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This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Coversheet: Hidden Economy

*Background Paper for Session 14 of the Tax Working Group
20 July, 2018*

Purpose of discussion

This background paper is for the Group's information. The paper:

- Provides an overview of Inland Revenue's understanding of the hidden economy, including its potential size, the types of economic activities normally carried out by hidden economy participants as well as the drivers and behaviours that would encourage a taxpayer to choose to operate in the hidden economy;
- Outlines potential policy, regulatory and administrative responses to the hidden economy;
- Provides an overview of Inland Revenue's Hidden Economy Programme, including its key areas of focus and recent marketing campaigns;
- Briefly covers the Budget 2018 compliance initiative and potential opportunities to respond to labour non-compliance; and
- Briefly covers Australia's recent Black Economy Taskforce and their recommendations.

Key points for discussion

- Does the Group agree with the Secretariat's overall judgment that Inland Revenue's current and planned responses are appropriate?
- Is addressing the hidden economy something the Group agrees Inland Revenue should continue to focus on, particularly in light of new technology and overseas developments?
- Is there any further information or advice that the Group would like?

Recommended actions

We recommend that you:

- a **note** that several submitters proposed that the Group take a strong focus on the hidden economy, as a potential source of government revenue and to minimise existing inequities.

- b **note** that Inland Revenue has an active hidden economy programme.
- c **note** that Inland Revenue is currently identifying legislative opportunities to improve tax compliance in specific industries, through the use of withholding taxes and third party reporting.
- d **note** that officials are keeping a watching brief on the implementation of the Australian Black Economy Taskforce recommendations.
- e **indicate** what the Group would like to include in the interim report about the hidden economy and the options for improving Inland Revenue's compliance capability.

Hidden Economy

*Background Paper for Session 14
of the Tax Working Group*

20 July 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

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Executive Summary

This paper outlines some of the issues and challenges in responding to the hidden economy in New Zealand, and raises several potential solutions to these challenges.

The paper illustrates that by its very nature the hidden economy is difficult to identify, measure and manage and provides a short summary of the key elements and drivers of the hidden economy, including the human and industry behaviours that lead to individuals operating in the hidden economy. Ultimately this behaviour undermines the fairness of the tax system and New Zealand's social capital.

The paper considers several policy and operational responses. These include traditional responses such as strengthening information sharing capabilities and stronger negative sanctions. As well, the paper considers several positive initiatives, including making it simple for taxpayers to comply with their tax obligations and better supporting new businesses to adopt technology that will encourage them to remain tax compliant. Inland Revenue's Business Transformation programme should also enable greater access to data to help more easily identify non-compliance and better respond to developing sub-industries of the hidden economy. It is essential that multi-agency cooperation is encouraged in order to have coordinated and effective investigative and prosecution activities.

Inland Revenue has an overarching strategic and operational programme that is actively responding to New Zealand's hidden economy. In recent years, Inland Revenue has received additional funding of \$85.2 million (over 10 years) in 2010 and \$25.4 million (over five years) in 2015 to scale up its investigative capability, as well as increasing its marketing towards the hidden economy and public awareness of hidden economy prosecutions. This programme can be credited with not only lifting tax compliance in key industries, but also positively influencing social attitudes and shifting public opinion away from purchasing from hidden economy businesses (e.g. cash job's).

This paper highlights new initiatives being developed which, in time, will further reduce the opportunity for taxpayers to successfully operate within the hidden economy. This includes \$3 million in Budget 2018 (over four years) to assist Inland Revenue in identifying legislative opportunities to improve tax compliance in specific industries, through the use of withholding taxes and/or a third party reporting regime. Officials are also monitoring new initiatives in Australia.

We consider that Inland Revenue's current and planned responses are appropriate, but addressing the hidden economy is something Inland Revenue should continue to focus on, particularly in light of new technology and overseas developments.

1. Introduction

1. The Group has asked for information on New Zealand's hidden economy.
2. This paper:
 - Provides an overview of what Inland Revenue knows about the hidden economy, including its potential size, the types of economic activities carried out by hidden economy taxpayers as well as identifying the behaviours and drivers that may encourage a taxpayer towards the hidden economy;
 - Outlines some of the potential policy, regulatory and administrative responses to the hidden economy;
 - Provides an overview of Inland Revenue's hidden economy programme, including key areas of focus and recent marketing campaigns;
 - Briefly covers the Budget 2018 compliance initiative and potential opportunities to respond to labour non-compliance; and
 - Briefly covers Australia's recent Black Economy Taskforce and some of the adopted recommendations.
3. A number of submitters (including Chartered Accountants Australia and New Zealand, the Council of Trade Unions and some civil society groups) proposed that the Group take a stronger focus on the shadow (hidden) economy. One submitter suggested that multifaceted strategies and activities are required to effectively deal with the hidden economy, including Inland Revenue being adequately resourced and maintaining a strong and visible audit presence in the community.
4. In recent years, many tax administrators (including New Zealand) have been taking an increased focus on the hidden economy, dedicating resources¹ towards gaining a better understanding of the hidden economy and developing more effective policy and administrative responses to particular industries.
5. One of the key issues with the hidden economy is its very nature (being hidden from regulatory agencies such as Inland Revenue), that makes its identification, measurement and management much more difficult.
6. However, Inland Revenue's Business Transformation should provide greater data analytics that will play an increasing role in effectively identifying and responding to these opaque commercial transactions.
7. There is potential merit in exploring new opportunities to more effectively respond to the hidden economy. These opportunities include:
 - further reducing compliance costs - to further minimise the obstacles viewed by hidden economy participants as a barrier to returning to the formal economy;
 - greater access to data to help more easily identify non-compliance and better respond to developing sub-industries of the hidden economy; and

¹ Inland Revenue received additional funding of \$85.2 million (over 10 years) in 2010 and an additional \$25.4 million (over five years) in 2015, to improve its ability to respond to the hidden economy.

- a broader range of sanctions and an underlying publicity campaign to demonstrate that these sanctions are being imposed.

2. Overview of the hidden economy

8. The reason the hidden economy exists is because some taxpayers are not voluntarily complying with their tax obligations. More than 85% of taxpayers file and pay on time. However, some taxpayers do not.
9. Some taxpayers may feel that they have no choice due to difficulties in understanding their compliance obligations, or due industry pressures or norms. Educating these taxpayers on the ease of compliance as well as changing social norms will help convince taxpayers that they're better off tax compliant.
10. However, others actually choose to ignore their tax obligations so they can maximise their profit. Taxpayers that choose to non-comply are risk-takers, and often are intentionally evasive. They require a greater effort to respond to and resolve through detecting under-reporting and other forms of non-compliance.
11. For many compliant taxpayers they expect to see their tax system being administered fairly, with agreed community standards of behaviour and sanctions for when taxpayers operate outside those societal norms. Seeing Inland Revenue responding to the hidden economy and subjecting non-compliant taxpayers to appropriate sanctions bolsters their belief that the tax system is fair. Trust and fairness in New Zealand's institutions is a key element of New Zealand's social capital.
12. One of key issues with the hidden economy is the economic distortion it creates. Non-compliant taxpayers unfairly obtain a competitive advantage over compliant taxpayers and consequently these non-compliant taxpayers achieve greater success than taxpayers that do pay their fair share of tax.
13. There are a large variety of terms used to describe these *unreported economic activities*, such as black, cash, hidden, informal, parallel, shadow and the underground economy. In addition, many revenue authorities have different definitions and interpretations of these terms. These include the type of activity undertaken (i.e. illegal vs. legal activities), whether the definition includes any type of undeclared taxable income (such as amounts caused by error) as well as terms such as 'Ghosts'² and 'Moonlighters'³ (OECD, 2017).
14. The Organisation for Economic Cooperation and Development (OECD) has adopted the term 'the non-observed economy'. These are activities that should be included in the country's GDP, but, for one reason or another, are not covered in statistical surveys or government records (OECD, 2012). This term includes:
 - Unreported income arising from legal activities;
 - Unreported income arising from illegal activities;
 - Production of goods for own use; and

² Individuals that are earning taxable income, but are invisible to the revenue authority.

³ Individuals that are known to Inland Revenue and pay tax on one or more sources of income, but have another source of income that they do not disclose to Inland Revenue.

- A ‘statistical underground’ reflecting the limitations in statistical techniques and information sources – such as incomplete surveys and inaccurate questionnaires.
15. Inland Revenue defines the hidden economy as “monetary and non-monetary transactions intentionally not declared or accurately reported (Cleland, 2011). This definition includes:
- Barter, cash transactions;
 - Not filing tax returns – no source of income;
 - Under reporting income or artificially inflating expenses;
 - Earning income from illegal activities; and
 - Deliberately engaging in fraudulent activities or using a false identity to obtain a refund or entitlement they are not otherwise entitled to.

Measuring the size of the hidden economy

16. There is no standard approach for assessing the size of the hidden economy. By its very nature, these activities are not easily visible or detectable by regulatory authorities, with the additional impediment of taxpayers having a strong financial incentive not to voluntarily comply with any questionnaires or surveys. Most statistical approaches are partially based on unobservable assumptions. The use of traditional tax gap measurement approaches (as a proxy measure for the hidden economy) is not considered entirely reliable, for similar reasons.
17. A range of estimation techniques have been used in an effort to accurately measure the hidden economy, including direct information gathering methods such as surveys and questionnaires alongside audit and tax return data, through to indirect methods such as macroeconomic and statistical estimation techniques. Most OECD tax administrators rely on direct methods (The Australian Treasury, 2017b).
18. One area of contention is whether to include ‘pure tax evasion’⁴ as an element of the hidden economy. Some tax authorities include pure tax evasion in their measurements. Others, such as HMRC do not (UK National Audit Office, 2015).
19. It is important to note that there is no direct relationship between revenue lost or forgone, and the size of the underlying hidden economy. This is because some tax revenue may be collected in the course of a hidden economy activity being performed (i.e. money laundered through legitimate businesses may be reflected in that business’s paid taxes).
20. In September 2017 the *Australian Black Economy Taskforce* convened an expert workshop in an attempt to accurately quantify the size of Australia’s hidden economy. Through their analysis of the underreporting of business income, illicit tobacco, gambling, drugs, and counterfeit goods, as well as money laundering and underpayment of wages to vulnerable workers, the taskforce valued the Australian

⁴ Pure tax evasion refers to a situation where the primary purpose of a financial transaction is to conceal income in order to reduce a person’s tax liability, rather than to supply goods and services.

hidden economy at as much as 3% of GDP, equating to \$50 billion in 2015-16 terms (The Australian Treasury, 2017b, p. 35).

21. Research published earlier this year by Victoria University, in conjunction with Inland Revenue, attempted to estimate the amount of taxable income the self-employed taxpayer may be under-declaring to Inland Revenue. This research uses the relationship between expenditure and income declared by employed individuals⁵, to infer the true income of the self-employed (Cabral & Gemmell, 2018). The researchers estimated that on average, self-employed individuals underreported approximately 20% of their gross income. This could represent forgone revenue of approximately \$850 million per annum, for unincorporated taxpayers⁶. This group represents around 55% of the total self-employed income. The research found that New Zealand appeared to be comparable to estimates for the United Kingdom and Canada, and less than other countries such as United States and Greece (Cabral & Gemmell, 2018), although the New Zealand research gives a more accurate estimate than those other studies.
22. In addition, it is important to note that while operating in the hidden economy brings clear financial benefits, the primary reason for participation may not always be tax evasion. The business or individual may conceal their transactions to avoid the cost of compliance with other regulations such as health and safety, employee or consumer rights, obligations such as child support or immigration reasons such as certain visas limit number of work hours per week. The indirect cost from other forms of regulatory avoidance also needs to be considered.

Hidden economy activities

23. There are many types of ‘hidden economy activities’. Many of these activities do have a tax evasion component; however as noted above, tax evasion may not be the main motivation for the activity. It is important to illustrate the breadth of activities to show the true size and scope of the hidden economy and therefore, the kind of strategy(s) required to effectively respond to it.
24. The most common hidden economy activity is the *underreporting of taxable income*. This includes ‘cash jobs’, not declaring rental income or income from sharing economy activities, skimming transactions, or offering / selling goods and services for cash. In some overseas jurisdictions, sales suppression technology may be deployed to artificially reduce their retail sales. As well, there would be some active businesses that are simply not known to regulators. While these economic activities are legal, the non-declaration of income is illegal.
25. Another activity associated with the hidden economy is paying for work *cash-in-hand*. This activity is essentially where the employer or payer is paying the person

⁵ Employed taxpayers have a reduced opportunity to evade their taxes because they're subject to PAYE and other withholding tax rules.

⁶ This amount does not include incorporated taxpayers (operating through companies or trusts) or include other adjustments such as GST or social policy obligations.

cash, rather than through the banking system. This is to avoid officially documenting and reporting the income, as well as potentially avoiding certain withholding tax requirements. In some cases, both the payer and the payee collude to ensure the payment is not officially recorded or declared. As well as taxes, the payer may want to avoid:

- Adhering to minimum wage law;
- Paying a 'full sales price' as the tax component of the work is being ignored;
- Tax compliance costs –i.e. registering for PAYE and ACC requirements; and
- Non-tax compliance costs – i.e. health and safety requirements.

However, the payee may also desire this outcome, for reasons that may include the following:

- To artificially reduce their own tax liability and not self-declare this income;
- Visa holders seeking to avoid exceeding their permitted hours of work;
- Not wanting to provide a traceable workmanship guarantee for the work;
- The payee is a 'ghost' or 'moonlighting' and the payee isn't allowed to carry out undocumented work; and
- Enable access to other entitlements available at lower levels of reported income e.g. Working for Families Tax Credits.

26. A similar activity is *sham contracting*, whereby the standard employment agreement is wrongly presented as an independent contracting agreement. The employer may be seeking to avoid PAYE, ACC and KiwiSaver payments, as well as the employee seeking to reduce their tax liability.
27. In some cases, the collusion between payers and payees can be better described as exploitation, where unscrupulous payers may coerce and deceive payees, with payers demanding additional payments be made to them by threatening no further paid work. This exploitation is likely to occur where payee would be considered a vulnerable worker or they are a temporary or new migrant seeking a pathway to residency (Stringer, 2016).
28. *Illicit tobacco, gambling and drugs* are another significant activity of the hidden economy. This may include excise evasion by illegally importing tax-free tobacco from overseas or New Zealand harvested tobacco sold to New Zealand consumers, illegal offshore gambling via the internet, as well as the illegal cultivation and distribution of drugs. For obvious reasons, these transactions are not routinely declared to Inland Revenue and consequently the tax on these transactions is evaded.
29. *Money laundering* is also an important activity of the hidden economy. A money laundering process is required if the individual wishes to convert their illegally obtained funds into legitimate wealth that can later be utilised in the formal economy. While in some cases tax is paid on the money laundering transaction, the process itself is necessary to convert the illegally obtained funds into legitimate wealth, and so its existence and success is helping facilitate the hidden economy.

30. New legislation in 2017⁷ enacted phase two of New Zealand's anti-money laundering regime, by extending the 2009 Act to ultimately include businesses such as lawyers, accountants, as well as amending the rules for businesses already covered (i.e. banks and casinos).
31. These activities are only some of the common hidden economy activities. Others that are likely to exist include identity fraud, counterfeit goods, motor vehicle fraud, origin of goods and duty fraud. This list illustrates that commercial activities conducted in the modern hidden economy are diverse and can take a variety of forms.

Drivers to enter and remain in the hidden economy

32. The reasons why a taxpayer would participate in these types of transactions can be complex. Often there are multiple drivers impacting on their decision. Some may not realise they are participating in the hidden economy, while more egregious individuals may choose to structure their commercial affairs to ensure they can maximise their illicit profits. These drivers include:
 33. *High tax and compliance burdens* provide a strong incentive for individuals to engage in hidden economy behaviour. The higher the cost of officially participating in the formal economy and where those burdens fall on the payer or payee, the stronger the incentive will be for taxpayers to operate outside the formal economy. This can be especially strong incentive where the taxpayer is facing weak economic environment and pressure on their commercial margins. (The Australian Treasury, 2017a).
 34. As well, a *complex regulatory environment* can also incentivise taxpayers to engage in hidden economy behaviour. This includes complying with their tax obligations and other regulatory requirements. Some individuals may view their requirements as needless burdens resulting from duplicative and overlapping government requirements (The Australian Treasury, 2017a).
 35. The *perception of risk and the likelihood of detection* also helps determine how willing taxpayers are to engage in the hidden economy. This perception can be heavily influenced by the experience and success of other hidden economy taxpayers and the level of visible enforcement (including the seriousness of prosecution and sentencing – such as civil vs criminal penalty and forfeiture of illegally obtained wealth). Some feel that transacting with online marketplaces and digital currencies makes their activities more difficult to detect and trace.
 36. *Beliefs* are also an important factor. Many hidden economy taxpayers will defend and justify their behaviour. Common beliefs and rationalisations include 'it's a victimless crime, 'everyone does it', and 'I'm just trying to keep up' or 'I'm an entrepreneur at heart' (Her Majesty's Revenue and Customs, 2012a). Additionally, some who feel that they contribute to society or the economy in other ways, see

⁷ The Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) Amendment Act 2017.

their behaviour to be fundamentally different from those who take without contributing. These beliefs can be reinforced where hidden economy taxpayers are seen to be successful and not subject to inquiry or sanctions.

37. The continuation of these beliefs ultimately undermines *the fairness and tax morale of the tax system*. In considering the Living Standards Framework, having a larger hidden economy is likely to reduce social capital. Some taxpayers may feel that a tax system that does not address the hidden economy is unfair due to horizontal equity (where they see others earning similar incomes but paying much less tax than them - i.e. competitors within the same industry). Likewise, some taxpayers may feel that a tax system that does not address the hidden economy is unfair due to vertical unfairness (where they consider others that are better off than them pay much less tax - i.e. tax practices of larger entities within their industry) (The Australian Treasury, 2017b). Tax morale can also decline where detection rates are low, and the available sanctions are seen as ineffective.
38. It is critical that any policy or administrative responses to the hidden economy adequately address these drivers and ensure the responses are upholding the fairness and equity of the tax system.

3. Potential responses to the hidden economy

39. There a number of potential responses to the hidden economy. These can be both positive as well as punitive and be a mix of policy and administrative initiatives. These initiatives would be aimed at both reducing the likelihood of new entrants into the hidden economy, as well as effectively encourage existing hidden economy taxpayers to re-enter the formal economy.
40. It is important that any solution does not increase compliance costs on businesses, especially for compliant taxpayers, as any increase could further encourage compliant taxpayers to transition into the hidden economy.
41. It is also important to note that deploying an overly aggressive approach towards hidden economy taxpayers (i.e. imposing extremely punitive penalties only, or aggressive communications from the tax administration) runs the risk of alienating both hidden economy taxpayers as well as the general public. Encouraging hidden economy taxpayers to return to the formal economy requires an empathetic and enabling tone that breaks down some of the barriers that fuel hidden economy attitudes and behaviours (Her Majesty's Revenue and Customs, 2012b).
42. One of the concerns raised by hidden economy participants is the cost of complying with regulatory requirements. It is important that government takes a strong focus in making easy for individuals and businesses to comply with their necessary regulatory requirements. This may include providing targeted education towards particular industries and groups to better support them right from the start as well as debunk 'tax myths'.
43. Encouraging taxpayers to engage in the formal economy from the start is much easier than attempting to later persuade a non-compliant individual to return to the formal economy (Her Majesty's Revenue and Customs, 2012b).
44. Government initiatives could include:
 - avoiding complex and duplicated regulatory requirements;
 - making it easy to interact with government agencies including dedicated contact channels for particular businesses or industries;
 - recognising that government communications needs to be in an 'easy-to-understand' language; and
 - attempting to leverage existing technology (such as accounting and payroll software) to reduce compliance costs, including supporting uptake for new businesses.
45. Another response is having a visible and efficient whole-of-government enforcement strategy. Multi-agency cooperation would include greater information sharing and matching powers as well as coordinated investigative resources. Importantly, applying a differentiated or risk-based approach will avoid low risk businesses being effectively over-regulated. Inland Revenue regularly engages with

other government agencies on shared compliance initiatives that impact the hidden economy.

46. Another potential response is ensuring there is a broad range of offences and sanctions for different types of taxpayer non-compliance. In particular, there is a need for several mid-range offences and sanctions for taxpayers that have engaged in activities that are not quite criminal, but are more egregious than civil and administrative penalties (essentially where a shortfall penalty or imprisonment would not be proportionate to the offending). These activities could include where the taxpayer was previously educated on their compliance obligations and subsequently has purposely provided false information, failed to keep proper records, or paid wages in cash. Sanctions could include increased compliance monitoring by the agency or not being able to participate in future government procurement opportunities.
47. As well, another important response is increased publicity of enforcement actions and outcomes. Public awareness of active compliance campaigns will remind compliant taxpayers that non-compliant taxpayers are ultimately not benefiting from their non-compliance, and the revenue authority is upholding the community standards of behaviour. Inland Revenue often issues press statements on recent prosecutions to remind the general public that Inland Revenue is identifying and responding to tax non-compliance.
48. Another important publicity campaign could instead be specifically designed around the consumers of the hidden economy businesses. Currently, many consumers do not believe that it's their responsibility to ensure businesses are complying and instead focused on 'getting a good deal'. One potential reason is that the status of the businesses tax compliance is not seen to provide the consumer with any direct benefit, as their priorities are instead quality and value (Her Majesty's Revenue and Customs, 2012b). However, limiting consumer demand for these types of goods and services would help convince these businesses that they may be financially better off by operating in the formal economy.
49. All of the potential initiatives listed above could go some way towards changing attitudes and beliefs.
50. However, it is important to note that the current cost/benefit equation is heavily weighted towards staying in the hidden economy (no tax liabilities, minimal compliance costs), and while efforts can be made to begin to correct this equation, it is unlikely that the hidden economy will become 'closed for business'.

4. Inland Revenue's hidden economy programme

51. Budget 2010 provided \$85.2m over ten years to help improve Inland Revenue's ability to detect and address those operating in the hidden economy. The programme's ten year strategy focuses on developing better intelligence, increasing Inland Revenue's tax audit capacity, and producing both broad as well as specific marketing and communications targeted towards both the seller and the consumer of hidden economy activities (see Appendix one). The primary aim of the programme is to change the behaviour of those who are a part of New Zealand's hidden economy.
52. While Inland Revenue has maintained a level of compliance activity across a variety of sectors and risks within the hidden economy, additional funding of \$25.4 million in 2015 helped increase support for Inland Revenue's educative and investigative activities in key sectors.
53. This revamped programme has four strategic goals:
- Reduce opportunities for taxpayers to participate in the hidden economy;
 - Positively influence social norms and attitudes;
 - Change administrative practices and policies to reduce hidden economy practices; and
 - Enhance Inland Revenue's capability to deal with the hidden economy and provide appropriate responses and optimise revenue for Government (Appendix One).
54. Key programme successes include:
- A steady decrease in the proportion of people saying they participated in cash jobs, from 34% (2011) to 25% (2016/17);
 - Fewer people saying they're likely to ask for 'cash price' knowing that tax is less likely to be paid on it, from 18% (2017) decreasing from 27% (2011);
 - Budget 2015 average return on investment is above \$5.8 for every \$1 spent⁸.
55. The revised programme has enabled an extended focus on three priority industries; targeting specific sub-sectors within the '*Hospitality*' and '*Construction*' industries, and those taxpayers who are operating partially or totally '*Outside the System*'.
56. Additionally, Inland Revenue is taking an increased focus on the sharing economy. As noted in The Future of Work discussion paper, technology platforms are becoming more integrated into modern society. Evolving industries such as digital currency and online marketplaces means more individuals are choosing to engage and transact digitally.
57. These platforms can decrease compliance costs for taxpayers and provide revenue authorities with increased visibility over digital transactions, however these platforms providers are often domiciled overseas and non-resident platform

⁸ Figures are year-to-date 31 May 2018.

providers may have broad discretion over what information they may disclose to revenue authorities. Officials are monitoring the sharing economy industries and are working alongside other revenue authorities in ensuring taxpayers operating in the sharing economy comply with their tax obligations.

58. Expanded information sharing protocols with other government agencies (i.e. Worksafe NZ, Employment NZ's Labour Inspectorate, NZ Police and the Companies office) has also enabled this increased focus. Inland Revenue is also closely working with other law enforcement agencies combating organised crime.

Building and Construction

59. The building and construction industries continue to have an increased focus by Inland Revenue since the programme's inception.
60. This industry group faces a range of complex issues that can impact on tax compliance. This includes project and budget pressures in part due to skilled labour shortages (in some cases involving migrant workforce with limited understanding of New Zealand's tax requirements), costs of construction, a competitive marketplace and the near-universal acceptance of 'cashies' (cash payments to construction contractors and traders) and subsequent income suppression. As well, poor record-keeping practices making cash transactions more difficult to detect.
61. Targeted segments have included:
- Residential building services;
 - Electrical; and
 - Plumbing.
62. Inland Revenue has undertaken several broad-based and targeted marketing campaigns including the current '*no grey areas*' campaign and the '*every undeclared cash job leaves a trail*' (Appendix two).
63. Taxpayer surveys revealed there are several differences between good tax compliers and poor tax compliers. Good compliers are more likely to:
- be older than poor tax compliers;
 - have an accountant or tax advisor; and
 - believe that cash jobs are not common in their industry and believe that it is not easy to operate a business outside of the tax system.
64. The main proactive compliance activities being carried out in this sector include undertaking open visits to building and construction sites. As well, Inland Revenue has increased its industry specific community compliance activities and tax audits of high risk cases as they are identified.

Hospitality

65. Hospitality has long been recognised as an active industry within the hidden economy. Significant levels of cash transactions combined with poor record keeping means there are easy opportunities for income suppression, which can be difficult to detect.
66. Targeted segments have included:
- Restaurants;
 - Cafes and Bakeries;
 - Takeaways; and
 - Liquor outlets.
67. A key success in this area has been matching other electronic transaction data with existing Inland Revenue data. The analysis of this data, combined with traditional investigation techniques has resulted in additional audit and compliance outcomes. The availability and use of third party data sets is likely to be even more important in the future.
68. Some of the main proactive compliance activities being carried out in this sector include undertaking open visits to hospitality businesses (to educate them about their record keeping requirements and help them establish good business practices), increased community compliance activities including taking a stronger presence in the regions, as well as tax audits of high risk cases as they are identified.

Outside the system

69. Inland Revenue is aware that a number of taxpayers are likely to be operating partially or totally *outside the tax system*. Because of their limited visibility, these taxpayers are inherently difficult to detect and respond to.
70. One approach Inland Revenue is progressing is to attempt to build customer profiles of typical *outside the system* taxpayers. These are taxpayers that are either unknown to Inland Revenue, or they are earning income that is reported but also earning additional income that they do not disclose to Inland Revenue. These profiles are expected to provide greater understanding of the barriers these taxpayers are likely to encounter, and help design more customised interventions towards these taxpayers.
71. Targeted segments have included:
- Totally outside the system (ghosts); and
 - Partially outside the system (moonlighters).
72. In mid-2016, Inland Revenue undertook direct marketing campaigns targeted towards potential outside the system taxpayers that had not declared any income for some years. Because of the nature of outside the system taxpayers, it is difficult to identify whether they had become self-employed, stopped working or relocated

overseas⁹. This campaign connected with many taxpayers that were ultimately found to be operating outside the tax system and successfully encouraged to return to the formal economy.

73. This campaign saw 47% of participants open Inland Revenue's email (excluding email bounce/fails), a 5% response rate, with 60% of those replies coming from taxpayers indicating that they had subsequently relocated overseas.
74. Better identifying ghosts and moonlighters requires greater access to third party datasets (such as from online marketplaces) is important. The recently introduced Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Bill contains a provision that would authorise the regular collection of datasets, where the collection is necessary for the administration of Inland Revenue.

⁹ Currently, there are limitations around the use of NZ Custom's data (i.e. passenger departure/arrival information). The recently introduced Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Bill includes a provision that will allow Inland Revenue to more efficiently use information collected from other agencies.

5. Future policy initiatives

Budget 2018 Compliance initiative

76. As part of Budget 2018, the government allocated \$3 million over four years to assist Inland Revenue in identifying legislative opportunities to improve tax compliance in specific industries, through the use of withholding taxes (schedular payment rules) and/or a third party reporting regime (New Zealand Government, 2018).
77. Schedular payments are payments made to contractors who perform certain activities. These are usually payments made under a 'contract for service'. The purpose of a withholding rate is to regularly deduct an approximate amount of tax from payments made by the payer, to the payee. At the end of the year, if required, the payee either completes a personal tax summary or an IR3, where the withholding amounts are credited towards the taxpayer's income tax liability for the income year.
78. The rules, job roles, industries and withholding rates are prescribed in the Income Tax Act¹⁰. The latest addition to the schedular payment rules was in early 2017, being contractors working under a labour hire arrangement¹¹.
79. In order to ensure that a person does not have too much tax withheld, the taxpayer can request a special rate certificate, where the prescribed flat rate would be inappropriate for the payee's circumstances (e.g. if the taxpayer has losses available). Once presented to the payer, the certificate allows the payer to pay the amounts at the rate provided in the certificate.
80. A third party reporting system would require certain payers to report the timing and amounts of any payments made to particular contractors within their industry to Inland Revenue. Gross payments are made to the payee, with the payer being responsible for reporting this information to Inland Revenue at the end of the tax year (or more regular intervals if prescribed). Because payees are aware of their income information is being reported, they are more likely to self-assess that income and consequently begin to voluntarily return to the formal economy.
81. While Inland Revenue does not currently administer a third party reporting system for contractors, Australia has since 2013 (Australian Taxation Office).
82. Inland Revenue officials are currently conducting a review of existing tax compliance data and intelligence, to identify whether particular industries should be included in the schedular payment rules and/or a third party reporting system. The impact of any potential future changes is yet to be determined.

¹⁰ RD 9 – RD 24 and Schedule four of the Income Tax Act 2007

¹¹ A labour hire arrangement is where a person is paid by a labour hire business to perform work or services directly for clients of the business or other person, instead of performing work or services for the business itself. The client will pay the labour hire business who then pay's the contractor.

Australia's Black Economy Taskforce

83. In December 2016, the Australian Government announced that it was establishing the Black Economy Taskforce. This taskforce was tasked to develop an innovative, forward-thinking and genuinely whole-of-government strategy to combat the black economy. This included undertaking a national roadshow of public and industry forums to gather and examine evidence on the scope, revenue risk and behavioural factors underpinning the black economy. As well, the taskforce conducted a thorough review existing policy responses and international best practice. (The Australian Treasury, 2017a).
84. An interim report was presented in March 2017, with a final report in October 2017. The final report included 80 policy and administrative recommendations (including supplementary recommendations).
85. The Australian Government decided to adopt several recommendations, including:
 - placing a cash transactions limit of \$10,000 (payments made to businesses);
 - restricting government procurement to businesses that have acceptable tax records;
 - additional operational funding to the Australian Tax Office to increase its enforcement activities;
 - expanding the existing third party reporting system to new industries; and
 - preventing businesses from claiming deductions for wages paid to employees (or payments to contractors) where that business has disregarded their withholding obligations on those wages or payments.
86. Additionally, in June, the Australian Government announced the establishment of a new advisory board to provide strategic advice on the trends and risks in the black economy (The Australian Treasury, 2018).
87. Inland Revenue officials are maintaining a watching brief on the implementation of these new measures, as well as the progress of other taskforce initiatives.

6. Conclusion

88. The hidden economy is complex and multifaceted. It can be difficult to obtain reliable estimates on its size. However ultimately, the hidden economy poses a threat to the integrity of the tax system and must be countered.
89. There are many reasons taxpayers may choose to operate in the hidden economy. Some simply are not aware of their actions and consequences due to poor or inaccurate business practices, with some believing that ignoring their tax obligations is the only way to stay in business. Others however, are fully aware of their actions and the consequences but nonetheless choose to exploit the rules to maximise their profits.
90. The growing digital economy offers new opportunities for taxpayers to earn income outside the tax system. However, technology also offers new opportunities to make it easier for taxpayers to comply, and enable Inland Revenue to have greater access to data to help more easily identify non-compliance and better respond to developing sub-industries of the hidden economy.
91. Whatever tools and measures are developed in the future, it is important to minimise compliance costs on compliant taxpayers, as any increases may risk pushing some compliant taxpayers towards the hidden economy.
92. Inland Revenue has made considerable progress in responding to the hidden economy, especially under the expanded hidden economy programme (strategic blueprint 2010-2020). In the high-risk industries outlined in the paper, businesses and consumers are more aware of Inland Revenue and its compliance capability; with non-compliant businesses being more aware of the consequences should they choose to ignore their tax obligations. There is merit in exploring new initiatives and sanctions to more effectively respond to the hidden economy.
93. Since 2010, Inland Revenue has been more effective in responding to taxpayers operating in the hidden economy, with better intelligence, targeted marketing, and more tax audits. Inland Revenue is not only changing the behaviour of these businesses, they are also shifting public opinion away from doing business with the hidden economy. New government policies both in New Zealand and in Australia illustrate that there will be a continued focus on addressing non-compliant taxpayers operating in the hidden economy.
94. We consider that Inland Revenue's current and planned responses are appropriate, but addressing the hidden economy is something that Inland Revenue should continue to focus on, particularly in light of new technology and overseas developments.

Appendix A: The overarching strategy for IR's hidden economy

HIDDEN ECONOMY PROGRAMME STRATEGIC BLUEPRINT 2010-20

Hidden Economy



OUR VISION

The opportunity to participate in the Hidden Economy will reduce and it will be more difficult to stay 'out of the system'

Society will have a lower tolerance of participation in the Hidden Economy, and will play a strong role in encouraging compliance

It will be easier for businesses and individuals to understand their compliance obligations. There will be an improved level playing field for honest businesses

There will be greater likelihood of detection and consequences for those who choose to participate in the Hidden Economy

BILATERAL COMMITMENTS

Return on Investment

Capability Uplift

Stimulate Innovative Approaches

OUR GOALS

Reducing opportunities to participate in the Hidden Economy in part or in whole

Positively influencing taxpaying norms, the public's attitudes and behaviours towards the Hidden Economy

Changing administrative practices, policies and where relevant, recommend remedial legislation to address the Hidden Economy

Enhancing our capability to deal with the Hidden Economy and provide the appropriate response to optimise revenue

THE KEY FEATURES OF A MULTI-DISCIPLINED APPROACH



Research & Evaluation

Research that informs tailored intervention design, and regular evaluations to support the longevity and effectiveness of the Programme.



Right from the Start

A focus on prevention and education right from the start, so customers find it easier to comply and difficult not to.



Policy & Change

Advocating for transformation, policy and legislative changes that create broad and sustainable compliance improvements.



Marketing & Communication

Sophisticated marketing and communications services which create a sustained focus on behaviour-change in high risk industries.



Local & Global Engagement

Local and international engagement with agencies, agents and associations, for shared learning and greater opportunities to influence compliance.



Behavioural Change

Keeping pace by testing and integrating behavioural-based innovations and expertise which address the drivers of non-compliance.



Intelligence

Cohesive data, information and insights which direct the prioritisation and treatment of current and emerging risks.



High Risk Focus

Addressing the relevant compliance problems, prevalent in high risk industries through targeted customer-centric campaigns.



Outside the System

Enduring and repeatable solutions to understand and address individuals and entities operating fully or partially outside the system.

Appendix B: Every undeclared cash job leaves a trail



1. The 'every undeclared cash job leaves a trail' advertising campaign ran from late October 2017 through to early December 2017, and involved direct marketing, native marketing, remarketing and Gmail advertising nationwide. The previous building and construction campaign was the 'it's a tax crime' campaign.
2. The concept was that undeclared cash jobs leave a trail, then Inland Revenue will follow and if the taxpayer does not come 'clean', the trail continues to grow, along with the certainty they'll be caught. The marketing strategy revolved around surrounding building and construction employees and contractors in their working environment and making them think twice before following through with undeclared cash jobs.
3. The target audience for this advertising campaign were tradespeople operating in Auckland, Wellington and Christchurch, with almost 50,000 taxpayers being directly contacted.
4. A post-campaign survey was carried out to measure the effectiveness of the campaign:
 - 82% of people surveyed were aware of the marketing campaign;
 - Radio was the most common place they saw or heard the campaign;
 - The campaign webpage received over 18,500 unique page views; and
 - Plenty of media pick up on TV, radio and press.

Glossary

Black Economy Taskforce: an Australian Government Taskforce tasked with developing a whole-of-government strategy to respond to the hidden economy in Australia.

Civil penalties: These are administrative penalties imposed by Inland Revenue. These include late filing and late payment penalties, and shortfall penalties.

Criminal penalties: These are penalties imposed by the Courts. These include fines and imprisonment.

Ghosts: Individuals that are earning taxable income but are invisible to the revenue authority. These taxpayer's existence, activities and source of income are totally unknown to Inland Revenue.

Moonlighters: Individuals that have an IRD number or are registered for GST and who pay tax one or more sources of income, but have another source of income that they do not disclose to Inland Revenue.

Outside the system: the population of 'ghost' taxpayers that are invisible to Inland Revenue.

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