

From Shadow to Formal Economy: Levelling the Playing Field in the Single Market

Presentation of Study
Committee on the Internal Market and
Consumer Protection
27 June 2013
Brussels

Structure of the presentation

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- Data issues
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Objective of the study

Key objectives of the study

- Provide **information on the size of the shadow economy** and the extent to which the **Internal Market** is affected by it
- Quantify, based on existing (limited) data the **tax gaps** in the **services sector**, the **customs gap** and the **VAT gap**
- Examine the contribution of a **reduction of the shadow economy** and the tax gaps to the **re-launching of the European economy**, focusing on the central role of the **Internal Market**
- Review **potential measures** to reduce the shadow economy

What is the shadow economy?

- The study defines the **shadow economy as comprising the activities of businesses and individuals who fail to comply with taxation laws and / or regulations and laws governing business activities**
- It includes illegal activities involving the supply of legal goods and services (for example, smuggling) but excludes illegal activities involving the supply of illegal goods and services (such as for example drugs)
- Tax evasion is included in the shadow economy but legal tax avoidance is not

Data issues – a major problem

- **Data are very scarce, and often only partial**
- In the case of the overall size of the shadow economy, there are no pan-European comprehensive statistics – need to rely on studies by Friedrich (academic specialising in the measuring the shadow economy), including for the DG Taxud
- For customs revenues, only source at the present time is annual report by EC on own resources – but incomplete as covers only detected tax evasion/fraud
- In the case of VAT, again only one pan-European study (by Reckon for DG Taxud)
- Bottom-line: data are very limited, and in may capture only the tip of the iceberg -> **need to be cautious when looking at shadow economy data and much more effort should be devoted to collecting / generating data on shadow economy**

The shadow economy in the EU27

- The shadow economy in the EU is estimated to be equal to **18.4% of GDP in 2012 or €2.35 trillion**
- The size of the shadow economy varies substantially across the EU

Size of the shadow economy as % of official GDP figure

Less than 10%	AT, LU, NL
10% to less than 15%	UK, FR, IE, FI, DE, DK, SE
15% to less than 20%	SK, CZ, BE, ES, PT
20% or more	IT, HU, SL, EL, PL, MT, CY, LV, EE, LT, RO, BG

Negative impacts of the shadow economy - summary

- It **undermines the functioning of the Single Market and its regulatory framework**
 - economic operators in the shadow economy typically do not comply with various laws and regulations aimed at regulating markets, protecting consumers, employees, and the environment
- Governments face **significant tax revenue losses**
 - such losses imply that the current spending cuts and tax increases implemented to reduce budget deficits are larger than they would be if all tax revenues due were effectively collected
- **Important social and economic programs, including those co-financed by the EU, may fall short of funding**

Negative impacts of the shadow economy - summary

- **Lower operational costs in the shadow economy**, resulting from tax evasion and non-compliance with regulatory requirements, **distort the level-playing field** in the Single Market between businesses and individuals operating in the formal and the shadow economy
 - Both within domestic markets and cross-border
- Over the **longer run**, the shadow economy generates **productive inefficiencies**
 - **Holds back potential of EU economy**

Tax gaps – an important consequence of the shadow economy

- A **tax gap** is the **difference between the level of tax collected and the total tax owed**
- This difference results from two types of activities, namely tax avoidance (which is legal) and tax evasion (which is illegal). Tax evasion is typically by far the largest component of a tax gap
- Therefore, tax gaps are important indicators of the size of the shadow economy
- **Unfortunately, there exist very few estimates of the total tax gaps at the pan-European level**

Tax gaps – an important consequence of the shadow economy

Tax	Size of the EU27-wide tax gap
All taxes in economy	€850 billion
Total taxes (VAT, income tax, etc.) in the services sector	€297 billion in 2011
Customs	€387 million in 2011 (only identified irregularities and fraud) (EC report) But, €10 billion loss caused by cigarette smuggling (Europol)
VAT	€120 billion in 2011

Reduction of the shadow economy and re-launch of the European economy / Single Market



- According to specialised studies, about 1/3 of the volume of activities in the shadow economy would continue to take place in the formal economy following an elimination of the shadow economy

Reduction of the shadow economy and re-launch of the European economy / Single Market

- **Elimination of shadow economy would strengthen Single Market by:**
 - bringing about a more **level-playing field** in the Single market, both as regards domestic and cross-border activities
 - ensuring that **consumers, legitimate businesses, and employees are better protected**, as compliance with various consumer, employment and environmental laws and regulations increases
 - increasing the **efficiency** of the allocation of economic resources in the Single Market, spurring productivity and long term growth

Reduction of the shadow economy and re-launch of the European economy / Single Market

- Elimination of shadow economy would also **reduce tax gaps** and generate additional revenues for governments - could **raise €285 billion in additional tax revenues annually**
 - reduce the level of taxation faced by economic agents in the formal economy or increase government spending or reduce the budget deficit, or a combination of the three
 - this will impart a positive stimulus to the economy – there exists considerable uncertainty about the precise size of the impact but it is very real

How to tackle the shadow economy - the services sector

- **Implementing administrative reform and simplification of compliance**, in particular through a **widespread use of electronic solutions and e-governance services**
- **Strengthening administrative and financial surveillance**, with particular emphasis on **assisted ex-ante compliance with a special focus on reducing compliance costs for SMEs**
- **Ensuring deeper and better cooperation between Member States**, with **automatic exchange of information**

How to tackle the shadow economy - the services sector



- **Promoting electronic payments as opposed to cash payments**
- **Reducing the financial attractiveness of operating in the shadow economy**
- **Implementing awareness raising activities and encouraging industry agreements**

How to tackle the shadow economy - customs

- The **current reform of the European customs**, if coupled with appropriate ICT solutions and effectively carried out, has the potential to decrease the shadow economy
 - Two special ECA reports identified a number of issues and deficiencies in current customs system
- **However, the recast** proposed by the European Commission **will substantially delay this important reform** - initial estimates of cost of postponement are significant
 - Phased implementation would be a way to reduce magnitude of such cost – key will be to ensure that UCC is ready for implementation in 2020 (unlike situation in 2013)

How to tackle the shadow economy - customs



- The **improvements in information technology (IT)** which were part of the scope of the Modernised Customs Code (MCC), and will be part of the UCC, if properly applied, are likely to bring benefits thanks to, *inter alia*, the **“single window concept”**
- Other potential options include:
 - the use of **radio-frequency identification (RFID) technology**
 - **real-time automation of cross-EU reporting** for filing declarations and surveillance of products

How to tackle the shadow economy - VAT

- Reforming VAT and strengthening the VAT system by adopting **better information and communication technologies in order to make it easier a) for taxpayers to comply and b) tax authorities to monitor economic transactions**
- It would be beneficial to **review the way in which VAT is collected in the EU**
 - A **combination of a “limited” data warehouse and the split payment system** would be most effective
 - This is due to the fact that the data warehouse model allows tracing transactions on a (near) real-time basis and the split payment system will enable authorities to block funds for certain transactions

How to tackle the shadow economy - VAT

- Increased use of
 - e-payments
 - e-invoicing
 - automated-real-time reporting
 - interconnected business registers and other national directories
- European-level cooperation and coordination, such as data sharing and mining
- Overall, it is essential to have better data – need to improve statistical and tax reporting and the integration of VAT systems, and allow for automatic exchange of data

7 Recommendations

1. Estimates of the size of the shadow economy and tax gaps in the various sectors of the economy should be developed more systematically to provide a **better evidence base for targeting policy and enforcement action**
 - There is a need for an **in-depth overhaul of European and national law and regulation in the areas of customs duties, VAT, auditing, tax and statistical reporting**
2. The EU should adopt a specific target to **reduce the shadow economy to 5% of the EU economy by 2020 and further reduce it to 2% by 2025**
 - Measures to achieve such objectives could include an **obligation to use electronic payment means** to settle transactions above a certain threshold and introducing a **split VAT system**

7 Recommendations

3. The European Commission should present **an urgent and comprehensive legislative package proposing reforms aimed at curbing the shadow economy** and levelling the playing field in the Single Market
4. The European Court of Auditors should take a **more focused stand on the deficiencies that exist in the collection of resources (customs and VAT) for the European budget**
5. The various measures should be subjected to detailed cost-benefit analysis for early implementation, including IA of postponement of UCC

7 Recommendations

6. IT developments have opened new avenues and means of fighting tax evasion and should be used to the fullest when appropriate

7. Ensure availability of appropriate human resources and infrastructure to avoid jeopardising the necessary reform process