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THOUGHTS ABOUT TAX GAP, THE TAX COMPLIANCE AND EFFICIENCY OF THE TAX SYSTEM

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A tax is a fine for doing well, a fine is a tax for doing wrong.

— Mark Twain

What happens if taxpayers do not voluntarily pay the "fine" for their good work?

Then there is a loss of revenue collections -- "tax gap". The tax gap is the difference between the amount of tax actually paid and the maximum amount of tax that could theoretically be collected if all relevant activities, income and assets were taxed at the standard tax rate and if all taxpayers have paid their tax obligations fully and correctly.

The difference between the amount of tax that is actually paid and the amount of tax that should be collected if all taxpayers pay the exact amount of tax that they owe under current laws is only one component of the tax gap, known as the "compliance gap". The compliance gap consists of: *assessment gap* and *collections gap*. Some taxpayers make simple mistakes in calculating tax, recording business transactions or filling out tax returns, despite being honest and wanting to fully comply. But the compliance gap includes a series of "dishonest" and undesirable behaviors - unpaid tax obligations, tax avoidance schemes, distorted legal interpretation of regulations, tax evasion and crime.

Unpaid tax liabilities – tax arrears, which the tax administration writes off due to the inability to collect them, represent a permanent loss of tax revenues, for example due to the termination and exit of some taxpayers - legal entities from the legal turnover. *Tax avoidance* schemes exist when the operations of taxpayers "seemingly" comply with the law, but are not in the spirit of the law, i.e. include tax planning for the use of tax rules to obtain some benefits, advantages, etc., especially through artificial transactions that do not have direct commercial or other business purposes. And a wrong legal interpretation of the laws can result in losses of tax revenues. This means, first of all, the methodology for calculating the amount of tax owed and the accounting treatment of transactions, for example in the case of the payment of benefits, the right to deduct VAT, transfer prices, etc.

A tax gap also results from tax evasion as the illegal behavior of taxpayers who intentionally omit, conceal or misrepresent information in order to reduce their tax obligations (eg understatement of income), as well as from organized criminal activities, such as what are frauds during VAT refunds, smuggling of goods, etc.

What is the other component of the tax gap?

The other component of the tax gap is the policy gap. The tax policy, translated into the current tax laws, regulates all elements of the tax base that should be taxed in practice. The difference between the tax calculated on this tax base determined in the tax laws and the tax calculated at a standard rate on the theoretical tax base which would include in taxation all items (activities, income and funds) that can theoretically be taxed, represents policy gap.

The policy gap consists of: expenditure gap and non-taxable gap. The expenditure gap consists of the budget expenditures for taxes, i.e. the costs for all measures that a government implements through the tax policy as part of the overall economic policy, which aim to accelerate economic development, increase the volume of investments by increasing the level of savings and increasing efficiency and productivity, enabling the flow of foreign capital through measures to attract foreign investments, etc. These various types of tax incentives are actually tax incentives and benefits for taxpayers and include: tax credit, tax deductions, tax exemptions, free zones, tax holidays (temporary tax exemptions), etc. General and selective reduction of tax rates can also be considered as a special tax incentive. In general, tax incentives are instruments with which certain economic effects and influences should be achieved, which should cause a reaction or behavior of economic subjects in a desired direction. Although they do not lead to a direct outflow of financial resources from the budget, they nevertheless represent a type of voluntarily "lost" tax revenues - the financial potential of the state, which would be collected in case of non-application of these measures.

And the shadow economy, that is, all economic activities and sources of income over which the state does not have adequate supervision, also generate a tax gap. There is no strict division here as to how much this is a gap in compliance and how much is a gap in policy, but of course the shadow economy has an undeniably large impact on the total tax gap.

Taxes, are the dues that we pay for the privileges of membership in an organized society.

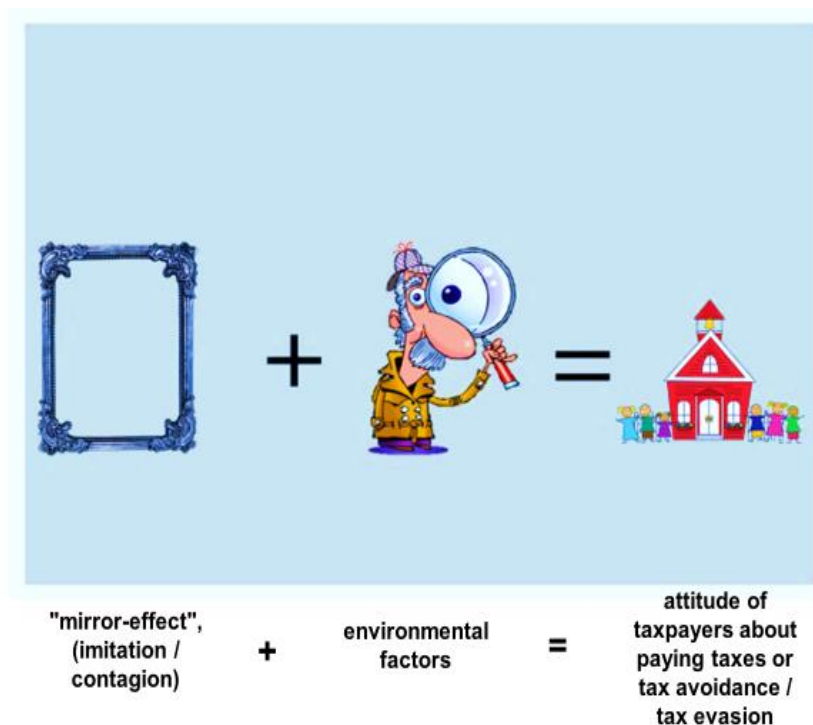
— Franklin D. Roosevelt

The tax gap is an indication of fiscal risk and that there are areas in which tax revenues should be mobilized. How to recognize the fiscal risk when collecting funds for organizing the society?

The tax gap resulting from the policy gap, especially the expenditure gap, shows the effectiveness of the tax policy and political decisions of the government. A particularly important issue here is the balance between the economic justification, on the one hand, and the effectiveness, on the other hand, of each tax incentive separately. Is the cost ie. are the lost tax revenues commensurate with and justify the benefits that taxpayers realize through the tax incentive? Are the expected objectives of the economic policy achieved through tax incentives? Could these goals be achieved more effectively with other measures? Are there negative side effects that follow tax incentives, eg tax planning and tax avoidance? What would be the economic consequences if the tax incentive does not exist / is abolished? What are other direct or indirect consequences of tax incentives that were not initially foreseen and what impact do they have? In general, the economic system should have its own "character" and the tax incentives should be coherent with the other components of the tax and overall economic policy.

Revenue losses for justified tax incentives should also be compensated by reducing the compliance gap. If the policy gap shows the effectiveness of the tax policy, the compliance gap shows the effectiveness of the tax administration. Namely, the concept of *tax compliance* refers to the readiness of taxpayers for voluntary legal, correct and timely fulfillment of tax obligations. Voluntary compliance consists of two components: tax awareness and tax morale. *Tax awareness* means a state where taxpayers know, understand and can correctly apply the legal provisions on taxes. *Tax morale*, on the other hand, refers to the perceptions and attitudes of taxpayers about paying taxes or, on the contrary, about tax avoidance and evasion. Tax morality shows ethics, as a set of accepted norms, values and valuations that create the taxpayer's behavior model. Tax morale is influenced by many socio-economic and institutional factors: the level of the tax burden, the usefulness of public expenditures, the perception of the benefits of paying taxes, the level of corruption, the honesty of other taxpayers

/ the feeling that other taxpayers avoid tax obligations, the level of the gray economy, the perception of the risk of detection of illegal behavior, the existence or lack of sanctions for evaders, etc. In doing so, one must take into account the so-called "mirror-effect", also known as "imitation effect" or "contagion effect". If the reputation, rating and demonstration of social responsibility are highly valued in the environment, this in itself will lead to higher tax morale and tax discipline, that is, to the correct fulfillment of tax obligations on a recurring basis. Contrary to this, the high level of shadow economy and tax evasion, taxpayers see as unfair competition and the possibility of being kicked out of the market, so such conditions have a negative effect on tax morale and tax compliance.



Taxpayer: that's someone who works for the federal government, but doesn't have to take a civil service examination.

— Ronald Reagan

What is the role of the tax administration and the government to enable taxpayers to "work for the state" by channeling taxes to the state treasure?

A key task of a successful tax administration today is to reduce the tax gap as much as possible and collect as much as possible of the amount of tax revenues that should be collected according to the laws. Realistically, one cannot expect to collect every penny of tax owed, but the tax administration should make an effort to collect the maximum possible amount of tax, i.e. anticipate and reduce any possible loss of tax revenue due to the compliance gap .

Fortunately, the majority of taxpayers voluntarily report and pay their tax obligations. Modern tax administration should therefore have approaches designed for the majority of taxpayers who intend to be compliant. Instead of being aimed at "hunting" errors through controls and punishing taxpayers (repression), the tax administration should focus on influencing and managing taxpayers' behavior in advance, making it easier for them to pay taxes, to act preventively, proactively and transparently for the measures it takes and for the detected compliance risks. The tax administration should use a wide range of tools compatible with the digitalization of society, new models and ways of working, new technologies, data sources and analytical tools, be internationally connected, all in the direction of better managing the compliance of taxpayers. Taking advantage of technological developments, modern tax administration should provide taxpayers with simple procedures for calculating and paying taxes and systems that provide a path leading to tax compliance and broadening the tax base. Tax assessment systems should be based on providing and expanding access to data for all sources of income, applying indirect taxation methods and preparing pre-filled tax returns, thus reducing the administrative burden on taxpayers, and ensures accurate fulfillment of tax obligations. In this tax administration, taxpayers will be freed from the pressure of controls and penalties and will

spontaneously enter a system in which they will "work for the state" by paying taxes so that they can enjoy the privileges of organized society.

The key issue is the trust of taxpayers in the tax administration and in all institutions in the state system. This "climate of trust" should be built, not only through measures to facilitate tax payment, but also through a wide range of measures to deal with the non-compliant behavior of some taxpayers, which should be appropriate to the degree of non-compliance. In the case of lower degrees of non-compliance, which are the result of insufficient knowledge, unintentional mistakes, deviations due to appropriate conditions of the taxpayer, etc., the so-called "soft" measures, which, basically, represent non-personalized and personalized communication with the aim of "detering" non-compliant taxpayers and correcting their non-compliance, i.e. "nudge" to the right path of compliant behavior. But for taxpayers whose determination is not to pay taxes, as well as for those who comply only with "force" from the tax administration, the sanctions established by the laws are the credible measure. With adjusted measures towards non-compliant taxpayers, the tax administration will demonstrate a fair attitude towards compliant taxpayers. Only in this way, both honest taxpayers who opted for tax compliance, and those who for some reason deviated from full compliance, and those who consciously chose to avoid paying tax, will receive information that the tax administration is fair, that all taxpayers have equal-fair treatment according to their behavior. Only in this way will the public have confidence in the tax administration and will understand that it reasonably applies its legal powers to ensure the protection of the tax base and tax revenues in the interest of the entire social community.

Finally, we must mention the role of the government as a whole, through all the organs in the state system, to deal with the phenomena of shadow economy, corruption, uncertainty in the justice system and similar negative phenomena. The reduction of the tax gap, indirectly by raising the tax morale and confidence in the tax system and in the overall state system, cannot be achieved without actually practicing a broad program of measures to deal with these phenomena. Thus, in the sphere of taxes, what starts as "the nudge" – pushing taxpayers towards compliant behavior, should turn into "the brudge" – bridging to a new reality, increased trust, increased awareness of obligations and benefits, and ends as "the trudge" – running, i.e. a changed way of thinking and a new spontaneous way of compliant behavior and a smaller compliance gap.