of the chain, although some might not be aware of the fact that they take part in a chain of fraud, gets an advantage (namely the VAT is not paid to the government, but shared between the parties).

carousel fraud). However, reverse charging entails significant disadvantages. It de-facto converts VAT into a general sales tax, with the possible problem of cascading, a higher risk for revenues as no tax is collected if the final seller fails to pay VAT due and impediments for the free movement of goods and services.

The EU ‘Anti-Fraud Strategy’ launched in 2006(26) resulted in a short term action plan presented by the Commission in December 2008. (27) Since then the Commission has tabled all the legislative proposals announced in this action plan and the Council adopted almost all of them. The result is a range of new measures such as the creation of Eurofisc (28) and more automated exchanges of information which are about to enter into force or did so only recently. Furthermore, the Commission is elaborating on new ways of tackling fraud, i.e. the introduction of a quick reaction mechanism, strategies for improving voluntary tax compliance, measures for improving the administrative cooperation with third countries and studies on new tax collection systems. (29)

5.3. TAX EVASION BY PLACING FINANCIAL WEALTH IN TAX HAVENS

Negotiating the adoption of measures equivalent to those applied within the EU regarding information exchange with non-EU countries with strong banking secrecy laws is a high priority of the EU (see COM(2012) 351 final). The return to financial wealth in form of interests and dividends are taxable in the home country of the owner of the assets and in a few Member States the wealth itself is subject to a wealth tax. However, the existence of tax havens implies that wealth can be kept hidden from

(29) The Commission is currently working on extending Eurofisc and other measures to the direct tax area. See COM(2012)351 final.
the domestic tax authorities. The deregulation of international capital movement and technological progress has significantly reduced the cost of moving capital across national borders. With an increasing number of individuals now owning foreign financial assets, it becomes more difficult for domestic tax authorities to keep track of their residents’ tax base.

The Savings Directive (2003/48/EC) aims to ensure that a Member State can raise residence-based taxes on its citizens’ interest income in accordance with its domestic tax laws. The Savings Directive, however, only covers interest income and does not ensure information sharing regarding the size of deposits.\(^{(30)}\) Furthermore, coordination through the EU and OECD has led to the conclusion of a number of bilateral tax treaties with a scope for information exchange upon request. The incompleteness of treaty networks and the existence of non-cooperating offshore jurisdictions imply that tax evaders generally have the possibility to place assets in a jurisdiction that has no tax treaty with their country of residence and thereby also avoid the taxation of the interest income. See Box 1 for further details on the Savings Directive.

\(^{(30)}\) For the majority of Member States which share information on individuals’ interest income, the value of deposits can be approximated by applying an imputed return. For the remaining countries (Luxembourg, Austria and non-EU countries) which are not sharing individual information, but opting for a withholding tax instead, it is more difficult to assess the value of bank deposits concerned and to ensure that final taxation of a given individual is correct.
The Savings Directive has a limited scope and tax evaders may circumvent its provisions in a number of ways. Firstly, geographical coverage is partial; hence moving assets to a non-participating jurisdiction is a simple and effective evasion strategy. Secondly, transferring the formal ownership of assets to a trust in a non-participating jurisdiction suffices to fall outside its scope. Thirdly, since the currently applicable Savings Directive does not include a so called substance-over-form test(31), investors may engage in a type of income shifting whereby interest bearing assets are replaced with structured products with returns linked to leading interest rates. Although in substance such derivatives are identical to debt claims, their returns are not formally interest payments and are therefore not subject to the provisions of the Savings Directive.

On 13 November 2008, the Commission adopted an amending proposal to the Savings Taxation Directive(32) with a view to closing existing loopholes and better preventing tax evasion.(33) Exchange of information provides tax administrations with invaluable information on income received and assets owned by their taxpayers. The information can also be particularly useful for risk analysis purposes and can serve as an incentive to voluntary compliance. The use of automatic exchange of information should be promoted where it is the most useful. The Commission has developed computerised formats for savings income and is currently developing new formats for income covered by Directive 2011/16 in order to implement secure and enhanced automatic exchange of information within the EU. The EU has a key role to play in promoting its standard of automatic exchange of information so as to give support to developing international standards of transparency and exchange of information in tax matters.

(31) The substance-over-form principle is an accounting concept used to ensure that the economic impact and not the legal form is used as basis for determining tax liability etc.
(33) The content of the Amending Proposal is not yet fully agreed by Member States.
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## Table A.1: Institutional arrangements for tax administration

<table>
<thead>
<tr>
<th>Country</th>
<th>Nature of body ('/1')</th>
<th>Major tax types administered by the national revenue body/ multiple directorates/2</th>
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(*1) USB - Unified semi-autonomous body; USBB - Unified semi-autonomous body with formal board or advisory group comprised of external officials; SDBF - Single directorate in MOF; MDMOF - Multiple directorates in MOF

* Municipalities tax real property; Tax and Customs Administration taxes acquisition.

**Wealth tax since 2001 incorporated in PIT:**

Table notes: /1. Belgium- The Federal Public Service Finances is now comprised of six general administrations: 1) taxation; 2) collection and recovery of taxes; 3) serious tax fraud; 4) customs and excise; 5) patrimonial documentation; and 6) treasury; Cyprus, Luxembourg, Malta- There are separate directorates for Direct Taxes, Indirect Taxes, and/or Customs and Excise; Denmark- As of March 2010, the Danish Tax Administration has merged with the Danish Ministry of Taxation to form a single unified and autonomous tax administration with a corporate structure, headed by a single (internal) board chaired by the Permanent Secretary of the Ministry of Taxation; this integrated Danish revenue body is now officially referred to as the "Danish Ministry of Taxation" (Skatteministeriet); Germany- Major taxes are administered separately by 16 State (Länder) MOFs, and subject to co-ordination and supervision by the Federal MOF; additionally, a Federal Central Tax Office, subordinated to the Federal MOF, performs certain central functions; Italy- Tax administration functions are carried out by a number of separate government and partly government-owned bodies: 1) Revenue Agency (Agenzia Entrate); main stream operations), 2) Guardia di Finanza (tax fraud), 3) Customs Agency (excise and VAT on imports), 4) Equitalia Spa (tax debt collection), and 5) SOGEI (information processing); Poland- With common head, Secretary of State; Sweden- Swedish Tax Agency with advisory council;

/2. Belgium- Specific general administration of customs and excises; Estonia-Heavy goods vehicle tax; Finland- Excise and motor vehicle taxes administered by separate state bodies; Germany- Revenue bodies determine property values for real property tax collected by municipalities; the motor vehicle tax will be administered by the Länder tax administrations by means of the official delegation of powers to them until 30 June 2014; Netherlands- * Municipalities tax real property; Tax and Customs Administration taxes acquisition. **Wealth tax since 2001 incorporated in PIT; Spain- Revenue body collaborates only in some aspects; wealth tax was abolished.

Table A.2: Sources and uses of third party information on individual income

**Sources of Individual Income Information**

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<th>Source</th>
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<th>Pensions</th>
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**Uses of Individual Income Information**

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