ANNEX 3. SURVEY ON TAX MORALE

The government of Latvia has declared[1] that it plans to increase Latvia's tax-to-GDP ratio by 2020, primarily by limiting the shadow economy. While the government of Latvia has previously expressed an intention to increase the tax-to-GDP ratio to 1/3, the current government has declared that it plans to reach this tax-to-GDP ratio by 2020. To this end, the World Bank was commissioned to do a review of the current tax system, which could assist the government in developing a new approach to tax policy. However, the government's plan to increase tax revenues will primarily be directed at limiting the shadow economy and improving tax collection.

Both local[2] and international[3] studies have indicated that Latvia has a considerable shadow economy, which significantly impacts tax revenues. The estimates vary, but the consensus is that economic activities taking place outside the formal economy account for a comparatively large part of Latvia's GDP. This has a serious impact on tax revenues, as a significant portion of income in Latvia goes untaxed. This further compounds the fact that Latvia's tax revenues compare unfavourably to those of other members states of the EU (see Section 1).

In addition to changes in tax administration, revenues may be increased by gaining a better understanding of why people avoid paying taxes. Adjustments to the operation of revenue bodies and the development of effective enforcement and deterrence strategies are of great importance. However, addressing the causes of why people participate in the shadow economy also requires insight into compliance behaviour and the reasons for non-compliance and tax evasion.

Taxpayer behaviour should be understood as a result of his/her personal norms and the social and economic environment in which he/she operates[4]. Recent research on tax evasion and compliance with tax law has given considerable attention to social and psychological factors, and the role that norms and questions of justice and fairness play in determining compliance behaviour. It has been argued that deterrence and punitive measures play a role when norms and convictions fail. Research suggests that there is a need to study the motivation of taxpayers from a perspective that is attuned to the social and economic context, and does not see people's choices as solely being determined by the desire to maximise pay-off.

Tax morale can broadly be defined as the intrinsic motivation to pay taxes and provides a way of explaining tax evasion. The social and psychological aspects of tax evasion have begun to attract the attention of academics and policy analysts, and the prominence of tax morale has increased. Even though its effect is difficult to quantify, the role of norms and personal convictions provides a potential way of explaining the variation between the levels of compliance with tax laws in different countries.

Tax morale is influenced by trust in state institutions and the tax system, and overall financial satisfaction[5]. Studies have identified that tax morale is influenced by various factors, such as education, employment status and marital status. However, trust in the government and the revenue collecting body play a crucial role in determining whether individuals will decide to comply with tax laws. What is more, higher financial satisfaction is associated with higher tax morale.

The Fiscal Discipline Council commissioned a survey on tax morale in Latvia. The survey was conducted in April 2016, and the sample consisted of 1029 respondents. 53% of respondents were female, and 47% were male.

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[1] http://www.pkc.gov.lv/vald%C4%ABbas-priorit%C4%81tes-2014

[2] http://www.sseriga.edu/en/centres/csb/shadow-economy-index-for-baltic-countires-2009-1015/

[3] Schneider, F (2015) *Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2015: Different Developments*, available at: http://www.econ.jku.at/members/Schneider/files/publications/2015/ShadEcEurope31.pdf,accessed on: 03/10/2016.

[4] OECD (2010) *Understanding and Influencing Taxpayers' Compliance Behaviour*, available at: https://www.oecd.org/tax/administration/46274793.pdf, accessed on 03/10/2016.

[5] Torgler, B. (2007) *Tax Compliance and Tax Morale*, Cheltenham: Edward Elgar Publishing.

The results of the survey suggest that Latvia's inhabitants are lenient towards not paying taxes. The results of the survey commissioned by the Fiscal Discipline Council indicated that the majority of Latvia's population thinks that tax evasion is not justifiable, but a considerable part of Latvia's society is lenient towards tax evasion, does not think that paying taxes is mandatory and has experience of tax evasion.
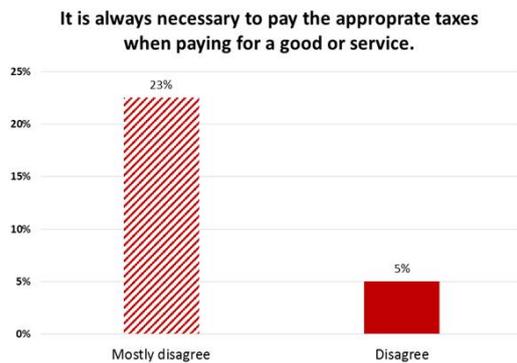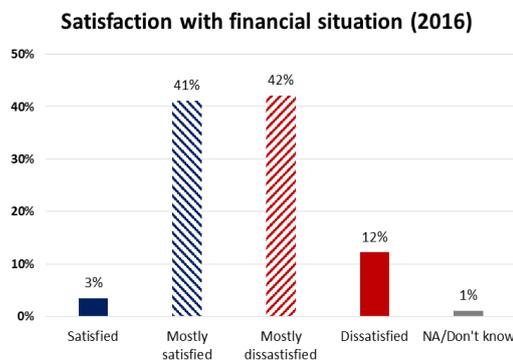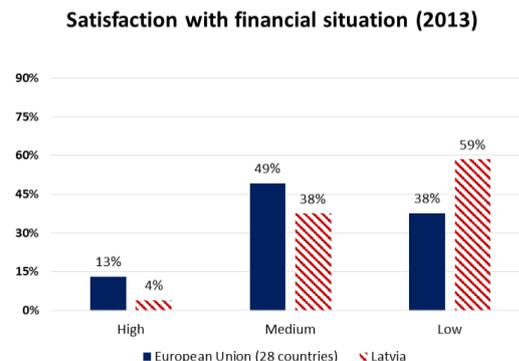

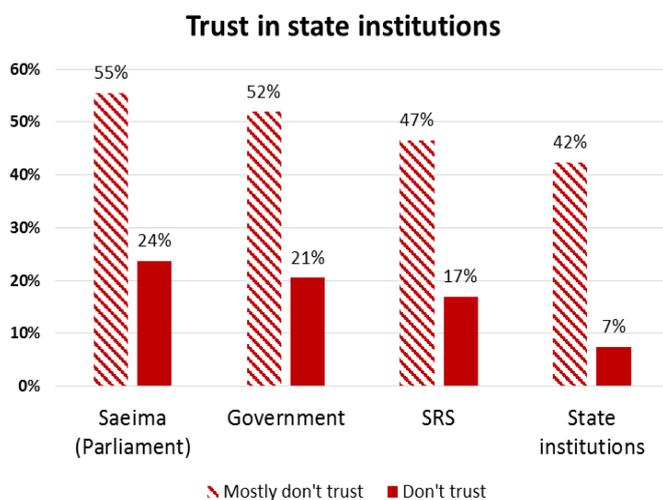*A3.1 Source: Council survey*
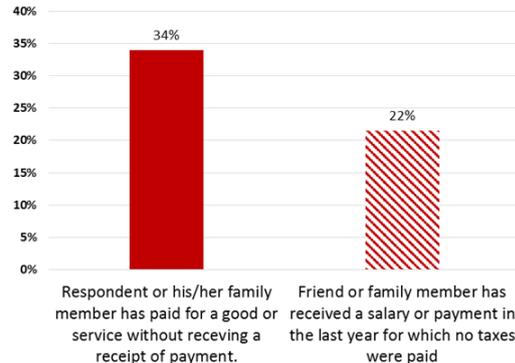
A3.2 Source: Council survey

The survey shows that people's satisfaction with their financial situation is low. Eurostat data from 2013 indicate that satisfaction with one's financial situation in Latvia is below the EU average. The results of the Council's survey confirm this, as the average level of financial satisfaction is comparable to data from 2013.

A3.3 Source: Council survey

A3.4 Source: Eurostat

The results of the survey indicate that people in Latvia have low trust in state institutions, and trust in the State Revenue Service (SRS) is below average. The results show that people's trust in the parliament, the government and the State Revenue Service is low. Even though trust in the tax collecting agency was higher than the parliament or government, the State Revenue Service score was lower than the score for state institutions in general.

A3.5 Source: Council survey

Satisfaction with the way taxes are spent

Legend:
- The collected taxes are spent appropriately.
- The quality of public services is appopriate, given the amount of collected taxes.

A3.6 Source: Council survey

**The population of Latvia is critical of the way tax revenues are spent and the quality of public services, even though paying taxes is believed to be a duty.*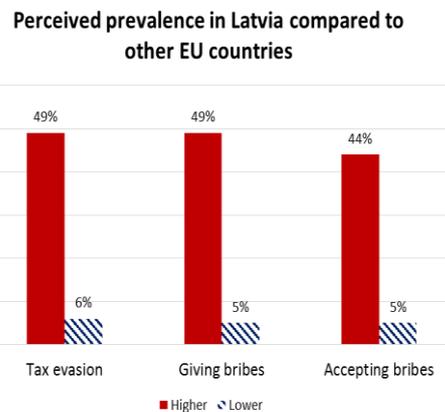* The results of the survey show that people think that the Latvian government does not use tax revenues appropriately. Furthermore, the quality of public services is deemed unsatisfactory (infrastructure and health care in particular) and inadequate, given how much revenue the government collects. Nonetheless, the vast majority believe that paying taxes is a duty.

The tax system in Latvia is believed to be unfair. Whether or not citizens perceive the distribution of income and exchange of taxes for public services to be fair influences their willingness to pay taxes. Our survey shows that 74% of all respondents believe that the tax system in Latvia is not fair.

People are dismissive of tax evasion and corruption, but believe that these are widespread in Latvia. The survey shows that the majority of respondents believe that giving and accepting bribes and evading taxes are not justifiable acts. However, a large part of respondents believe that such practices are much more widespread in Latvia than they are on average in the EU.

The justifiability of tax evasion and bribery

Legend: Unjustifiable, Mostly unjustifiable

A3.7 Source: Council survey

Perceived prevalence in Latvia compared to other EU countries
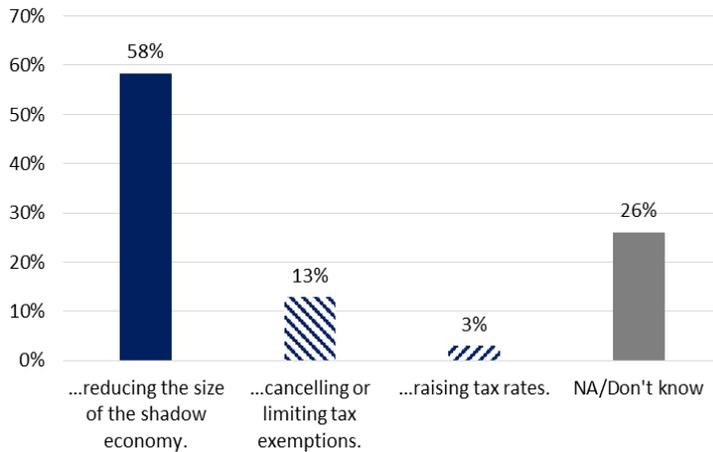
Legend: Higher, Lower
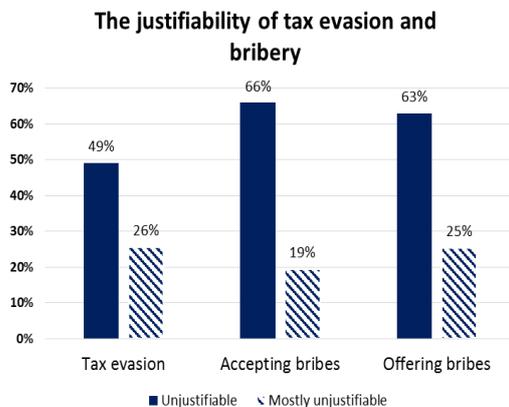
A3.8 Source: Council survey

The majority thinks that the state should provide more services, but this preference is offset by an unwillingness to pay higher taxes. The majority of respondents agreed or mostly that the state should take greater care that everyone is provided for (64%) and fund health care to a greater extent (81). This would suggest a preference for a welfare state. Nonetheless, the results of another recent survey[6] show that the preference for state-funded services decreases once it is made explicit that increasing the range of public services would mean higher taxes.

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[6] *Baltic International Bank Latvijas Barometrs*, June 2016, available at:
http://www.bib.eu/wrapper/fileviewcounter?rid=1869, accessed on 03/10/2016.

Reaching the intended tax-to-GDP ratio of 1/3 should be primarily achieved by...

...reducing the size of the shadow economy.	58%
...cancelling or limiting tax exemptions.	13%
...raising tax rates.	3%
NA/Don't know	26%

A3.9 Source: Council survey

The majority thinks that tax revenues should be increased by reducing the size of the shadow economy. When presented with different alternatives to raising government revenues, 58% of respondents said that this should be done by limiting tax evasion. This would be preferable to raising tax rates or reviewing tax breaks.

In conclusion, the survey shows that Latvia performs poorly on questions that can be used as proxies for tax morale. While many think that tax evasion is unjustifiable and tax revenues should be increased by reducing the shadow economy, a significant part of Latvia's society is tolerant towards tax evasion and has experience of tax evasion. What is more, questions concerning financial satisfaction, trust in state institutions, the quality of public services, the prevalence of corruption and tax evasion, and perceptions of the tax system indicate widespread dissatisfaction and mistrust.

The Council suggests strengthening tax morale as a way of improving compliance with tax law. This can be achieved by building trust in the tax system and State Revenue Service. Furthermore, by strengthening and clarifying the link between the amount of taxes paid and the quality and scope of public services, faith in the fairness of the fiscal exchange may be increased.