Società italiana di economia pubblica

WORKING PAPER
No 313
aprile 2004

TAX ADMINISTRATION AND SHADOW ECONOMY IN EU NEW MEMBERS

VIKTOR TRASBERG
University of Tartu, Estonia

This paper is part of a wider research program on Taxation in EU New Members, carried on at University of Pavia, under the direction of L. Bernardi, M. Chandler and L. Gandullia, and the supervision of V. Tanzi.

JEL CLASSIFICATION: H20 – H24 – H25

KEYWORDS: Taxation – Tax Reforms – EU New Members

TAX ADMINISTRATION AND SHADOW ECONOMY IN EU NEW MEMBERS

by

Viktor Trasberg

University of Tartu, Estonia

Abstract

This paper is part of a wider research program on taxation in EU New members, directed by L Bernardi, M. Chandler and L. Gandullia under the supervision of V. Tanzi. As an urgent task, transition countries required a new tax system, which allows governments to collect sufficient amount of revenues to accomplish needed public expenditures. During the first periods of reforms institutional weaknesses of tax collection and large extent of shadow economy activities became serious obstacles for budget revenue. The paper gives an analysis of tax gap reasons, administration developments and shadow economy in transition countries. The paper begins with the introduction on tax administration problems; the second section introduces the concept of tax gap and depicts interrelations between tax administration, shadow economy and tax evasion. Tax avoidance is strongly correlated with high tax burden, which in turn drives budgets to deficit. Attempts to balance budgets through increased tax rates forces businesses to avoid taxes and leave official economy sector. Third section considers tax administration developments in the period of transition and institutional weaknesses on tax collection and gives need and foundations for institutional changes in tax administration. Fourth section outlines explosion of shadow economy activities during early periods of reforms, which characterizes all transition countries. Here are analyzed its particular reasons and circumstances in the transition countries.

JEL Classification numbers : H20, H24, H25

Key words: Taxation, Tax Reforms, EU New members,

E-mail Addresses: viktor@ec.ut.ee

Department of Public and Environmental Economics

University of Pavia – Italy – April 2004

1. Introduction and contents

This chapter of the research generalizes certain aspects concerning tax administration developments in New European Union member countries from Central Europe and the Baltic States. During the last decade all these countries have passed radical social and economic reforms to become full members of EU. One of the most difficult challenges in transition countries has been institutional build-up in line with general economic restructuring, privatization and stabilization activities. Nevertheless, developing a new tax system, establishing well-organized and fiscally capable revenue collection mechanism is not an easy task.

The inherited tax system by the former transition countries was not "generally suitable for gradual reform" (Taxation and transition 1994). During the command economy, resources for production of public goods were channeled primarily from state owned enterprises to government budget. There was no need for special revenue collection and resource allocation institutions other than central planning agencies or committees.

As companies became private, foundations for since existed government budget revenues declined radically. Moreover, in the situation of fast falling output and decrease of individuals real incomes the transition countries governments became fiscally trapped. Implementation of structural reforms and social protection required adequate funds for public spending but revenue basis disappeared or eroded. Therefore, governments in new emerging market economies had to adopt new principles of tax system and to establish efficient revenue collection institutions.

There have been developed certain criteria with which the efficient tax system and administration should meet[1]. Besides, researchers have analyzed different aspects of tax reform conditions, developments and results for transition countries[2]. Particularly, a new tax system in those countries must respond for the needs of expanding market economy, guarantee needed fiscal resources for government activities and distort as little as possible the entrepreneurial incentives (Taxation and Transition 1994). As

---

[1] Institutionally, EBRD, World Bank, International Monetary Fund, OECD and others have developed their recommendations and strategy for tax administration reforms. Relevant references are presented on the list of We-site sources.

[2] For example, Mitra and Stern (2003); Tanzi and Tsibouris (2000); Ebrill and Havrylyshyn (1999); Silvani and Baer (1997); Local And Regional Tax Administration In Transition Countries (2000).

general principle, tax administration should be organizationally efficient, and also transparent, understandable and logical for taxpayers.

Tax levels and administration procedures are also significant elements of investment environment. Entrepreneurs, planning investments, are concerned not only about the level of tax rates but also about tax related procedures and other tax system characteristics. As it has been said, "a revenue administration, that is perceived to be arbitrary or predatory, discourages investment" (Gill 2003).

Nevertheless, the majority of literature about the reforming tax system in transition countries concerns more about general tax policy developments and less attention is given how to reform tax administration organization itself (Local And Regional Tax Administration In Transition Countries 2000; Mitra and Stern 2003). Developing a new tax system is a wide scale time consuming and permanent process. For that reason, improving tax administrative capacity is still an imperative issue in all mentioned new EU member countries. It includes not only adopting new laws, founding new tax structure and radical improvement of tax administrative process, but also change of behavior of all involved parties – as well taxpayers and administrators[3]. It is crucial to create and strengthen a new “tax culture and ethics” as an important factor that supports well-organized tax administration[4].

Especially, the tax collecting capacity is directly correlated with scope of shadow economy activities. By the certain reasons, which will be discussed below, most of transition economies suffered from outburst of shadow economy activities in the early period of market reforms. High level of unofficial economic conduct limits potential budget revenues, destabilizes the public morale and has other various negative impacts on economy and society. Accordingly, progress of tax administration reforms in transition economies is widely related with getting control and thereafter reducing unofficial economic activities.

Above all, the chapter’s main focus is to draw interrelations between tax administration processes and shadow economy activities along with analyzing those

[3] General structure of activities needed for tax reform in transition countries is given on Tanzi and Tsibouris (2000*);* Local And Regional Tax Administration In Transition Countries (2000); Mitra and Stern (2003)

[4] More detailed analyses of the named concept is provided on the works of Alm and Martinez-Vazquez (2000); Nerre (2001), and Tanzi (2000).

issues in certain New EU member countries. Therefore, the paper is structured in following manner. After introduction, the second part presents a formal scheme to analyze tax gap reasons as weaknesses in tax administration and extent of shadow economy activities. The third part characterizes tax administration situation and developments on the period of transition and last part generalizes shadow economy activities in New EU member countries.

2. Shadow economy and tax administration

2.1. Tax gap reasons

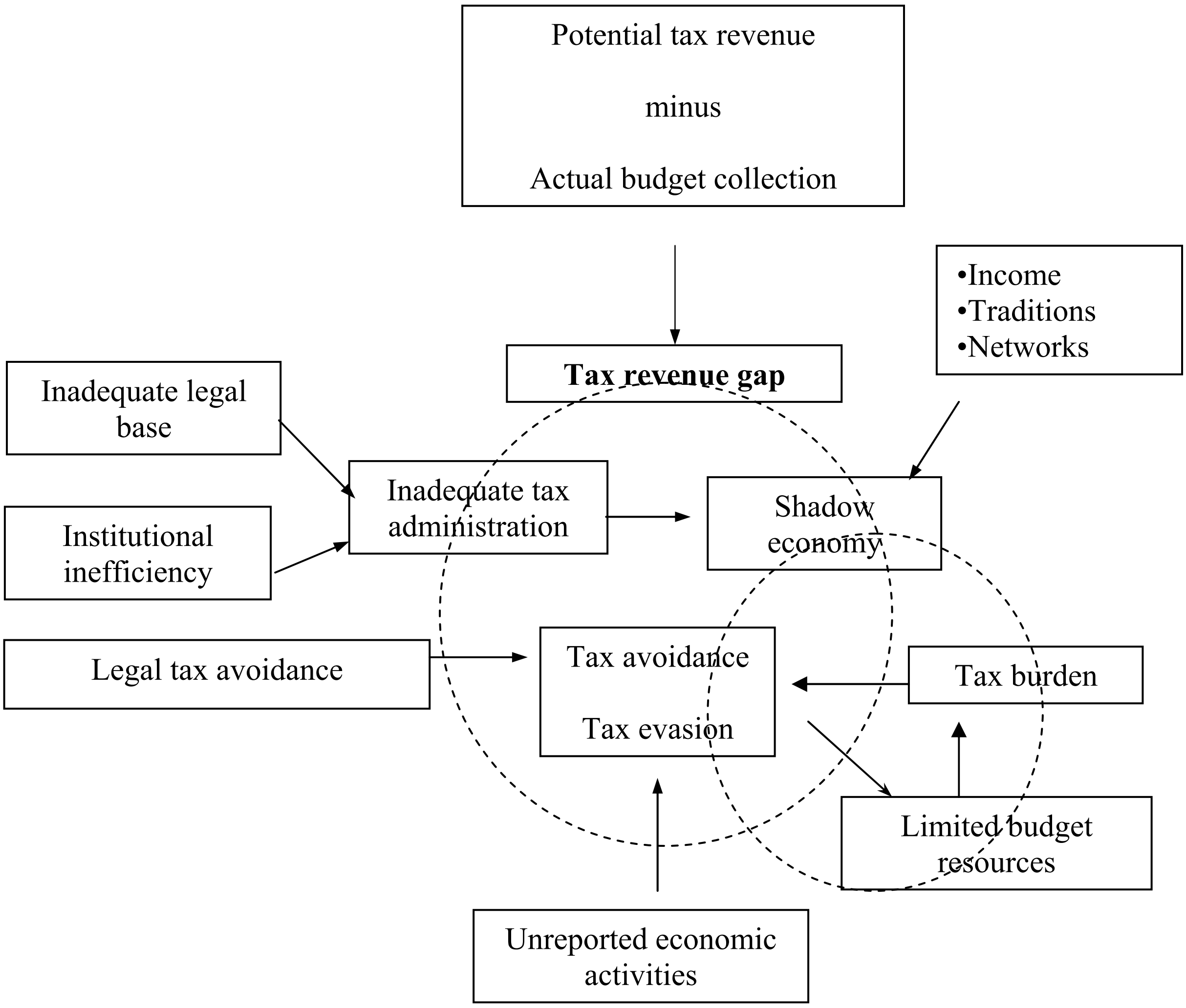
The most important task of tax administration is fiscal – to collect planned amount of tax revenues to cover needs for public expenditures. In reality, tax administrators in many countries are struggling with revenue administration inefficiencies, which not allow collect predicted amount of tax revenues. Therefore, tax administration should be improved continuously or reshaped totally as in the case of transition economies.

Widely recognized measure of the tax revenue service effectiveness became size of country's tax gap – the "difference between the tax that should be paid according to the tax laws… and the tax which is actually collected" (Silvani 1997).

There are several reasons for tax gap or taxpayers' noncompliance. Rationally, tax gap includes taxes not paid due to evasion; tax arrears; the shortfall in taxes due to taxpayers' misunderstanding of the tax laws and by other reasons (Silvani 1997*)*. Nevertheless, the exact size of the tax gap is complicated to calculate because it is not viable to obtain overwhelming data to estimate the precise potential tax base and predict tax subjects' compliance level. Particularly, the extent of tax gap largely depends on country's economical, political, historical and cultural circumstances. In the paper are focused on two important aspects of tax gap – inefficiencies related to tax administration and scope of shadow economy activities.

Scheme 1 visualizes main relations for tax gap as well depicts their interrelations and rationale. Circles on the scheme connect blocks, the activities on which are interrelated or interdependent. Further on, the scheme is taken as an explanatory tool for analyzing transition countries tax administration developments and scope of shadow economy activities.

Scheme 1. Tax administration and shadow economy



As mentioned, there are several reasons why potential tax revenues differ from actually collected ones. By the scheme, tax gap depends on inadequate tax administration and shadow economy activities, which both materialize on tax avoidance or evasion.

Tax administration cannot be efficient without comprehensive legislative basis, but beside the strong legal foundations for taxation, institutional aspect is also critically important. Tax administration means establishing capable tax collecting agencies; distributing employees among tax offices; maintaining information systems between governmental agencies; calculation and levying taxes; inspection of individuals and companies; solving contradiction between taxpayers and revenue administrators; charging penalties for noncompliant taxpayers and many other activities.

Therefore, tax collection institutions and agencies should be well organized, properly managed and capable. For example, taxpayers' noncompliance depends directly of the possibility of control of their activities records or incomes. As stated, "administrators overall effectiveness will be low if auditing are not effective in discouraging evasion" (Silvani 1997). However, post communist countries tax administration on early period of reforms characterizes with clearly inadequate and instable legal base in combination with inefficient tax administering. Technically poorly equipped tax agencies, low skilled and little motivated or even corrupt tax officials were reasons for unsatisfactory tax revenue collection.

To generalize, all aspects of tax administration must be continuously monitored and analyzed to make required improvements in the case of organizational and institutional inefficiencies. Particularly it is important on the circumstances greater than ever globalization of economic activities and widening difficult-to-tax business like Internet related commercial transactions.

2.2. Tax gap and shadow economy

There is an extensive literature what analyses shadow economy extent, reasons and impact on economy and society[5]. Researchers also have developed comprehensive taxonomy's of the conception of shadow economy[6]. Nevertheless, here we are concerning only those shadow economy aspects, which are related to tax evasion and not focusing on several other negative (or sometimes positive) results which are arising from unofficial economic activities. Therefore, here the term shadow economy is used to "refer to the value of economic activity that would be taxable were it reported to the

[5] Mentioned literature here include works of Schneider and Enste (2000), Johnson and Kaufmann (2001), Johnson, Kaufmann and Shleifer(1997), Lacko M., (1999)and Brooks (2001).
[6] For example Schneider and Enste (2000).

tax authorities" (Brooks 2001). Logically, the lager is the extent of shadow economy, the wider the gap between potential amount of taxes and their real collection.

What are the motives behind entrepreneurs shadow economy activities and individual's reasons to avoid reporting their incomes or cheat? By the common understanding, there is a mix of several reasons for existence of shadow economy activities (see also Scheme 1). Here are emphasized three aspects, which are considered also as related tax gap reasons.

First, different theoretical and empirical studies have proofed that extent of shadow economy activities is related with high tax burden on individuals and companies[7]. Some authors extend that cause and emphasize total government regulations burden as rationale for shadow economy (Johnson and Kaufmann 2001).

Staying outside of official economy and not reporting their incomes, individuals' will save considerable amounts of money, otherwise taken by governments as taxes. Similarly for companies, a possibility to hide from paying taxes maintains income and additionally gives them competitive advantage to compare with law-respectful companies. For example, companies might be motivated to use unofficial labor, which allows evading payments of social security contributions.

Second, several findings suggest that inadequate and weak tax institutions are reason for shadow economy activities[8]. In opposite, the adequate strength and efficiency of the government institutions declines extent of shadow economy. If there are poor legal foundations or law enforcement is weak and unstable, then motivation and opportunities to avoid taxes will increase.

Making tax administration stronger does not automatically mean that government should just add number of tax laws and statutes or toughen law enforcement. There is a risk that increased regulation makes tax system more complex and enhances power of bureaucracy. Particularly, in situation of fragile democracies in transition countries, stronger government action might lead to increased tax noncompliance, depressed entrepreneurial activities and corruption. Extent of corruption is one clear reason that limits government's ability to collect taxes (Tanzi and Tsibouris 2000; Johnson and Kaufmann 2001). Corruption undermines societies trust to tax authorities, distorts and

[7] All earlier mentioned authors emphasize if tax burden as a main reason for shadow economy activities.
[8] For example, Tanzi and Tsibouris (2000); Schneider and Enste (2000); Johnson and Kaufmann (2001).

decreases transparency of the economic environment and therefore turns down both domestic and foreign investment. Worldwide, tax administrations constantly figure near the top of public-sector organizations with a high level of corruption (Gill 2003).

The third group of reasons explains shadow economy activities on the ground of societies historical traditions and mentality. For example, “social networks, personal relationships and high profit from shadow economy activities” are strong motives, which keep away people from working unofficially (Schneider 2000). By some means, supportive main-set towards shadow economy demonstrates also citizen’s distrust or ignorance against the state. Due to earlier harmful experience, former post-communist countries had clearly many reasons not to trust their governments. Therefore, shadow economy should be considered as “natural wrongdoing” which exists always and cannot be replaced completely. The question should be focused in another way - how to diminish its scope and turn down its negative consequences, particularly to societies' tax collecting abilities.

2.3. Tax avoidance and erosion

Weak tax administration and underground economy activities both become visible as tax avoidance and tax evasion (see Scheme 1). Tax avoidance is here defined as attentive activities of businesses or individuals to minimize their tax burden. Tax avoidance includes, for example employee discounts, fringe benefits, all do-it-yourself work and neighbor help (Local And Regional Tax Administration 2000; Schneider and Enste 2000). Usually those activities are not illegal, however, inadequate or unclear law implicitly supports tax escaping.

Legal tax avoidance happens if it is possibility to use loopholes in tax laws. Often that is possible in combination of complexity of tax laws and inexperienced tax officials. As examples serve wide use of *offshore* companies in transition countries for business dealings to avoid taxes or great difficulties to tax properly sophisticated stock market transactions.

Paradoxically, in one hand, sophisticated and detailed tax regulations can cover more largely all possible income sources and economic transactions, but on other hand, may provide additional possibilities to legal tax avoidance. For example, there are drawn causality between complexity of income tax system and its impact on shadow economy (Schneider and Enste 2000). They conclude that sophisticated tax system creates possibilities to legal tax avoidance due to tax exemptions, but as positively, decreases labor supply in a shadow economy.

In contrast, tax evasion is identified when taxes, imposed on individuals or businesses, are just not paid and thus is committed an illegal act. Tax evasion includes unreported income from self-employment or different and other business activities. Tax evasion means therefore principal cheating and namely considered as shadow economic activities.

Tax avoidance and erosion are directly related to potential budget revenue shortage[9] (see Scheme 1). Limited budget revenue is cutting government's abilities to put into practice its spending policies - provision of public services and implementing welfare programs. As a short-term reaction, governments are making efforts fulfill the budget shortage by increasing taxes rates. In turn, higher tax burden distorts tax subjects´ economic conduct and may expand tax evasion and shadow economy activities. As literature points out, a spiral like movements can take place on such circumstances - decrease in tax revenue collections will force governments to increase tax rates, which again opposed by the taxpayers with attempts to evade taxes (Schneider and Enste 2000).

To some extent, closing tax loopholes by governments can reduce legal tax avoidance and illegal tax evasion. However, too strong and bureaucratic tax administrations bring risks that tax base will distorted. Particularly, in transition economies "too heavy-handed approach in dealing with tax evasion could damage dynamism of small business and the informal sector" (OECD 2000).

[9] The term here is used is to make difference from term "budget deficit", which has more specific meaning

3. Tax administration situation and developments in the period of transition

3.1 Structural changes and decline of government

Organizational principles of command type of economies are widely presented on literature concerning transitional societies. In those societies, centralized planning system regulated resource allocation, production decisions and public spending (Tanzi, and Tsibouris 2000). Majority of financial flows required for public needs were generated by the state owned enterprises as “surpluses” of their economic activities. These surpluses were captured by the state budget, using mixture of taxes like turnover taxes on goods, “profit taxes” and payroll taxes (Taxation and Transition 1994). Those “taxes” were mainly as individualized “normative” by enterprises or industries for fiscal transfers to the centralized budget. Planning bodies were able directly control and distribute enterprises finances due the limited number of production entities. As resource for funding social and public programs were amounted directly by the planning institutions, there was no need for (tax) revenue administration.

Governments’ expenditure size in former communist countries was remarkably high if compared to EU average level on early 1990s. At the beginning of reforms in 1989-1991, government expenditure covered in many countries more than 50 per cent as weighted against of GDP level (see Table 1).

Table 1 Consolidated government expenditure, per cent of GDP, average level per period

	1989-1991	*1992-1994*	*1995-1997*	*1998-2000*	*2001-2002*
Czech Rep.	59.6	48.2	42.4	42.2	45.4
Slovak Rep.	59.6	55.8	45.9	43.9	48.1
Hungary	58.2	62.0	50.3	47.4	52.3
Poland	45.5	50.0	47.1	42.4	43.9
Slovenia	44.3	46.2	43.4	43.7	42.6
Estonia	33.8	36.5	39.9	40.7	37.7
Latvia	42.0	33.9	40.7	43.1	38.0
Lithuania	47.3	31.2	34.5	37.2	31.6

Source: Transition Reports on years 1994, 1997 and 2003 and authors’ calculation

As a part of market reforms rationale in all transition countries, the economic role of government started to downturn remarkably in the course of transition. Many functions of government just disappeared or were given to private economic agents. Along with state role declining in economy, as well decreased its expenditure share in GDP. In average, the Baltic countries government expenditure size in GDP has been lower than in Central European transition countries.

But beside the natural process of government sector decline, other factors also limited government's expenditure capacity. Namely, at the beginning of reforms most of the governments in transition countries were just not able to collect as much revenues to continue with previous expenditure level. Two reasons of that must be are pointed out - collapse on former budget revenue funding principles and impulsive explosion of shadow economy activities.

Preceding revenue collection principles were practically paralyzed and traditional "tax" base disappeared in most of transition countries. Soviet type enterprises, previously the main taxpayers, were economically instable and their activities declined sharply. In addition, in early 1990s, total output fell in all transition countries. As pointed out by studies, emerging of new firms in the private sector could not generate immediately enough tax revenues (Local And Regional Tax Administration In Transition Countries 2000).

In addition, legal base for tax collection was insufficient and tax law enforcement remarkably weak. As properly mentioned, "old system is largely gone, but a new system (was) far from coming into existence. Thus…a kind of institutional vacuum has developed" (Tanzi, and Tsibouris 2000 p.3).

In present-day terms, tax-administrating institutions were missing or in were emerging stage in most transition countries. Personal income taxation was in infant phase and consumer taxes (VAT, excises, other) missed in most of the transition countries.

As well, tax administration institutions were often incapable in the situation of unprecedented explosion of shadow economic activities. New emerging private sector had strong incentives not to declare their revenues and also "outstanding" inventiveness to find and use tax law weaknesses. Success in encouraging new private companies by governments to report about their incomes was insubstantial and as a result, extensive tax evasion took place.

3.2 General government fiscal balance

Despite the fact that most governments of transition countries cut their expenditure in the period 1989-1991, most of them were not able to keep general government budget balanced[10]. Transition countries general government balance during the transition years is presented on Table 2.

Table 2 General government balance, (in per cent of GDP), average per period

	1989-1991	*1992-1994*	*1995-1997*	*1998-2000*	*2001-2002*
Czech Rep.	-1.4	-0.4	-1.8	-3.2	-5.9
Slovak Rep.	-1.4	-7.3	-2.0	-7.2	-7.3
Hungary	-1.1	-6.5	-5.5	-3.9	-7.0
Poland	-3.6	-5.3	-3.2	-3.3	-6.1
Slovenia	0.9	0.2	-0.5	-1.2	-2.2
Estonia	3.4	0.1	-0.2	-1.8	1.0
Latvia	3.1	-1.0	-1.8	-2.6	-2.4
Lithuania	-4.4	-2.8	-3.6	-5.7	-1.6

Sources: Transition Report, 1994, 1997,2003 and authors' calculations

There is no common level on government budget disbalance for all transition economies during the years 1989-2002. One group of reformer countries like Estonia, Latvia and Slovenia, were able to cut their expenditures and maintained balanced or low deficit even in the situation of considerable decline of output and decrease of government revenues on years 1989-1994. Another group of countries (Hungary, Poland, Lithuania) failed by different reasons cut radically government expenditures and therefore suffered from larger budget deficits.

All countries general government budgets, except for Estonia, were on deficit during the period 2001-2002. During recent years New European Union members had to implement costly structural reforms to be qualified with EU and NATO requirements.

[10]Only Hungary and Poland had on period 1989-1991 full control over their national budgets, all other selected countries were on that time as parts of federal countries.

Necessary structural reforms include implementation of pension and healthcare reforms, improving environment protection and infrastructure functioning, accomplish with military and other reforms. As Table 2 presents, government's budgets deficit were during 2001-2002 even bigger than a decade ago.

3.3 Tax administration reform in New EU member countries

3.3.1 Tax administration reforms

Reforming or improving tax system and administration is not only transition or developing countries' problem. Also, governments in developed countries meet continuous pressure to modernize tax system in order to keep their economies competitive and collect adequate resources for social programs.

Nevertheless, clear difference between developed EU and transition countries was the time limit, within the new tax systems must put into operation. Transition countries required new tax system and institutions promptly - to replace without delay the old revenue system. There was no time and possibilities for gradual improvement or experimenting with existing tax arrangements. Building up a new and efficient tax administration system is not an easy task in the situation of fast collapse of half a century existed economic and social organization.

As a matter of fact, fast reforms brought very essential changes to individuals' and companies' activities. Equally in personal and business level, in many transition countries tax obligations were entirely new phenomenon and additional burden during the period of radical reforms and falling living standard. Obviously one of the reasons for individual taxpayers high noncompliance was also lack of experience with tax reporting. In addition, attitude towards tax authorities was not very grateful.

As mentioned, it was an urgent need in transition economies to establish a tax system that can respond to the conditions of the market economy and assure funding government programs in the situation of fast decline of production. Success of the reforming tax administration and increasing tax-collecting capacity was directly related with achievements in general economic reform. Privatization, economic restructuring and stabilization activities influenced build-up of new taxation system and forced continuously develop its legal foundations. At the same time, progress in tax system reforming has positive impact on attraction of foreign investments, stabilization of government finances systems and declining of shadow economy.

Reforming tax administration was highly dependent from government's political commitment and its capability to make radical and fast changes. As was mentioned by the United Nation Economic Commission for Europe, the prospect of EU membership has had an enormous impact on the process and nature of tax reform in these economies, especially in more recent years before they became EU members (Tax Reforms in the EU Acceding Countries 2004).

Nevertheless, while the New EU member countries have developed modern tax policy and legislation, the institutional changes of tax administration delayed that of policy. This is due, "not only to a greater focus on changes in (tax) policy rather than administration in the early years of transition, but also to the fact that demands on administration arising from changes in tax policy would usually precede development of supporting institutions" (Mitra and Stern 2003). Considering that, shaping frames of tax reforms should consider imminent European Union membership and therefore increase their administrative capacity and institutional efficiency.

3.3.2. Institutional efficiency

Tax administration inefficiency in transition countries was caused by legal, institutional and managerial weaknesses. These are interrelated components, which must be improved to increase effectiveness of the tax procedures generally.

Legal aspects of tax administration means that law should adequately cover the taxation related issues and sufficiently proceeded. Most of transition countries loopholes in tax law have been as obstacles for efficient revenue collection. Tax laws and regulations have changed often due to fast changing economic environment. Also, law has not been enough strong, which would allow authorities successfully pursue cases of tax evasion through the courts (OECD 2000). At the same time, driven by administrative considerations, tax legislation should be given simple as possible not to devastate new entrepreneurial incentives and confuse unsophisticated taxpayers.

Institutionally, increase of tax administration efficiency as many similarities with business organization and consists many specific characteristics[11]. Generally, capable institution requires clear vision of its functions and organizational structure; rational allocation of employment and professional management; improvements in technology and better client service.

Tax administration institution should have appropriate autonomy and its responsibilities and organizational structure exactly defined. Studies in transition countries have revealed disorganized coordination between tax administration agencies, unclear administrative power and inadequate delegations of responsibilities and illogical distribution of employees by bureaus and departments (Local And Regional Tax Administration In Transition Countries 2000).

In managerial aspects, revenue collection offices in transition economies are often poorly equipped and managed. The problem is inappropriate use of modern computer and office technology; ineffective use of available information to control non-compliance; weak collection enforcement and the existence of corrupt practices. Often motivation of tax authorities employees was weak due to low salaries and unpleasant working conditions (Local And Regional Tax Administration 2000).

Nevertheless, tax administration has strengthened in all New EU members and improved towards a purpose oriented, functional and efficient tax collection institutions.

4. Shadow economy and noncompliance

4.1 Explosion of shadow economy

As economic activities moved outside the state sector, a match between government revenue and expenditure side became problematical in all transition economies. In addition, as living standards generally fell, governments faced pressure to increase expenditure despite at the same time as economic downturn swept tax base. Emerging private sector wasn't able to produce suitable amount of revenues to fulfill the revenue gap.

[11] For example, detailed description of activities required tax administrative institutions is given on Local And Regional Tax Administration In Transition Countries (2000).

Attempts to increase existing tax burden followed by large-scale tax avoidance and growth of unofficial economic activities. Then taxpayers became "subject to an ever greater tax pressure…prompting many to withdraw from business or to opt for the underground economy" (Åslund 2003).

Therefore, then radical reforms began on early 1990s; all transition economies met fast increase of shadow economy activities. Shadow economy included very wide range of activities – from "innocent" unreported labor activities to severe criminal actions. Many of those activities were related with tax evasion, tax fraud and corruption.

Table 3 presents average level of shadow economy on transition countries on first half of the 1990s. To estimate level of underground activities, there can be used different methods[12]. As table shows, countries' results are unlike due to various methods are used by different researchers.

Table 3. Size of shadow economy in transition countries, as GDP level, per period

Country	*1990-93*	*199-95*
Czech Rep.	13.4 (28.7)	14.5 (23.2)
Slovak Rep.	14.2 (30.6)	10.2 (30.2)
Poland	20.3 (31.8)	13.9 (25.9)
Hungary	30.7 (30.9)	28.4 (30.5)
Slovenia	- (28.5)	- (24.0)
Estonia	23.9 (35.9)	18.5 (37.0)
Latvia	24.3 (34.9)	35.3 (43.6)
Lithuania	26.0 (38.1)	25.2 (47.0)

Sources: Scheneider and Enste(2000) and here used studies of Johnson, Kaufmann and Shleifer (1997); Lacko (1999). Estimates are given in brackets.

Figures presented by Schneider and Enste show smaller level of shadow economy activities then those estimated by Lacko. As the table presents, estimated level of total underground activities varies about 13 percent in Czech Republic to more than 38 percent in Lithuania on period 1990-93. The period later, the average size of the shadow economy was about the same in Central European States but even increased in the

[12] Methods described by Schneider and Enste(2000); Brooks (2001)

Baltic States. However, level of shadow economies remain high in most of transition countries and hence had negative impact on potential government budget revenues.

Explosion of shadow economy in combination with falling output and disappearing tax base created immediately problems with of budget revenues. The turn to shadow economy undermines tax base and makes it hard for the state to provide important public services such as infrastructure development, social programs and health care.

4.2 Decrease of shadow economy in New EU member countries

As was noticed above, there are many reasons behind tax avoidance and shadow economy activities. Concerning possibilities to decrease shadow economy in the transition economies, three general aspects are emphasized here.

First, apparent excessive tax burden of individuals and businesses is the main reason, which makes tax evasion as “sin worth to commit it”, particularly in the situation where government lacks the capability to enforce proper compliance, emerging businesses. Contrarily, the experience of the Baltic States suggests that high tax rates have encouraged informal economic activities and discouraged formal employment (OECD 2000). Increase of tax and government regulation burden in low-income transitional societies is resisted more strongly than far richer societies[13]. Therefore, optimal level of tax rates keep businesses to on official economy and individuals are not so hostile to report about their incomes.

Second, a high level of regulations, bureaucracy and corruption, generalized as burden imposed by government, is realized to be even stronger reason for rise of shadow economy than high marginal corporate or personal income rates (Johnson and Kaufmann 2001). Fast demolishing and formerly strongly centralized political and economical system left a gap before new democratic institutions were capable to govern the society efficiently. As a result, uncertain legal environment and lack of democratic control over institutions was followed by the increase of bureaucracy and corruption. Buildup of efficient administrative institutions is a relatively slow process and requires remarkable legal, administrative and behavioral activities. Nevertheless, as economic and social reforms have progressed, most of the transition countries have experienced a

---

[13] Johnson and Kaufmann (2001)

general shift towards formal activities (OECD Baltic States 2000; Local And Regional Tax Administration In Transition Countries 2000).

Third, there is need to create and promote widely recognized by the society tax “ethics” and social "norms ", which support law-respectful behavior. The existence of such norms suggests, that individuals will comply with tax responsibilities because they believe that it is the good social behavior[14]. The tax an administration should shape individuals’ and entrepreneurs’ behavior towards loyalty with their tax liabilities and therefore, incorporate them into official taxpayers "society".

Taking consideration of new EU members’ post-communist legacy, there has been prevailing a mutual mistrust between taxpayers and the tax authorities, which materialized on absence of tradition of voluntary compliance with tax liabilities. Perceptively, enhancing trust in the fairness of the tax administration would encourage voluntary compliance (Mitra and Stern 2003). Based on that, transition countries tax administration reforms has been targeted to wide recognition of voluntary compliance, the self-assessment of tax obligations by taxpayers and clearly defined rights and obligations both of the tax authorities and the taxpayers. Hunting noncompliant taxpayers and strong punishing tax evaders are not in themselves as the main objectives of the tax administration. Successful administrations make the taxpayer community realize that non-compliance will be detected and effectively punished (Silvani 1997).

In conclusion, in the course of economic reforms and strengthening of government capability, tax administration has increased efficiency and amount of taxes in most of New EU member countries. The goal of harmonizing their systems of public finance with those in the EU has provided was one of the most important catalysts of the reforms (Tax Reforms in the EU Acceding Countries 2004). In line with decrease of tax burdens, taxpayers-friendly tax procedures and transparent government activities, the extent of shadow economy activities decreased in all former transition countries.

[14] More detailed explanation of the concept is provided by Alm and Martinez-Vazquez (2000); Tanzi and Tsibouris (2000); Brooks (2001).

References

Alm, J. and Martinez-Vazquez, J. (2000) *Institutions, Paradigms, and Tax Evasion in Developing and transition Countries*, World Bank Internet Homepage www.worldbank.org/wbi/publicfinance/publicresources/

Åslund, A. (2002) *Building Capitalism,* London: Cambridge University Press.

Brooks N. (2001) 'Key Issues in Income Tax: Challenges of Tax Administration and Compliance' Asian Development Bank 2001 http://www.adb.org/Documents/Events/2001/Tax_Conference/paper_brooks.pdf

European Bank for Reconstruction and Development, (1997) , *Transition Report 1997* , London: EBRD.

European Bank for Reconstruction and Development, (2003) , *Transition Report 2003* , London: EBRD.

Gill, J. (2003) *The Nuts and Bolts of Revenue Administration Reform*, The World Bank Complement for presentation on Revenue Administration Reform January 2003, Washington D.C.: World Bank http://www1.worldbank.org/publicsector/tax/NutsBolts.pdf

Johnson, S. and Kaufmann, D. (2001) *Institutions and the Underground Economy* in *A Decade of Transition: Achievements and Challenges,* edited by O. Havrylyshyn and S. M. Nsouli, Washington D.C.: International Monetary Fund.

Johnson, S., Kaufmann, D. and Shleifer, A. (1997) *The unofficial economy in transition*, Brookings Papers on Economic Activity No 2 (1997) Fall, Washington D.C: The Brookings Institution.

Lacko M. (1999) *Hidden Economy an Unknown Quantity? Comparative analyses of Hidden economies in Transition Countries in 1989-95*, Working Paper 9905, Department of Economics, University of Linz, Austria.

Hôgye, M (ed) (2000) Local And Regional Tax Administration In Transition Countries , Budapest: OSI Publications.

Mitra, P. and Stern, N. (2003) *Tax Systems in Transition*, WB Working Paper 2947, Washington D.C.: The World Bank.

Nerré B. (2001) *The Emergence of a Tax Culture in Russia*, paper presented at "The 57th Congress of the International Institute of Public Finance: The Role of Political Economy in the Theory and Practice of Public Finance" in Linz, Austria, August 27-30, 2001.

OECD (2000) *Regional Economic Assessment: The Baltic States*, Paris: OECD.

Schneider, Fr. and Enste, D. (2000) *Shadow Economies Around the World: Size, Causes and Consequences,* IMF working paper, WP/00/26, Washington, D.C.: The International Monetary Fund.

Silvani, C. and Baer, K. (1997) Designing Tax Administration Reform Strategy: Experiences and Guidelines, IMF working paper, WP/97/30, Washington, D.C.: The International Monetary Fund.

Tanzi, V. and Tsibouris, G. (2000) *Fiscal reform over ten years of transition*, IMF W.P. WP/00/113, Washington, D.C.: IMF.

Tax Reforms in the EU Acceding Countries (2004) in *Economic Survey of Europe 2004* No1, Geneva: Secretariat of the Economic Commission For Europe.

Taxation and transition (1994) in *Transition Report 1994*, European Bank for Reconstruction and Development, London: EBRD.

Web-sites

http://www.imf.org/ - International Monetary Fund

http://www.oecd.org/ - OECD Tax Administration

http://www1.worldbank.org/publicsector/tax/ - World Bank *Tax Policy and Administration*