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Master Thesis

Administrative Dimensions of Tax System Reform in Transition Countries - Comparison between Croatian and Slovenian Tax Administration

Student: Aleksandar Dragojlovic

Supervisors: Dr. Veronica Junjan
Dr. Duco Bannink

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Abstract

This Master Thesis presents administrative dimensions of Tax system reform in transition countries. Efficient and effective reform of tax policy and Tax Administration is essential for successful economic reforms. The major mistake in tax reform in transition countries was focus primarily on modernizing tax policies and relegating Tax Administration and taxpayer issues to a remote second place. The results have been in many cases a decreasing level of tax collections and an increasing level of tax evasion. It was clear that there is no successful tax reform without, also successful Tax Administration reform. Unequal treatment of taxpayers, a weak enforcement strategy and poor focus on taxpayers are results of inadequate organizational and management structures. As a theoretical framework Street-level bureaucracy theory, Tax theory, and Organizational theory are adopted. The theoretical framework clearly defines desirable organizational and management state structures in Tax Administration in transition countries. The empirical part consists of comparative analysis between two countries: Croatia and Slovenia. They were members of former Yugoslavia republics and are characterized by planned socialism background. The analysis is based on data collected using the primary and secondary sources - documentary analysis, the archival technique, documents, and media. Planned socialism legacy explains the starting position for reforms characterised by a low level of effectiveness and efficiency of Tax Administrations in both countries. On the other side, the higher gap between the desirable and current organizational and management state structure in Croatian than in Slovenian Tax Administration explains the higher level of tax evasions in Croatia. To conclude, based on the results of comparative analyzes between these two countries various recommendation are proposed for Serbia. Establishment of an adequate organizational and management state structure for Serbian Tax Administration is right the way to decrease levels of tax evasion and to increase levels of collected taxes.

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Chapter 1 - Introduction

Tax Administration is essential for every country. In the situation with full tax compliance, which is extreme and an ideal situation, the role of the Tax Administration would be restricted to the provision of facilities for citizens to discharge their responsibilities to the society. In the case of non-compliance, the Tax Administration will have to play the role of policeman. Due to lack of resources and in the situation that it cannot play the role of a policeman to all taxpayers, one of the solutions is to support a voluntary compliance. In that sense, the fundamental role of the Tax Administration is to render quality taxpayer services and to encourage voluntary compliance of tax laws, to detect and penalise non-compliance. The extent of success of the Tax Administration in its role should be reflected through a higher revenue growth. Only with collected taxes, governments are able to provide all public services and to implement welfare programs.

We are witnesses that there is always a sector in economy of a country that builds its profits on tax evasion. This, so called 'underground sector' is a significant part of many economies. The major activity and goal of the underground economy is tax evasion. Tax evasion is defined as the sum of all taxable money income unreported with the intention to evade tax (Feige, 1990). Every government tries to keep tax evasion as low as possible. Tax evasion is a widespread problem in all countries, especially in transition countries. In these countries, tax evasion is very high. It is due to inadequate organizational structure to capture tax evasion, lack of sufficiently trained personnel to detect sophisticated tax evasion techniques, inadequate training, and insufficient resources to retain skilled personnel (Martinez-Vazquez&McNab, 1997). Tax evasion has an important effect on economy through direct (budget deficits and investment in public goods) and indirect (welfare loses due to shift to economic activities where taxes can be evaded) consequences. High level of tax evasion reduces 'government's ability to implement important reforms and provide adequate public goods' (Torgler, 2004: 3). Surveys of taxpayers in countries such as Australia, the Netherlands, Sweden and US showed that about one quarter of respondents actually admits to deliberately under responding income on their tax returns (Hasseldine&Li, 1999).

The size of the underground economy is more than double higher in transition than in developed countries. Average size of the underground economy (as a percentage of GDP) in East and Central European countries and former Soviet Union countries is 37.9% while in OECD countries it is 16.4% (Schneider, 2005). The underground economy expanded in all countries in the 1990s. Reason is that 'the benefits of staying in the informal economy were increasing (absence of the need to pay taxes) in relation to the benefits associated with

public services (weakness of government structures)' (Grabowski, 2005: 307). In the last fifteen years, countries in transition have experienced an impressive growth of private sectors through the process of privatization, restructuring and liquidation of state assets. According to EBRD estimates the share of private sector in GDP has increased on average from 11% in 1989 to 73.2% in 2002 (Masciandaro, 2004: 15). According to Grabowski, significant increase in the size of private sectors and stronger sensitivity to financial incentives caused that the underground economy has grown in the last fifteen years. The level and the size of underground economy in developed, in comparison to transition countries is very important to realize the importance and significance of this issue. All countries realize that a high level of the underground economy is a big threat for their economies and for their sustainable development. The level of tax evasion corresponds to the level of underground economy but not entirely. Tax evasion includes both legal (income earned from cash jobs) and illegal (prostitution, illegal gambling, etc) activities. The total level of tax evasion is smaller than the total size of underground economy. In order to estimate the level of tax evasion, the size of the underground economy needs to be adjusted. This can be achieved by excluding the value of non-taxable activities from estimates on the size of the underground economy. In that sense, here the term **underground economy** is used to 'refer to the value of economic activity that would be taxable were it reported to the tax authorities' (Brooks, 2001: 8). Accordingly, the level of underground economy will be used as a proxy to measure level of tax evasion.

Efficient and effective reform of tax policy and Tax Administration is essential for successful economic reforms in transition countries. In this Master Thesis, term 'transition countries' refer to the group of countries which had experienced socialist planned economies. The principles and practices of tax systems under planned socialism have largely determined the path of tax reform during the transition period. The legacy from planned socialism produced negative consequences for Tax Administration in transition countries (Martinez-Vazquez&McNab, 1997: 5-7). Also, the major mistake in tax reform in transition countries was focus primarily on modernizing tax policies and relegating Tax Administration and taxpayer issues to a remote second place. This is due to the time required for these efforts to take effect and it was and still is measured in years. There is no successful tax reform without Tax Administration reforms. The focus was shifted to tax policy reform, in many cases without considering the limited capacity of the Tax Administration. The results have been in many cases a decreasing level of tax collections and an increasing level of tax evasion (Martinez-Vazquez&McNab, 1997).

Based on aforementioned, and the necessity to decrease the level of tax evasion in transition countries, the main issue in this Master Thesis will be to define what is the

desirable organizational and management Tax Administration structure in transition countries that has to be established in order to decrease the level of tax evasion. The main actor in capturing tax evaders is **the 'Tax Administrator'**. They are the most important part in every Tax Administration. The level of their skills, knowledge and autonomy are essential to decrease the level of tax evasion. Autonomy was on a very low level during the planned socialism period and resulted in a high level of tax evasion. In the case of Croatia and Slovenia, the state-owned enterprises were under the strong protection of the government. Central bank provided loans to banks, which funded companies that are favoured but not profitable. In the context of fiscal policy, lack of fiscal discipline and implementing of soft budget constrains toward these companies resulted in a lower level of tax collection (Murphy, 2006). In other words, lack of fiscal discipline increased the level of tax evasion. Although tax administrators were able to detect tax evasion, lack of autonomy to do work properly neutralizes their skills to punish tax evaders. The pressure for lenient inspection of state-owned enterprises was strong and the result was in increasing levels of tax evasion. **The Main Research Question**, in this Master Thesis, is: What organizational and management structure, a state in transition, should have in order to increase autonomy of tax administrators which will decrease the level of tax evasion? **The Sub Research Questions** are: Which factors that influence the relationship between tax administrators and taxpayers, which can produce a high level of tax evasion in transition countries? What are the main factors that push people to avoid paying taxes? What organizational and management state structure is desirable in Tax Administration in transition countries? What are the consequences of planned socialism legacy for Tax Administrations in transition countries? What is the organizational and management state structure in Croatian Tax Administration? What is the organizational and management state structure in Slovenian Tax Administration? What are the main differences of the organization and management in state structure between Croatian and Slovenian Tax Administration that explain different levels of tax evasion? What recommendations can be drawn for the Serbian Tax Administration?

It is also important to define what autonomy is, or even more important, who is an autonomous person? We can say that autonomous person acts morally solely in order to successfully accomplish tasks, independently of other pressures and incentives. In other words, increasing knowledge, professional skills, and specialization of tax administrators will increase their autonomy. Increasing autonomy of tax administrators results in a lower level of tax evasion. In order to answer to the main research question, a comprehensive theoretical framework will be used. Theoretical framework consists of three theories: Street Level Bureaucracy theory, Tax theory and Organizational theory. Link between the research questions and theoretical framework is provided below.

Tax administrators may be seen as street-level bureaucrats that are in daily contact with taxpayers. Street-level bureaucrats may be defined as 'public service workers who interact directly with citizens in the course of their jobs, and who have substantial discretion in the execution of their work' (Lipsky, 1980: 3). Beside tax administrators, street-level bureaucrats include different public service workers such as police officers, social workers, etc. The main characteristic of their work is a confrontation with high demands for their services on one side and inadequate organizational and personal resources for doing job on the other side (Elmore, 1978). To make their work more manageable they are using coping mechanism. In relations between tax administrators and taxpayers' two things have to be taken into consideration. First, tax administrators confront with different taxpayers. Taxpayers are a heterogeneous group with different levels of power. It is not realistic to assume that all taxpayers are a week category and that tax administrators can easily bear with them. Second, we should not exclude possibility of converging interests between tax administrators and taxpayers. Empirical research in Denmark showed that inspectors have different attitude for different enterprises - public enterprises are subject to a more lenient inspection than private enterprises, large private enterprises are subject to more lenient inspection than small private enterprises, and leniency of the regulatory action is influenced by the degree of organizational match between the inspector and regulated enterprises (Nielson, 2006). In transition countries enterprises were state-owned with a high degree of organizational matches between the inspector and regulated enterprises. Autonomy of tax administrators was on a low level and under the strong pressure for lenient inspection of public owned enterprises. That resulted in a higher level of tax evasion in transition than in developed countries. After the privatisation of public owned enterprises in transition countries situation is completely different. Enterprises are private owned and the organizational structure between the inspector and the enterprises is different. More strict control may be expected on one side, but private enterprises will bring very sophisticated tax evasion schemes on the other side. In that sense highly educated and autonomous tax administrators are necessary in new circumstances. Planned socialism legacy has a strong influence on the starting position for reforms. However, after necessary changes, stronger position of tax administrators will lead to more efficient tax control and result in decreased levels of tax evasion.

For Tax theory is very important to understand why people avoid paying taxes. Using the economic approach of tax evasion and a rational economic behaviour toward tax compliance, 'taxpayer is seen to be making a rational calculation that weighs the gains from successful non-compliance (the tax obligation that is not paid and is kept for personal use) against the expected loss (the value of the penalty times the probability of detection) for

being caught' (Mikesell&Birskyte, 2007: 1046). As the probability of being caught increases, the expected gain from non-compliance falls and as the severity of fines and other consequences from being caught increases, the expected gain from non-compliance falls. The tax authorities should establish adequate audit rate and the penalties, in order to limit tax non-compliance to desired level. Enforcement strategy builds the desired compliance rate by a mixture of audit rates and severity of penalties. Three approaches will be used to explain economic costs of tax evasion and the role of tax administrators in catching tax evaders. The first approach is Cowell's (1990) Model, the second is Bird&Martinez-Vazquez&Alm's (2003) Model, and the third is Bloomquist's (2004) Model. Evasion costs are higher when the time length of time between an act of evasion and its detection is shorter. Shorter time length can be achieved only with highly educated and autonomous tax administrators able to detect tax evasion. According to that, there is a positive correlation between capability of tax administrators on one side and evasion costs on the other side. In addition, establishing taxpayer-oriented approach, besides enforcement strategy, will have positive influence on the level of collected taxes. Tax Administration has to treat taxpayers like citizens who have to fulfil some obligations and not like criminals whose main aim is to cheat the government. Establishing strong enforcement strategy and implementing taxpayer-oriented approach will contribute to increased levels of tax collection.

Last but not least, Organizational theory will define the desirable organizational and management state structure in Tax Administration in transition countries that has to be established in order to decrease the level of tax evasion. In the context of reform of Tax Administration, focus will be on the following organizational and management state structure: clear positioning of Tax Administration within the overall government structure, level of Tax Administration autonomy, internal organizational structure within the Tax Administration, the set up of Large Taxpayer Units (organization - state structure) and the set up of modern human resource management within the Tax Administration, including the focus on taxpayers (management - state) (Gill, 2003). Discussing pros and cons for establishing independent Tax Administration, for a high autonomy of Tax Administration, reasons to establish internal organizational structure based on functional criteria, including set up of Large Taxpayer Units, institute modern human resource management, and reasons to focus on taxpayers will provide a role model and desirable state structure of Tax Administration in transition countries. Establishing adequate organizational and management state structure in Tax Administration will strengthen the position of tax administrators and lead to a lower level of tax evasion.

The aforementioned theories will provide theoretical background for empirical research. The empirical part consists of comparative analysis between two countries: Croatia

and Slovenia. They were members of former Yugoslavia republics characterized by planned socialism background. The influence of planned socialism legacy on Tax Administration reform will be presented. The assumption is that planned socialism legacy produced the same negative implication regarding Tax Administration in all transition countries including Croatia and Slovenia. The difference in the level of tax evasion in these two countries will be explained by comparing desirable organizational and management state structure in Tax Administration adopted by developed countries and current organizational and management state structure in Croatian and Slovenian Tax Administration. The higher gap between desirable and current organizational and management state structures in Tax Administration will lead to a higher level of the underground economy. The closer are desirable and current organizational and management state structures in Tax Administration it will result in a lower level of the underground economy. In this context, Croatia and Slovenia have the same historical background, but different organizational and management state structures in Tax Administration. This will explain different levels of the underground economy in these two countries. Also, focused comparisons of organizational and management state structures in Croatian and Slovenian Tax Administration, as a technique of comparison, will be used (Hogue&Harrop, 2004: 80). Data will be collected using the primary and secondary sources - documentary analysis, the archival technique, documents, and media (Grix, 2004: 131-134). The official documents issued by Croatian and Slovenian Tax Administrations and viewpoints of experts regarding reforms and current state in Tax Administration in these countries will be used. In the end, in conclusion part, based on the results of comparative analysis in these two countries various recommendations will be proposed for Serbia. Establishing adequate organizational and management state structure in Serbian Tax Administration will lead to a lower level of tax evasion and a higher level of collected taxes.

Chapter 2 - Theoretical Framework

The theoretical framework consists of three theories: Street Level Bureaucracy theory, Tax theory and Organizational theory. Every theory will contribute for making a comprehensive theoretical framework in order to give answers on the main research questions. The core elements of theories are provided below.

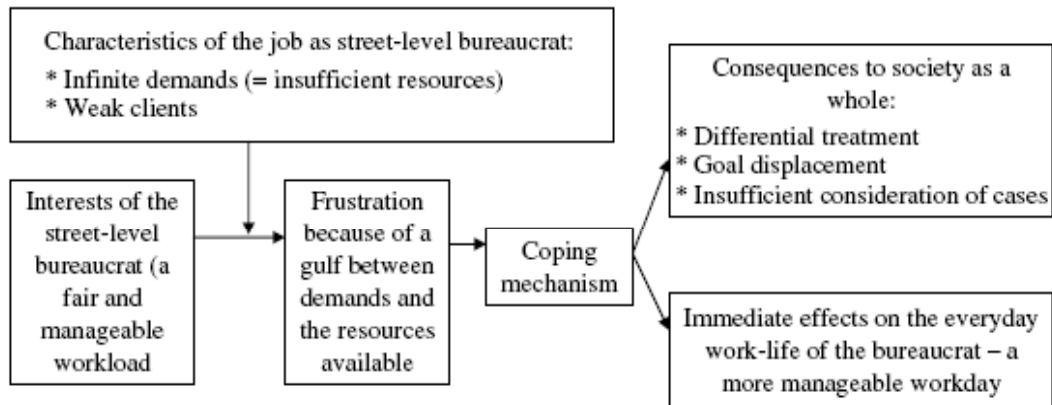
2.1 Street Level Bureaucracy theory

There are two theoretical approaches that policy analysts offer in order to answer the questions such as, how are policies implemented, what factors affect implementation, and how can policy implementation be strengthened? They are (Gilson&Walker, 2004): top-down and bottom-up perspectives. The main differences between these two approaches is that in top-down approach implementation is planned and controlled from the top (by central planers) and the gap between objectives and outcomes results in implementation failure. On the other side, bottom-up perspective sees policy changes as a much more dynamic process and the gap between objectives and outcomes is a demonstration how policy is recreated through the process of implementation. The founding father of bottom-up perspective is Michael Lipsky. He first used the term 'street level bureaucrats' in analysing the behaviour of front-line staff in policy delivery agencies. Lipsky defines street-level bureaucrats as 'public service workers who interact directly with citizens in the course of their jobs, and who have substantial discretion in the execution of their work' (Lipsky, 1980: 3). This category can include different public service workers such as police officers, social workers, tax workers, etc. The main characteristic of their work is that they confront with a high demands for their services on one side and inadequate organizational and personal resources for doing the job on the other side (Elmore, 1978). They confront with inadequate time in relation to the limitless needs and find that work situations and outcomes are unpredictable (Hill&Hupe, 2002: 53). It was argued that street-level bureaucrats possess discretion in distributing services or providing sanctions to clients. According to Lipsky, front-line workers have 'considerable discretion in determining the nature, amount, and quality of benefits and sanctions provided by their agencies' (Lipsky, 1980: 13). The successful street-level bureaucrats with their own needs, learn how to manipulate rules, control clients, carefully ration services and benefits, and thus to redefine public policy (Prottas, 1979: 103). They are able to act relatively autonomously from the authority of organisation in which they work (Lipsky, 1980: 16; Prottas, 1979: 111).

According to Riccucci, there are three groups of actors in hierarchical lines who are involved in the implementation process. The first group are the elected, appointed and career officials. They interpret the law, issue the rules and regulations, and carry out the laws. The second group are the local agency officials. They follow the instructions defined from the first group of actors and develop and implement programs for clients. The third group are the street level workers. They implement policies defined from the previous two groups. All actors in implementation process add some specific values that can affect policy delivery and the output. The role of the street-level workers is the most important for implementation programs because 'the actions of front-line workers have substantial and sometimes unexpected consequence for the actual direction and outcome of programs' (Riccucci, 2002: 903). Because they 'process people', the power of street level workers is very high (Hasenfeld, 1992: 4). It is argued that street-level bureaucrats have discretion in how social welfare programs are administered (Riccucci, 2002) or that 'the caseworkers who interact directly with clients . . . play an especially important role in determining how benefits are distributed' (Keiser, 1999: 9). Street-level bureaucrats must transform citizens into clients - take individuals and place them in administrative categories such as "mentally ill," "alcoholic," or "poor" (Protas, 1979: 1). Street-level bureaucrats have power to change the defined policies, and have a high influence on the outcomes of the policies. They are looking on clients as individuals with strengths and weaknesses and they do not tend to treat citizen-clients as faceless, dehumanized cases. Street-level bureaucrats try to make their work more manageable and to avoid confrontation with work failures. Actually, they want to minimize negative aspects of the job and hence of frustration. However, behaviour of street-level bureaucrats is positively motivated too, as a way of maximizing job satisfaction.

As was mentioned before, street-level bureaucrats are confronted with a high demands for their services and inadequate organizational and personal resources to accomplish clients' demands. They are neither able to accomplish quantity of demands nor quality (substance) of demands. In order to accomplish their tasks they develop coping mechanisms. Actually, they are compelled to use coping mechanism. Otherwise, they would be psychologically exhausting with never-ending demands. Even they do not feel good to use coping mechanisms, they use it as a tool to achieve a fair and manageable workload (Nielsen, 2006). Street-level bureaucrats may be policy-makers, but they are using this freedom mainly to manage their work. We can call this (Hill&Hupe, 2007: 283) 'coping strategies' (Lipsky), 'defences against discretion' (Satyamurti) or 'strategies of survival' (Hughes). The explanatory mechanism of a street-level bureaucrat (according to traditional studies) is illustrated in Figure 1. (Nielsen, 2006: 865).

Figure 1. The traditional explanatory model of street-level bureaucratic behaviour

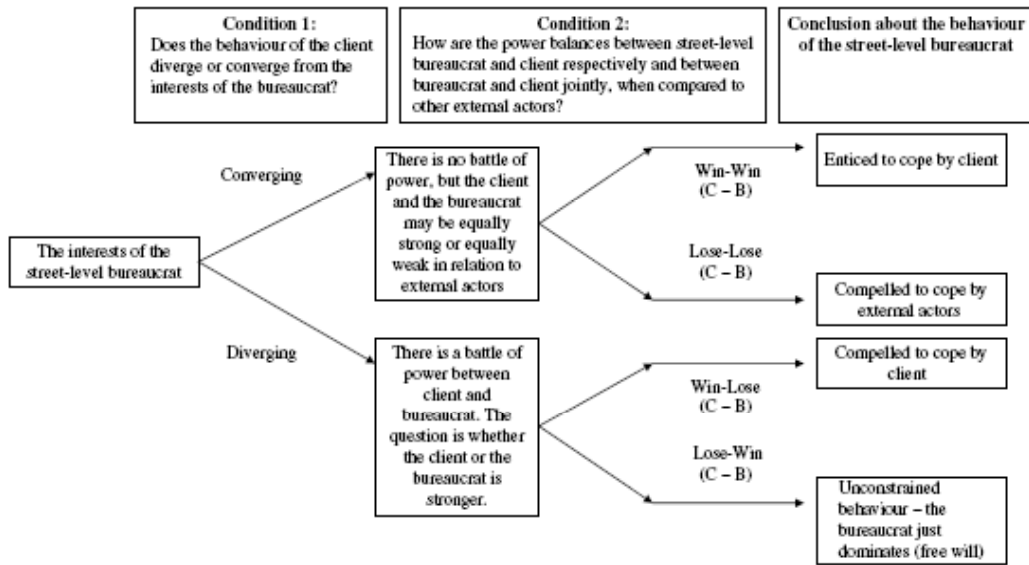


Source: Nielson (2006: 865)

Based on the Figure 1, work of a street-level bureaucrat is characterized by infinite demands and weak clients. Due to organizational and personal deficiencies to achieve high clients' demands in their interest is to use coping mechanisms. Coping mechanisms will produce two outcomes: differential treatment, goal displacement and insufficient consideration of cases on one side, and a more manageable work on the other side. According to this concept, each interaction between client and bureaucrat involves conflict. Namely, 'client wishes to insure that his understanding of his case prevails, the street level bureaucrat wishes to obtain the bureaucratically relevant information in a minimal amount of time. The situation is complicated further, by the difficulty clients frequently have providing information in bureaucratically correct formats' (Protas, 1979: 104).

Contrary to this model, an alternate model is made, which includes a broader range of job characteristics and explains the behaviour of other street-level bureaucrats besides social service personnel. Figure 2, illustrates the relation between bureaucrats and clients that can result in one of four situations (win-win, lose-lose, win-lose, lose-win) based on two conditions (Nielsen, 2006: 872).

Figure 2. Model of behavioural outcomes concerning reasons to cope



Source: Nielson (2006: 872)

Based on the two conditions, conclusions are provided in regard to behaviour of the street-level bureaucrats. First condition is regarding the converging and diverging interests between the bureaucrat and his clients. The second condition is a matter of power balances between the bureaucrat and the client (when they have diverging interests) and between the bureaucrat and clients jointly in respect to other external actors (when they have converging interests). The whole process can result in four possible situations: win-win, lose-lose, win-lose, and lose-win. Contrary to the previous model it is not realistic to assume that all clients are a weaker than the bureaucrat and to exclude the possibility of converging interests (win-win situation between the client and bureaucrat). Clients are a heterogeneous group and can have strong powers. In that sense, the contemporary state creates both right and obligations for citizens. To use the rights and to fulfil the obligation, citizens need good access to administration. In this case, term access refers to the relationship between the state and citizens where, 'public' or 'citizens' should not be conceptualized as an undifferentiated mass. Different social classes seek different things from administration, have different level of dependency on the state, and enjoy different levels of political efficacy in claiming their rights and protecting their interests (Smith, 1988: 177; Crenson, 1971: 11-18). Furthermore, political resource is only a potential source of influence. Individuals with the same amount of resources may exert different degrees of influence because they use their resources in different ways. Whenever an individual chooses not to

use all of his resources in order to gain influence, it may be concluded that his actual present influence is less than his potential future influence (Dahl, 1969: 271).

As a result, in the situation where client's behaviour converges with the interests of the street-level bureaucrats, external actors (administrative and political leaders) could diverge or converge with these interests. In the case of divergence of interests, it becomes crucial how powerful the alliance between bureaucrats and clients is, compared to these external actors. In other words, in case of converging interests between client and bureaucrat, the surroundings become an independent fellow player or opponent. Otherwise, when the interests of the street-level bureaucrat diverge with the interests of the client, the surroundings play no independent role, but may become an ally to one of them (Nielsen, 2006).

Relations between a street-level worker and a client may be tested using assumptions provided in Table 1. This model will contribute to better understanding of relations between tax administrators and taxpayers in transition countries. Table 1, illustrates these relations (Nielsen, 2006: 877).

Table 1. Coherence between the regulatory inspectors' interests and regulated companies' power resources

Power resource with potential effect on the behaviour of the inspector	Motivational mechanism	Conclusion regarding whether the power resource diverges or converges with the inspector's interests
Organizational similarity	Represents positive pressure on the inspectors' interest in positive interaction with the regulated	Converges
Knowledge	Represents positive pressure on the inspectors' interest in professional challenges	Converges
Local economic strength	Represents negative pressure on the interest in autonomy	Diverges

Source: Nielson (2006: 877)

There are three assumptions in the model. The first assumption is that organizational similarity between inspectors and regulated enterprises results in situations where the power resource converges with the inspector's interests. The second assumption is that client's knowledge will lead to the state that the power resource converges with the inspector's interests. In the end, the third assumption is that local economic strength will

lead to the state that **the power resource diverges with the inspector's interests**. Based on these assumptions, this model was tested concerning the regulation of 174 Danish enterprises in four different regulatory areas (municipal enforcement of environmental regulation, county's enforcement of environmental regulation, national regulation of occupational health and safety, and municipal enforcement of fire precaution regulations). The results show that public enterprises are subject to a more lenient inspection than private enterprises and large private enterprises are subject to more lenient inspection than small private enterprises. Furthermore, the results show that leniency of the regulatory action is influenced by a degree of organizational match between the inspector and the regulated enterprise. The more the working conditions and organizational structures of the enterprise equal the working conditions and organizational structures of the regulatory inspector, the more lenient are his or her regulatory actions. Accepting the argument that **organizational match represents a positive pressure on the inspector's interests**, it is concluded that organizational match entices the inspector to treat the regulatee more leniently. It results in a win-win situation where the regulatee gets a more lenient inspection on one side and the inspector gets a more pleasant work day on the other side. The level of negotiation has a positive, significant effect on the leniency of inspection. In addition, a high degree of knowledge and a high degree of local economic strength have a significant influence on the degree of negotiation. Inspectors have different attitude for different enterprises. For one group of enterprises inspectors spend more time in helping out, listening, searching for possible solutions than with others. To summarize, 'a regulated company that possesses either organizational match or knowledge is able to entice the inspector to either a more lenient inspection or a higher degree of negotiation. Moreover, a company with local economic strength is able to compel the inspector to a high degree of negotiation, something that in turn will lead to a more lenient inspection' (Nielson, 2006: 880).

Economic structure in transition countries is characterized by state-owned enterprises. The impact on tax administrator's autonomy is depicted through pressure for more lenient inspection toward state-owned enterprises. In situation where they cannot do work properly, the level of autonomy is on a low level. As a result, we have a higher level of tax evasion in transition than in developed countries. After privatisation of state-owned enterprises, tax administrators are in a better position than before. However, then tax administrators start to confront with highly sophisticated tax evasion schemes. In order to cope with these problems, high autonomy must be provided by establishing an adequate organizational and management state structure in Tax Administration. The burden of planned socialism legacy that will be explained later, has a strong impact on reform

processes, but with a clear vision of the leaders the main goal is achievable. Specialization and standardization of working processes is possible to increase only with establishing the adequate organizational and management state structure in Tax Administration in transition countries. Moving towards high autonomy of Tax Administration, establishing adequate internal organizational structure, improving quality of tax administrators and focusing on taxpayers will contribute to increasing of quality in inspection. Different attitude of tax administrators for different enterprises has a strong influence on the level of collected taxes. Fairness of the tax system is ruined and a culture to cheat the government is created. Also, an environment where enterprises are not equal in front of the Tax Administration is formed. In such circumstances organizational matches between Tax Administration and taxpayers, level of knowledge and local economic strength will decide the level of taxes that enterprises have to pay. Similar organizational matches between Tax Administration and taxpayers, a high level of knowledge and a high local economic strength of taxpayers will result in a more lenient Tax Administration inspection toward these enterprises. As a result, we have a lower level of tax collection than planned. In order to overcome this issue, strengthening organizational and management state structure is crucial. Moving towards desirable organizational and management state structure, explained in Section 2.3, will increase capacity of Tax Administration in order to cope with tax issues. This results in an increased level of tax collections and increased trust in the fairness of Tax Administration. Increasing capability of tax administrators to bear with taxpayers will have significant positive influence on the level of tax evasion. Otherwise, inadequate organizational and management state structure of Tax Administration will result in a weak institution for collecting taxes and increased level of tax evasion. Establishing the equity principle with increasing efficiency and effectiveness of Tax Administration is the right way to increase levels of tax collection.

2.2 Tax theory

The effects of tax evasion play significant role in every society. Government's ability to service all citizens' demands, in a significant way depends on the amounts of collected taxes. With collected taxes, the government serves health system, education, social services, infrastructures (roads, highways, railways and other), etc. Essential interest of every government is that the level of tax evasion should be as low, as possible. First of all, it is important to distinguish between tax avoidance and tax evasion. Tax avoidance is a change in behaviour to reduce tax liability. It is within the legal framework of the tax law and taxpayers just use available mechanisms to reduce level of tax liability. In order to reduce the level of tax liability in their interest is to make detailed statement of the transaction (Sandmo, 2005). On the other side, tax evasion is outside the legal framework of tax law and the taxpayer worries about the possibility of his action being detected. Furthermore, we can distinguish these terms based on three aspects (Cowell, 1990: 10): legal, moral and agnostic. From the legal point of view, the distinction between evasion and avoidance can be taken purely a question of legal boundaries: evasion is outside the law and avoidance is not. From the moral point of view, it is argued that certain types of avoidance are just morally wrong as evasion and therefore should be treated the same as evasion for the purposes of analysis. In the end, from the agnostic point of view evasion and avoidance are merely two arbitrary segments of a continuum that stretches from innocent tax planning to outrageous fraud.

The taxpayer's decision to comply, or not to comply, with his fiscal obligations has been the subject of considerable literature on the themes of tax evasion (Bird, 2004). There are two different paradigms that are used in order to encourage tax compliance, each with different implications for tax compliance behaviour. The first paradigm is a standard economic model of tax evasion based on the economic theory of crime that emphasizes repression of illegal behaviour through frequent audits and rigid penalties. The second paradigm recognises the role of enforcement strategy (audit and penalties), but also emphasizes the role of tax administrators as facilitators and a providers of services to tax paying. It stresses the role of social norms in tax compliance, in the sense that the government can change tax compliance by changing the social norm of tax compliance (Bird&Martinez-Vazquez&Alm, 2003: 156). Regarding Tax theory, focus will be on the enforcement tools to increase tax compliance (first paradigm) but we should have to bear in mind that focusing on taxpayers is the second very important part to increase tax compliance (second paradigm).

According to Cowell, the taxpayer may perceive certain choices with regard to tax declaration, financial transactions, or economic activity to be potentially costly in that they

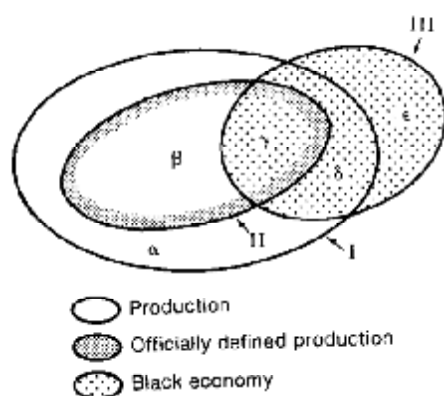
are subject to the threat of exposure and penalty. This perception will influence such choices, hence influencing the response of the economy as a whole to the fact of evasion and apparatus of control. The important issue in tax regulation is which system of compliance serves best the implementation of the tax policy. The following are the general systems of compliance: voluntary compliance, institutional compliance, tax-assessment by the tax office and conditional assessment. One of the most important problems facing any Tax Administration is related to non-compliance. The main aim of Tax Administration is to try to collect taxes from those who owed them. Tax Administration deals with a wide range of taxpayers, and collecting taxes from all is a very difficult task. It is argued: 'it has never been easy to collect taxes from lawyers who take cash for a Saturday office visit, waiters who receive most of their income as tips, landlords who collect rent in cash, small business people who skim part of their profits or hire people off-the books, cash-only window cleaners, roofers and painters, or large corporations that contract out to sweatshops. It has been even more difficult to collect taxes from crack cocaine dealers, smugglers, hit-men and hit-women, and those who make their living defrauding and extorting their clients' (Brooks, 2001: 6). However, we do not have to live in illusions that taxes can be collected from all taxpayers. Even more, tax evasion should not be totally eliminated because 'the resource cost required to collect every dollar of liability would not be worth the benefits from having the extra revenue for public use' (Mikesell&Birskyte, 2007: 1049). In than context, it was the question why Internal Revenue Service (IRS)¹ does not increase the level of tax compliance regarding individual income tax from 87% toward 90%? The answer was that social cost of spending more on the IRS would exceed the social benefit of the increased revenue (Wadhawan&Gray, 1998). On the other side, substantial tax evasion cannot be tolerated because it is necessary to preserve the revenue base, to protect honest taxpayers, and to keep the actual burden distribution consistent with the law intended.

As was mentioned, the main aim of Tax Administration is to decrease levels of tax evasion. In that context, the term underground economy is strongly connected with tax evasion. The underground economy is the basis for tax evasion and refers to the part of economy that generates income, but goes untaxed. It comprises a wide range of economic activities. For this aspect of economy there are a lot of adjectives that can be used to describe this activity (Brooks, 2001: 8): black, cash, covert, dual, grey, hidden, illegal, informal, invisible, irregular, marginal, moonlight, parallel, second, shadow, subterranean,

¹ IRS is the US government agency responsible for tax collection and tax law enforcement

twilight, under-the-table, unobserved, unofficial, unrecorded, unreported, etc. Level of the underground economy will be used as a proxy to measure tax evasion. A schematic depiction of the relationship among different types of economic transaction is shown in Figure 3 (Cowell, 1990: 15). First boundary lies between transactions that constitute production and those that do not. Second boundary is the official production boundary, which represents what actually appears in country's national accounts. It is inside the first boundary because official statistics more strictly define what constitutes production than economists. Third boundary delimits the underground (black) economy. Three different types of economic activity can be distinguished within the underground economy category. Two of them (δ and γ) belong to both categories (formal and underground economy) because some activities may successfully be concealed from the tax authorities but show up in estimated expenditures (reason is that statistics on national accounts are cross-checked from several sources). The third part of the underground economy is the benefit from fraud and tax evasion outside production sector.

Figure 3. The scope of the underground economy

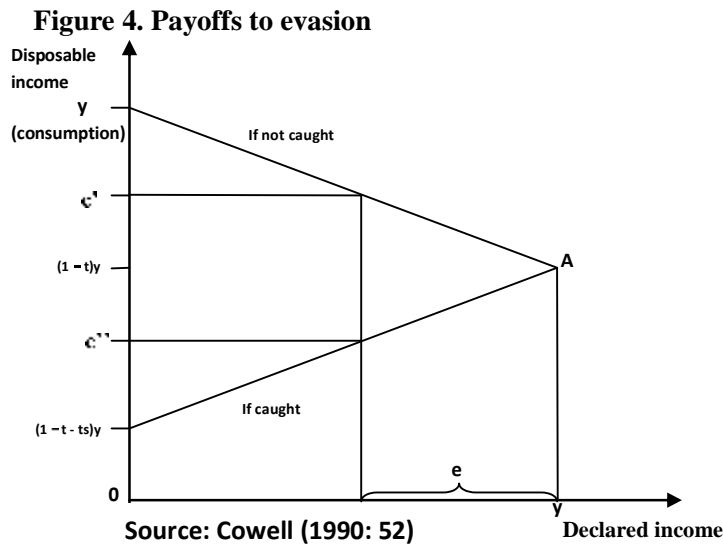


Source: Cowell (1990: 15)

Explanation. α : housework, do-it-yourself work, voluntary organizations; β : legal official production, private and public sectors; γ : underground economy allowed for in official accounts; δ : underground economy not allowed for in official accounts; ϵ : benefit fraud and tax evasion outside production sector; I, II, III: boundaries

The incentives for evasion depend on the costs and benefits expected from non-compliance. The benefits of evasion tend to increase with the amounts of tax to be paid. The costs of tax evasion vary with the penalties involved, and the probability of being caught by authorities (Hogue, etc, 1998). In order to explain reasons for tax avoiding and to understand possible economic benefits and costs of tax evasion, we have to use economic model based on several assumptions. The assumptions are (Cowell, 1990: 51): a) the taxpayer has a fixed

gross income, y , which is liable to tax; b) there is a proportional income tax at rate t ; c) there is a fixed probability, p , that tax evasion will be discovered and punished; and d) the tax on any income found to have concealed from the authorities is subject to surcharge at a rate s . Based on these assumptions, it will be convenient to refer to the collection as $\psi = (p, s, t)$ as the tax-enforcement parameters. Figure 4, presents payoffs to evasion (Cowell, 1990: 52).



What can we conclude from this Figure? Based on this Figure we have three types of taxpayers: absolutely honest, partially honest and absolutely dishonest taxpayers. The situation that confronts each taxpayer is: for every dollar of gross income, he would receive $\$(1 - t)$ if he honestly declared it to the tax authority, $\$1$ if he dishonestly failed to declare it but managed to escape detection, and $\$(1 - t - ts)$ if he was dishonest and got caught. Declared income is measured along the horizontal axis and where disposal income (consumption) in the two states 'if not caught' and 'if caught' is related to declared income by the two sloping straight lines that meet at A. The situation where taxpayer is absolutely honest is presented by point A. In this point, taxpayer declares income in y and has disposable income $(1 - t)y$. In the situation where he is dishonest, his disposable income depends on how much he evades. Concealing an amount of income e (so that he reports and amount $y - e$), his consumption is c' if he is not caught and c'' if he is caught. When he is blatantly dishonest and reports nothing, his consumption is y if he is not caught and $(1 - t - ts)y$ if he is caught. This view of tax behaviour Mikesell & Birskyte named the compliance a lottery view. In this view, that can be called a rational economic behaviour toward tax compliance, 'taxpayer is seen to be making a rational calculation that weighs the gains from

successful non-compliance (the tax obligation that is not paid and is kept for personal use) against the expected loss (the value of the penalty times, the probability of detection) for being caught' (Mikesell&Birskyte, 2007: 1046). As the probability of being caught increases, the expected gain from non-compliance falls and as the severity of fines and other consequences from being caught increases, the expected gain from non-compliance falls. Tax authorities should establish adequate audit rate and the penalties, in order to limit tax non-compliance to a desired level. Enforcement strategy builds the desired compliance rate by a mixture of audit rates and severity of penalties².

Presented economic approach of tax evasion is based on the crime methodology. The previous model can be more clarified using the following approach. Similar like previous model, this approach has several assumptions (Bird&Martinez-Vazquez&Alm, 2003: 148): a) individual receives a fixed amount of income I , and must choose how much of this income to declare to the tax authorities and how much to under-report; b) individual pays taxes at rate t on every dollar D of income that is declared, while no taxes are paid on under-reported income; c) individual may be audited with a fixed, random probability p ; if audited, then all under-reported income is discovered, and this individual must pay a penalty at rate f on each dollar that he or she was supposed to pay in taxes but did not pay. Based on these assumptions, we have two possible situations. First, individual's income (I_c) if caught under-reporting equals:

$$I_c = I - tD - f[t(I-D)]$$

Second, individual's income (I_n) if is not caught under-reporting, equals:

$$I_n = I - tD$$

Accordingly, the individual chooses declared income to maximize the expected utility of the evasion gamble, or

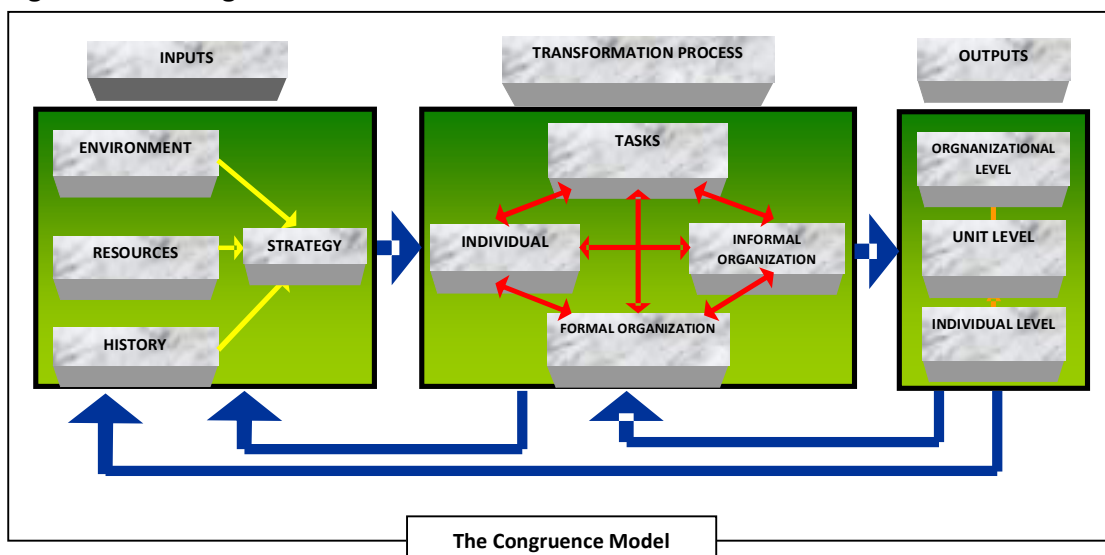
$$E U(I) = pU(I_c) + (1-p)U(I_n)$$

² The other view of tax compliance is 'the responsible taxpayer view' where emphasis is more on taxpayer education than on enforcement action against taxpayers

where E is the expectation operator and utility $[U(I)]$ is a function only of income. According to this model, increase in the probability of detection (p) and the penalty rate (f) unambiguously effect declared income. Increase in income has an ambiguity effect on declared income (it depends of individual's attitude toward risk). In addition, increase in the tax rate (t) has an ambiguity effect on declared income (higher tax rate increases the return to cheating, which reduce the amount of declared income but higher tax rate also reduces income). Based on aforementioned, tax audit probability and penalties have positive influence on the level of tax compliance.

The questions about the deterrent effects associated with penalties and the probability of detection are central for the tax compliance. Unlike other law enforcers, tax administrators 'do not start from a crime and work backward to suspects, but scan tax records looking for evidence of evasion' (Andreoni, etc, 1998: 818). Before explanation how penalties for non-compliance, together with audit control, can decrease the level of tax evasion, it is very useful to use Congruence Model in order to have the whole picture regarding Tax Administration functions and to understand better the relations between tax administrators and environment. The main functions of Tax Administration are (Tanzi&Pellecio, 1995): information and instruction of taxpayers; registration organizing and processing tax returns; coercive collection; control and supervision; and legal service complain. The Congruence Model considers Tax Administration as an enterprise that operates in a real environment. In order to accomplish its main functions, Tax Administration uses input for their work, and through the transformation process produces output. Figure 5, illustrates the Congruence Model (Gill, 2000: 9).

Figure 5. The Congruence Model



Source: Gill (2000:9)

The essential ingredients of organization, depicted in Figure 5, are (Davis & Scott, 2007: 19): environment, strategy and goals, work and technology (tasks), formal organization, informal organizational, and people. The main idea of this model is that efficiency and effectiveness of organization in achieving their main goals depends on the congruence or fit between different parts of the model. When there is a gap or lack of congruence between different parts it will result in an inadequate performance. The main elements of inputs are the environment (legal framework, the executive, the legislature, the judiciary, public sector institutions, public agencies, public service unions, taxpayers, stakeholders, banks, the economic environment, fiscal policy, other environmental factors), resources (capital, people, infrastructure, technology, information, legal authority and goodwill), and history (the effect of past events and decisions on current and future operations, strategic resource commitments, the nature of past crises and the response of the organization to them, the evolution of core norms and values and the experience with past reform efforts). Strategy of organization, as the fourth element, derives from the previous three. The main elements of the transformation process are tasks (the specific work activities and functions that are carried out to achieve the objectives of the organization), formal organization (governance arrangements, the institutional framework consisting of formal laws, rules and regulations applicable to the functioning of the organization, business processes, etc), informal organization (informal norms, conventions, values, processes, etc.), and individuals (success of the organization critically depends on their numbers, skill level, experience, commitment and morale). As a final result we have the output of the organization that represents the final product (amount of collected taxes, level of tax evasion, reputation of Tax Administration, etc). Outputs measure how efficient and effective the organization is in achieving its goals (Gill, 2000). Tax administrators operate in a complex and dynamic environment. Taxpayers are the most important element of that environment. They are using different methods to evade taxes. The more sophisticated the taxpayers, the more complex are methods that they use to avoid taxes. Accordingly, the level of taxpayer's sophistication influences the degree of investigation skills of tax administrators (the more sophisticated the taxpayer, the higher level of tax administrator's investigation skills is necessary). Also, it adds to the proportion of resources that need to be devoted to detection and control of tax fraud. With establishing of an adequate and strong formal and informal organization, the position of tax administrators, in respect to the taxpayers, will be stronger and in the end will result in a higher level of tax compliance.

Based on aforementioned, 'compliance with tax laws must be created, cultivated, monitored and enforced in all countries' (Bird, 2004: 138). The Tax Administration has to establish adequate penalties for non-compliance taxpayers and maybe rewards taxpayers

that comply with their obligations on time. People comply with tax laws 'so long as they feel that non-compliance may cost more, that is, that the penalties likely to be suffered in case evasion is detected exceed the tax to be paid' (Bird, 2004: 138)³. Due to lack of resources, Tax Administration cannot play the role of a policeman for every taxpayer. In that sense, self assessment is a method that is wide accepted. According to that method, taxpayer will have to assess how much they have to pay according to tax laws on one side, and Tax Administration will control the regularity of the whole process on the other side. To ensure that self-assessment will bring a high level of tax compliance, an appropriate penalty system and audit control is still necessary. Tax Administration can be effective only in an environment in which citizens (taxpayers) are induced to comply with tax laws voluntarily. The legal environment, or more precise tax laws and rules, determine penalties for non-compliance (Gill, 2000). For instance, diagnostic question is defined as following: are the penalties for non-compliance adequate to discourage non-compliance and tax evasion? The possible situation is that penalties for non-filing of tax returns, non-payment of taxes, attempt to evade taxes and duties, failure to give information, giving false evidence, etc. are inadequate to deter non-compliance and tax evasion. The possible reform option is to match penalties with the tax implications of defaults, so as to encourage compliance.

In intention to enforce taxes two types of errors can be made: Type I Error (where an offending taxpayer is not found or in other words falling to catch tax evaders), and Type II Error (where a taxpayer is wrongly charged with a tax offense). In order to minimize a Type I Error, automatic penalties can be used to prove offenses, but in the same time to fall in the trap to maximize a Type II Error and to punish the innocent taxpayers. Penalties, as an important part to decrease tax evasion, should be increased with (Bird, 2004): the potential revenue loss due to the tax offense; the difficulty and cost of detecting the offence; the effect of the offence on other taxpayers; the offender's state of mind (a higher penalty should apply if the offence is deliberate and pre-planned); and recidivism. Also, we have to take in consideration that 'penalties should depend on the similarity of the offence to actions which are punishable under other laws, given the cultural context' (Bird, 2004: 143). As Bird argued, we have several other things to bear in mind when we discuss about this issue: different channels of evasion, although they may legally constitute different offenses, are often substitutes as far as the taxpayer is concerned; issue concerns penalties for technical offenses which do not result in explicit underpayment of taxes; when several

³ To have comprehensive picture regarding why people pay taxes it is necessary to add elements such as social values, public morality, and people's perception about fairness of the system

different taxes are payable by the same taxpayer, penalties should predispose taxpayers to attempt to evade the most easily enforced taxes if evasion cannot be completely curbed; and with any reasonable interest-cum-penalty structure, especially time-varying penalties, tax delinquency should not pay.

As was mentioned, beside the penalties, as an instrument to decrease the level of tax evasion, tax audit is the second element of that picture. Even more than that, tax audit is the most important element of the enforcement strategy of any Tax Administration. As the compliance lottery view predicts, higher tax audit rates increase tax compliance (Mikesell&Birskyte, 2007). This relationship is not linear and the impact of audit is not uniform for all taxpayers. Also, some auditing programs may be more effective in encouraging compliance than other. In order to catch tax evaders, auditors (tax administrators) ability and autonomy is very important. The model that can be very useful is Tax Compliance Simulator (TCS)⁴. According to Bloomquist, for income that is not visible, TCS assumes taxpayers adopt the approach of standard microeconomic theory, which says that a risk neutral taxpayer will evade tax whenever the perceived audit rate (p) and penalty rate (f) take on values that make the following expression true (Bloomquist, 2004):

$$p < \frac{1}{(1+f)}, \text{ where } f \geq 0$$

The taxpayers with a high compliance opportunity costs (high discount rate) are more likely to evade than other taxpayers (Bloomquist, 2004). Regarding to that TCS modifies the taxpayers reporting decision by incorporating variables to account for the time lag between an act of evasion and its detection and the taxpayer's discount rate. The model has included a third variable that represents an auditor's ability to detect evasion. With these modifications, the taxpayer's income reporting decision becomes (Bloomquist, 2004):

$$p < \frac{1}{(1+g)}, \text{ where } g = (f \times d) / (1+r_i)^t$$

⁴ Tax Compliance Simulator is a model that combines both theoretical models and known empirical relationship into a decision support tool that analysts can use to investigate the possible implications of alternative compliance strategies

In this formula, (t) is the number of periods between evasion and detection, (d) is auditor detection rate ($0=d=1.0$), and (r_i) is discount rate for taxpayer [$i(r_i \sim N(r,s), r_i = 0)$], with (r) and (s) determined by the user. The present value cost evasion is inversely related as an exponent to the length of time between an act of evasion and its detection. In the end, how much is voluntarily reported by taxpayers is presented in next formula, which takes into account reporting of both visible and non-visible income components:

$$T_r = t(Y_v + ? Y_{nv}), \text{ where } ? = \begin{cases} 1 & \text{if } p \geq \frac{1}{(1+g)} \\ 0 & \text{otherwise} \end{cases}$$

In this formula, (Tr) is the reported tax amount, (Yv) is visible income, (Ynv) is non-visible income, and (t) is the tax rate. Evasion costs are higher when the time length between an act of evasion and its detection is shorter. Shorter time length can be achieved only with high educated tax administrators that are able to detect tax evasion. There is a correlation between evasion costs on one side and ability and autonomy of tax administrators on the other side. Audit rate produces much better results than high penalties rate. With high rates of detection even mild penalties can be an effective deterrent (Mikesell&Birskyte, 2007). The results of the study in Swiss cantons show that audit probability has positive and significant association with compliance, while the penalties has positive but insignificant association with compliance. Many other studies showed that penalties and audit probabilities have deterrent effect, but magnitude of these effects is still unclear (Pommerehne&Frey, 1992). In the end, it was said that two things are unavoidable: death and taxes (Stiglitz, 1985). Based on aforementioned we can conclude that today only one of these is unavoidable.

Based on the previous three models (Cowell's Model, Bird&Martinez-Vazquez&Alm's Model, and Bloomquist's Model), the role of tax administrators in capturing tax evaders is crucial. In these models, taxpayers make calculation between gains of non-compliance on one side and expected loss on the side. The higher probability that taxpayers will be caught by tax administrators and the shorter time length between act of evasion and act of detection, result in the higher expected loss. According to that, tax administrators' ability to work autonomously is very important. Otherwise, in situations where taxpayers recognize that probability to be caught is low and where time length between the act of evasion and the act of detection is long, the gains of non-compliance is high. That situation was in planned socialism period where state-owned enterprises were under more lenient inspection than private enterprises. Actually, tax administrators could not have done their job properly. In order to increase taxpayers expected loss for being caught Tax

Administration has to establish adequate organizational and management state structure. With increasing autonomy of Tax Administration, effective internal organizational structure and well trained tax administrators, taxpayers expected loss will be increased. Adequate organizational state structure will increase specialization of tax administrators and adequate management state structure will increase professional skills and readiness of tax administrators to bear with taxpayers. Both of them, adequate organizational and management state structure, will produce positive, synergetic effect to Tax Administration. Taxpayers have to know that every attempt to cheat government will be punished. That will create environment where paying taxes are obligations which have to be fulfilled by all taxpayers. In addition to that, with adequate organizational and management state structure, Tax Administration will be able to implement taxpayers-oriented approach. Beside strong enforcement strategy (tax audit and penalties), focus on taxpayers is an additional element to increase the level of tax compliance. Treating taxpayers as clients, not as criminals whose main aim is to avoid paying taxes, will produce a positive effect on the level of tax compliance. Accordingly, in order to set up strong enforcement strategy and to implement taxpayers-oriented approach, establishing adequate organizational and management state structure, explained in Section 2.3, is essential. Furthermore, both state structures are necessary to be established in order to decrease levels of tax evasion. Establishing adequate organizational state structure, without adequate management state structure, and the other way around, will produce weak institutions for collecting taxes. Both structures have to be established in the same time, or to tend to do that, in order to make an adequate and responsible Tax Administration.

2.3 Organizational theory

It is often argued that public sector organizations face greater pressures for representativeness, accountability, and responsiveness than private firms. Accordingly, internal organizational structures will be influenced and constrained by external forces. Following set of observations about environmental influence are important when we analyze organization of public sectors (Jaffee, 2001: 226): public organization provides a large number of opportunities for 'multiple access to multiple authoritative decision makers', that is, policy-making processes are designed to be influenced by a range constituencies that represent a wide range of views; the pressures for accountability and fear of the political and legal repercussions of decisions results in administrative behaviour that is highly cautious and constrained by multiple layers of approval; the goals and objectives of the public organization may be imposed by 'multiple external authorities' such as the legislative and judicial branches of government; the entry of political appointees can result in a rapid change in organizational priorities for the purpose of short-term political gain; and budget constraints and public oversight of employee salaries and compensation diminish the range of incentives that can be used to encourage inventiveness, risk taking, and extraordinary work effort; adaptation to environmental demands may not be the most efficient but is the one which is required for the ongoing flow of public funds and support. Establishing an adequate organizational and management state structure in Tax Administration is influenced by the necessity to have strong institution for collecting taxes. Weak Tax Administration results in increasing levels of tax evasion and a smaller state budget. Enforcement strategy (tax audit and penalties) and taxpayer-oriented approach can be implemented effectively only with an adequate organizational and management state structure.

Situation in transition countries was characterised with a low level of economic development and a high level of the underground economy. The Tax Administration was undeveloped and not able to operate efficiently. As a result, we had a high level of tax evasion in transition countries. The legacy of planned socialism that transition countries experienced includes tradition of negotiation of taxes, an interventionist tradition, lack of tradition with voluntary compliance, undeveloped Tax Administration, etc. In addition, there was lack of transparency in Tax Administration activities and enterprises did not know what other companies in similar circumstance paid. Actually, planned socialism legacy produced weak institutions for collecting taxes unprepared to bear with tax evaders on one side and with lack of focus on taxpayers on the other side. Based on Street-level bureaucracy theory, the impact on tax administrator's autonomy is depicted through pressure for more lenient inspection toward state-owned enterprises. In other words, tax administrators had different

attitude for different enterprises and culture where cheating government is not punishable is established. Based on Tax theory, the main elements for decreasing level of tax evasion are strong enforcement strategy and focus on taxpayers. Both elements were weak in transition countries. Using the both theories together, Street-level bureaucracy theory and Tax theory, we can conclude that organizational and management state structure was inadequate. Inappropriate state structures in Tax Administration resulted in a high level of tax evasion in transition countries. In that sense, in order to overcome aforementioned issues, Organizational theory will define organizational and management state structure that has to be established in transition countries.

In order to increase **capability of tax administrator's** Tax Administration has to be well established. Equal treatment of taxpayers, strong enforcement strategy and taxpayers-oriented approach are essential elements to increase levels of tax collection. Capability of tax administrators to discover taxpayers whose main aim is to cheat the government and their ability to implement taxpayers-oriented approach are crucial for establishing a strong Tax Administration. Levels of tax collection increase only with an adequate inspection audit and penalty rates (enforcement strategy) and with clear focus on taxpayers (taxpayer-oriented approach). Accordingly, in order to decrease levels of tax evasion, the following organizational and management state structure in Tax Administration has to be taken into consideration: clear positioning of Tax Administration within the overall government structure, level of Tax Administration autonomy, internal organizational structure of the Tax Administration, and the set up of Large Taxpayer Units (organization - state), establishment of the modern human resources management within the Tax Administration, and focus on taxpayers (management - state).

In the context of positioning Tax Administration within overall government structure, in the last fifteen years there were discussions which are the best solutions for the Tax Administration. In every country, the main problem regarding Tax Administration reform is lack of sufficient resources. The term resources are encompassing people and equipment. Especially in transition countries, it is very difficult to employ young, educated people or to raise wages in Tax Administration in order to make a modern and efficient one. Even more, it is tough to provide some basics needs, such as computers or office space. Many reforms failed because resources were not provided on time (Bird, 2004). Supporters of independent Tax Administration argued that problems occurred because the Tax Administration is usually not an independent body. Reform of Tax Administration in transition countries was inefficient because of the existing budgetary and personnel regulations which made it difficult for governments to provide independent tax collectors the appropriate motivated structures and most of all, the flexibility to make its own decisions on how to spend their

budgets, or how to structure their organization. Inadequately motivated and flexible structures is not only in terms of providing an adequate compensation level but also in terms of the ease in hiring of qualified personnel and firing erring ones (Manasan, 2003). Due to budget restrictions, wages in Tax Administration are lower than wages in the private sector. For this reason, Tax Administration can neither attract nor keep the high quality personnel. In order to compensate low salary, tax administrators try to make compensation with their 'services' which result in a widespread public perception, that Tax Administration is inefficient, incapable and corruptive (Ott, 1998).

Position of the Tax Administration to a large extent depends on the differences in the political structures and systems in the public sector administration in countries and longstanding in historical practices. Reasons for a more autonomous Tax Administration may be found in politicians' motivation to do that. One of the explanations is that politicians give more autonomy to the Tax Administration because it is necessary 'to create a credible commitment to taxpayers that the tax collection agency will be more competent, efficient and fair' (Taliercio, 2004: 213). Politicians may support the reforms because they have to collect a large amount of money in order to finance larger expenditure programs, which could then conceivably generate greater political benefits. However, the problem is that when reforms become successful, politicians want to withdraw support for the reform because its cost outweighs the benefits. Granting autonomy to the revenue administration represent attempts of politicians to employ a commitment technology in order to convince taxpayers of their faithfulness to the reforms so as to increase tax compliance and increase tax revenues (Taliercio, 2004). Establishing the Tax Administration as an independent body will depoliticize tax collection and minimize the risks that politicians will undo the reform at a later date.

The logical question, after arguments for an independent Tax Administration, is what the shortfalls of such actions are. The disadvantages of establishing independent Tax Administration can include the following (Hadler, 2000; Transberg 2004): improved revenues could be realized without the costs of establishing a new agency; the establishment of a new agency may be promoted by those who stand to benefit; autonomous agencies have proven more costly than the agencies they replace (in some cases, the collection costs to tax revenue ration have increased); establishment of executive agencies is not an alternative to civil service reform, and may contribute to fragmentation of the civil service and to problems of inter-agency cooperation; a clear regulatory and supervisory framework is needed to ensure that autonomy is not abused; autonomy does not guarantee an end to political interference; and legal and political factors may continue to constrain human resource policies. Furthermore, autonomy may improve performance, but it may also contribute to

conflicts with ministries, budget balkanisation, fragmented accountability, and strengthening of special interests and patronage (Therkildsen, 2004).

As we can see from the theoretical debate above there is no unique answer how to position the Tax Administration in overall government structure. Some experts are in favour of the independent Tax Administration, their offices being granted the status of ministries, or a body independent of finance ministry, while others believe the Tax Administration should be a part of the national Ministry of Finance. However, a Tax Administration institution should have appropriate autonomy and its responsibilities and organizational structure must be exactly defined (Hogue, etc, 2000). The way countries establish Tax Administration is a sensitive question that should take in consideration many aspects. The level of achieved democracy is also an important part of the overall picture. Regardless of differences in this respect, all experts are in favour of an effective (the capability to achieve a high level of tax compliance) and efficient (the capability to make administrative costs per unit of tax revenue as small as possible) Tax Administration. For transition countries, it was argued that Tax Administration should be part of Ministry of Finance. The main argument for such decision was fear of political influence on Tax Administration. Actually, it was assumed that there is a link between level of independency of Tax Administration on one side and level of democratisation in political system on the other side (Ott, 1998). In that sense, a higher level of independency may be allowed only if there is a higher level of democratisation in political system. If the situation is the other way around, a higher level of independency is allowed even the level of democratisation in political system is on a low level, we will have situation that Tax Administration is an instrument in the hands of political elite. Because of that, it is better for Tax Administration to be part of Ministry of Finance than independent body. Increasing the democratisation in political system, will allow to change the position of Tax Administration. Only high level of democratisation is a guarantee that Tax Administration will not be used as a tool for achieving better political position.

Another very important question is autonomy of Tax Administration inside the Ministry of Finance. Tax Administration should have appropriate level of autonomy and its responsibilities and organizational structure must be exactly defined. Only with high level of autonomy, Tax Administration can increase efficiency and effectiveness. In situation when Tax Administration is highly dependent from the Ministry of Finance, defined objectives can not be achieved. In that context, quite often Tax Administration is compared with central banks. However, central banks are usually much more efficient than Tax Administration. Young people want to work in central banks, salaries are high, working conditions are better, equipment is more sophisticated, the possibilities of advancement better, etc. Accordingly, an more autonomous Tax Administration would improve professionalism in Tax

Administration, or more precisely (Ott, 1998: 6): (1) the rewarding and promotion of employees according to the responsibility of their job and their success in performing it; (2) a job classification system which clearly defines the responsibilities of each position; (3) independence from political influence and pressures enabling people to retain their jobs long enough to pay back their education; (4) setting up of minimal conditions for each position and objective testing and (5) continuous education modified according and adjusted to the needs of each individual job position. Actually, the main argument is that making 'Tax Administration more 'business-like' and free of the financing and personnel rules that govern the public sector would reduce the motive for corruption by giving emphasis to performance-linked budgets and compensation schemes' (Manasan, 2003: 2). The above is generally able to provide better pay and other incentives to their staff while also imposing greater accountability for performance (Gallacher, 2004).

Functional organizational structure within the Tax Administration is an important part of contemporary Tax Administration. We can distinguish three organizational models (Owens, 2006): 'type of tax' criteria, 'functional' basis criteria, and 'taxpayer segments' criteria. These categories have been parallels in the literature of Organizational theory for private enterprises (Mintzberg, 1983: 48). For the private enterprises, the three models for organization structure are: product-based, functional, and client based. Many of the Tax Administrations combine these three approaches. Table 2, presents comparative analysis of organizational structures between public and private organizations.

Table 2. Organizational design

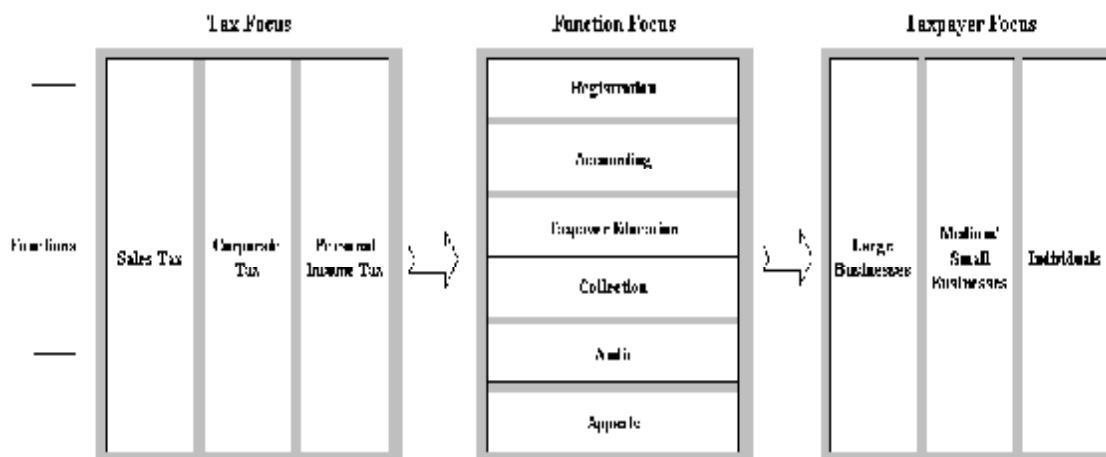
<i>PRIVATE ORGANIZATION</i>	<i>TAX ADMINISTRATION</i>
Product Base	Type of Tax
Functional	Functional
Client	Client or Taxpayer Segment

Source: Mintzberg (1983: 48)

The evolution of organizational design through history is presented in Figure 6 (Ebrill, etc, 2002: 135). The first organizational model was very popular in the past. It entails separate multi-functional departments for each tax that were largely self-sufficient and independent from each other. During the period of implementation, beside the fact that justifies existence, a lot of shortcomings were noticed (Ott, 1998): inherent duplication of functions; inconvenience for taxpayers with multiple tax dealings; complicated compliance management implications; a propensity for uneven and inconsistent treatment of taxpayers

across taxes; and under utilization of staff. It was generally considered suboptimal to have the Tax Administration organized into the VAT, income, and excise departments, and better to have them organized into audit, services, archiving, and enforcement departments (Gallacher, 2004; Hogue, etc, 2000). In this way, a greater standardization is provided of work process across taxes and the efficiency is improved. Furthermore, the productivity will increase due to specialisation in particular fields, possibility for checking and control is better, and effectiveness of operation increases. Today over two-thirds of OECD countries have adopted the functional model as the primary method for structuring Tax Administration operations. In the end, the newest method is to organize operations around 'taxpayer segment' (for-example, large businesses, small/medium sized businesses, wage earners, etc). According to this method, each group of taxpayers has different characteristics and tax compliance behaviour and, as a result, present different risks to revenue. The example of using this method is US Internal revenue service. This method is still in early stages of use, but many countries have partially applied this approach by establishing Large Taxpayer Units to fully administer the affairs of their largest taxpayers.

Figure 6. The evolution of organizational design ideas for Tax Administration



Source: Ebrill, Keen, Bodin, and Summers (2002: 135)

To reorganize Tax Administration along functional lines is a long, time consuming process. It involves shifting of employees into new departments, opening new jobs, starting adequate training, etc (Hogue, etc, 2000). However, organized Tax Administration on functional basis is the right way to increase compliance and to decrease tax evasion.

As was mentioned in the previous paragraph, some countries have partially accepted 'tax payer' segment criteria by establishing Large Taxpayer Units. There are three broad views how to run a Tax Administration (Bird, 2004): first, establish a set of rules and apply them in the same way towards everybody; second, establish special rules for some but apply other rules to others; and third, establish general rules that are applied initially only to some but with the clear idea and obligation of extending those rules subsequently to all. Regarding the first option there are some against establishing the Large Taxpayer Units because the same rules have to be applied for everybody in order to achieve the fairness criteria. It was argued that with establishing Large Taxpayer Units, fairness principle will be ruined and that Tax Administration will ignore or not dedicate enough resources and effort to the non-large taxpayers. However, this approach is not acceptable because practice has shown that establishing Large Taxpayer Units brings a lot of benefits. Most advisors, the IMF and experts think that it is a good practice to provide special attention, especially with regard to audit and enforcement to the largest taxpayers (Gallacher, 2004). The main reason for that is the fact that large enterprises contribute the major part of Value added tax (VAT) and profit tax (sometimes more than 90 percent). They contribute in a significant amount of income tax paid by their employees. Also, many of large taxpayers have complex tax affairs, characterised by one or more of the following factors (OECD, 2004): multiple operating entities that are widely dispersed geographically; diverse business activities and/or involvement in transactions that frequently raise complex/novel law interpretation issues; significant off-shore transactions, often with related parties; high volume of transactions in the course of day to day business activities; use of complex financing arrangements; use of professional tax advisers, part of whose brief is to minimize their exposure to taxation. Because of all aforementioned, this unit should be consisted of leading experts in the tax field that are highly professional and screened for corruption (Ott, 1998). There is clear evidence that in most countries which have established Large Taxpayer Units the compliance of this taxpayer group has improved (Silvani & Baer, 1997).

The management issue in Tax Administration is very important. Strengthening the capacity of employees are essential tasks for every organization. In the case of Tax Administration this task is very important. With appropriate organizational structure and technical equipment but without well skilled and trained tax administrators, the main goal cannot be achieved. Less skilled tax administrators will result in a low autonomy of tax administrators. It will be much easier for taxpayers to manipulate with tax administrators and much easier to avoid taxes. The personal matters of Tax Administration reform must not be ignored. Furthermore, in order to focus on taxpayers (taxpayers-oriented approach) well

trained employees are necessary. Only with high professional staff, Tax Administration can implement taxpayers-oriented approach and increase effectiveness.

Tax Administration staff needs to have a degree of job security, and know that the organization has fair personnel policies. The requirement for a degree of job security should be weighed against the need for establishing staff accountability and responsibility (Silvani & Baer, 1997; Gill, 2000). Personnel policies will be determined largely by the kind of organization which is adopted. A Tax Administration that is dependent on a larger public sector agency such as a Ministry of Finance or of the economy will have to follow agency's personnel policies. A more autonomous organization will have greater flexibility in defining its own organization and structure. The quality of tax administrators is essential for improving efficiency of Tax Administration. In that sense, modern human resource department (HRD) is necessary. Several challenges confront Tax Administration in the HRM and staff development area⁵: scarcity of well-trained professionals; limited scope of work; and weak link of staff development to strategic organizational objectives. As we can see in Figure 5, in analyzing the Tax Administration process, diagnostic framework covers formal and informal organizational arrangements, as well as characteristics of staff and their relationship to the organization, e.g., qualifications, skills, and personal goals, and incentives of managers and staff relative to organizational requirements and expectations - generic organizational, HR, and, by extension, training factors. The human resource departments in transition countries usually do not understand what their main role is and provide only basic functions (they are usually recordkeepers).

Very important question in every public administration is the recruitment process. The recruitment process is one of the essential and critical functions of human resources because it supplies persons with specific knowledge, skills, and abilities needed to perform public services (Selden, 2003). Private firms are very aggressive on the labour market in order to employ the best workers. They know that only with highly educated people, that possess specific skills and knowledge, they can survive market competition. The public sector organization has to do the same thing. They have to tend to recruit the best-qualified and the most competent workers. Only with that strategy, public sector can bear with private sector and successfully fulfil all obligations. The governments realize the necessity to pay much more attention to human resource management. In the competitive marketplace, like is today, where you have to compete for a limited labour pool, recruitment process has to be

⁵ www.worldbank.org

fast and based on merit (Selden, 2003). The main goal of human resource management departments is to develop systems that will attract, develop, motivate, and retain the best and brightest employees. Furthermore, different campaigns can be launched to demonstrate the positive attributes of public sector work and to invite young people to start to work in public administration. To decrease the level of tax evasion, highly educated tax administrators are necessary. Enterprises use more and more sophisticated tax evasion schemes, and to 'fight' with we need well skilled and trained employees. Tax administrators are always in contact with taxpayers, and reasons to strengthen capacities of tax administrators are obvious. In addition, more focus on taxpayers can be only achieved with highly trained and educated staff. Necessity to treat taxpayers like citizens who have to fulfil some obligations and not like criminals and helping them to pay taxes is very important part to increase tax compliance. Providing right information on time is strongly connected with staff characteristics. The more trained and specialized staff will be able to provide better information than less skilled employees. In addition to that, client-oriented internet web site is additional important element to increase level of communication between taxpayers and Tax Administration. In that sense, internet web site is a tool to increase level of knowledge, awareness, and willingness of taxpayers to comply with their obligations. Accordingly, relations between tax administrators and taxpayers will be on a higher level and effectiveness of Tax Administrations will be increased.

Based on the aforementioned, establishing of the desirable organizational and management state structure in Tax Administration is essential to increase capability of tax administrators. Capability of tax administrators means that they are able to confront with taxpayers whose main aim is to cheat the government on one side, and to implement taxpayers-oriented approach on the other side. Adequate audit inspection and penalties rate will deter taxpayers to avoid paying taxes. Client-oriented approach will encourage taxpayers to pay taxes. Using them together and in the same time will result in an increased level of tax collection. Increasing professional skills, specialization and capability of tax administrators are essential in order to decrease levels of tax evasion. Readiness of tax administrators to bear with complex tax issue and with sophisticate tax evasion schemes depends on quality of organizational and management state structure in Tax Administration. Equal treatment of taxpayers, strong enforcement strategy (audit and penalties) and taxpayer-oriented approach are main elements to increase levels of tax collection. We should be aware that implementing these elements requires a lot of energies, knowledge, resources and patience. However, moving towards desirable organizational and management state structure in Tax Administration is the right way to monitor and encourage people to pay taxes. Having

different attitudes for different companies (Street-level Bureaucracy theory) and weak enforcement strategy together with weak focus on taxpayers (Tax theory) can only encourage citizens to cheat government. In order to overcome these issues, explained in Section 2.1 and Section 2.2, the following desirable organizational and management state structure Tax Administration in transition countries has to establish in order to increase capability and autonomy of tax administrators:

First, independent Tax Administration can provide a lot of benefits and an opportunity for substantive changes in Tax Administration. Tax Administration as an independent body should have more opportunity to achieve main goals of reform and to influence the reform process and outcomes of the reforms. However, experts are not unique regarding this question and every country has to decide what to do, base on their specific conditions. For transition countries the best solution is that Tax Administration stay inside the Ministry of Finance. Otherwise, we will have situation that Tax Administration is an instrument in the hands of political elite. The reason for that we should look in a low level of democratisation in political system. In order to avoid this unpleasant and dangerous situation, positioning of Tax Administration inside the Ministry of Finance is the best option for transition countries. With progressing in democratisation, position of Tax Administration in the overall government structure can be put on the agenda again.

Second, whenever Tax Administration is an independent body or a part of the Ministry of Finance, it has to have an appropriate level of autonomy in order to increase effectiveness and efficiency. High level of Tax Administration autonomy derives from its specific position in society. Planed state budget is possible to achieve only if taxes are collected in sufficient amount. In that sense, autonomy of Tax Administration has to be granted. High dependency from the Ministry of Finance will have negative influence on Tax administration efficiency. Possibility to make own decisions regarding internal organizational structure, recruitment process or salary schemes is an important element to increase efficiency of Tax Administration. Otherwise, strong dependency from the higher authority in making crucial decisions for own development, will result in a weak institution for collecting taxes. In that sense, a high level of Tax Administration autonomy inside the Ministry of Finance is an important element to increase efficiency and effectiveness of organization. Organization will be much more professional and capable to bear with tax evaders if can arrange structure based on own criteria. Furthermore, that will lead to a better focus on taxpayers and, as a result, a high level of collected taxes will be achieved.

Third, internal organizational structure of Tax Administration must be based on the functional line. Such organizational structure will increase professional skills and specialization of tax administrators. If we take into the consideration characteristics of

planned socialism legacy, increasing the specialization of tax administrators is a very important. Autonomy of tax administrators will be increased and a better position in respect to the taxpayers will be established. Establishing 'type of tax' criteria brings a lot shortcoming explained above. In order to avoid these shortcomings, establishing internal organizational structure based on functional criteria is the best option. The internal structure must be organized into audit, services and enforcement departments, which is a much better solution than establishing VAT, income and excise departments. As was explained, type of criteria that is adopted for internal organizational structure has strong influence on the quality of human resources in organization. In that sense, making decision regarding internal organizational structure is essential for Tax Administration. Inadequate structure leads to a lower level of professionalism and capability of employees and result in a lower level of collected taxes. The strong and adequate internal organizational structure is a necessary condition for strong Tax Administration.

Fourth, Large Taxpayer Units have to be established. Large enterprises contribute the major part of all collected taxes and have complex tax affairs. In order to collect sufficient amount of taxes from large enterprises, special attention has to be dedicated for them. Large Taxpayer Units should be consisted of leading tax experts and well trained tax administrators. Actually, special strategy towards large enterprises has to be established. Due to fact that they are the most important client for Tax Administration, reasons for establishing such units are obvious. Benefits from establishing Large Taxpayers Units are depicted through a higher level of collected taxes. In addition, these units should be a model for other departments in organization. High professionalism, specialization and focus on taxpayers have to characterise these units and to be example how other departments in organization have to look like.

Fifth, human resource department should have a more active role in attracting young, educated people to work in the Tax Administration. They have to act like human resource departments in private enterprises and to 'fight' for new employees. In addition, permanent education of current employees is a very important part of the whole reform process. Only with well trained staff Tax Administration can confront in an adequate way with taxpayers. Today, tax evasion schemes are very sophisticate and well trained tax administrators are necessary in order to cope with tax evasion issue. As was mentioned, type of internal organizational structure that Tax Administration has adopted has strong influence on quality of employees. A functional criterion is the best option in that sense, which increase the specialization and professionalism of employees. Using the other criteria will have negative effect on the quality of human resources in organization and result in a lower level of collected taxes. Furthermore, quality of human resources has strong influence on

focus on taxpayers. High skilled and professional employees will be more successful in focusing on taxpayers than less skilled and less capable.

Sixth, focusing on taxpayers is an important element to increase level of collected taxes. Focusing on taxpayers is an approach that was adopted in all developed countries. Tax Administration must understand that taxpayers are the most important actors in their environment and to treat them as citizens who have to fulfil some obligations. As was said before, it is not good to treat taxpayers as a criminals whose main aim is to avoid paying taxes. Implementing taxpayer-oriented approach will increase readiness and willingness of taxpayers to cooperate with Tax Administration. In addition, client oriented internet web site is a very important element of whole process. Providing more information regarding taxpayer's liabilities and information regarding changes in tax laws are important elements to increase tax compliance. As was argued, quality of human resources has strong influence on readiness of tax administrators to focus on taxpayers. Higher trained and professional employees will better implement this approach than less skilled and less professional. In the end, we should never forget that taxpayers have some rights too and not only obligations.

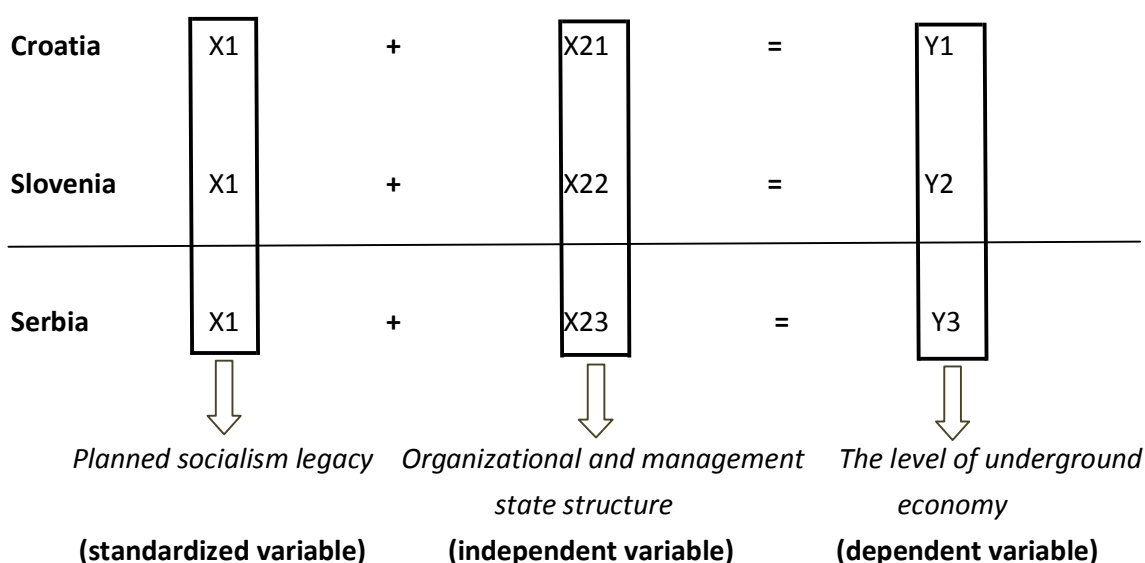
Chapter 3 - Methodology

In disclosing the most appropriate method for making comparisons in my Project, it has to be taken into the consideration that using specific methods will result in a trade-off between the complexity and generalization. Using the case study, as a method of comparison, more attention will be paid on the context and the complexity of the system in one or a limited number of countries and it will be less capable to produce generalizations of systems. On the other side, the use of statistical modelling, as a method of comparison, will provide opportunity to make generalizations of systems but will be less capable to go deeper into the complexity of the systems (Peters, 1998: 5). In my research, case study is a more appropriate model than statistical approach, because tendency is to look deeper into the organizational and management state structures of Tax Administration in two countries. Deriving conclusions regarding the complexity of systems is more important than making generalizations of systems. In addition to that, the main goal of using case oriented approach is both historically interpretive and causally analytic (Ragin, 1987: 35). Using of the historically interpretative approach can provide opportunity to understand or interpret specific cases because of their intrinsic value. Causally analytic view will produce limited generalization concerning the causes of theoretically defined categories of empirical phenomena common to a set of cases.

Five types of studies are classified as being components of comparative politics (Peters, 1998: 11-22): single country studies, process and institution studies, typology formation, regional statistical analyses, and global statistical studies. Using the specific type of comparative studies depends on the purpose of research. In my case using the second type (process and institution studies) will be the most appropriate approach. This method 'select a small number of instances of a process or of institutions that appear similar (or at least appear 'comparable') in some important way and then use those instances to illuminate the nature of either the process or the institution itself or the politics of the countries within which it occurs' (Peters, 1998: 13). Furthermore, focused comparisons of organizational and management state structure in Croatian and Slovenian Tax Administration will be used, as a technique of comparison (Hogue&Harrop, 2004: 80). This is an appropriate technique in this research, because focused comparisons are characterized with a few cases and qualitative comparison of a few instances. Focused comparisons remain sensitive to history. Format works particularly well when few countries are compared over time, examining how they vary in their response to common problems such as transition to new system. The next question is how countries should be selected for focused comparisons. There are two approaches: the 'most similar' and the 'most different' design.

The 'most similar design' will be used because analyzed countries have similar historical and economical background. Taking into consideration all aforementioned, and based on chosen approach, two countries are being compared: Croatia and Slovenia. They have very similar history (characterised by planned socialism background), culture and political institutions. The assumption is that planned socialism legacy produced the same negative implications regarding the Tax Administrations in all transition countries including Croatia and Slovenia. In that sense, planned socialism legacy is a standardized variable. On the other side, organizational and management structure in Croatian and Slovenian Tax Administration is an explanatory variable regarding the level of underground economy. Actually, looking into the gap between desirable organizational and management state structure in Tax Administration, explained in Chapter 1, and current organizational and management state structure in Croatian and Slovenian Tax Administration will explain the difference in the level of underground economy (dependent variable) in these two countries. Figure 7, presents methodological approach used in this Master Thesis.

Figure 7. Methodological approach



Based on Figure 7, planned socialism legacy explains a low level of effectiveness and efficiency of Tax Administrations in both countries. The gap between desirable and current organizational and management state structure in Croatian and Slovenian Tax Administration will explain difference between two countries regarding the level of underground economy. Based on the results, recommendation for Serbia will be proposed in the sense of desirable organizational and management state structure that has to be

established in Tax Administration and path that Serbia has to follow. For this purpose, the Congruence Model will be used, as explained in previous Chapter. Congruence Model is an input-output model where organization efficiency in achieving goals depends on the congruence or fit between different parts of the model. In the case of Tax Administration, the most important parts of the model are the following: input (taxpayers), transformation process (organizational and management state structure), and output (level of collected taxes). Establishing adequate organizational and management state structure (transformation process) will increase capability of Serbian Tax Administration to bear with taxpayers (input) and in the end, increase level of collected taxes (output). On the other side, effects of planned socialism legacy will be considered like in the case of Croatia and Slovenia.

As we said, planned socialism legacy is standardized variable and it includes (Martinez-Vazquez&McNab, 1997: 6-7): an interventionist tradition, customized and negotiated taxes, taxes hidden from the population and lack of tradition with voluntary compliance, absence of conventional excess burdens, low profile of production and trade taxes, taxes and income redistribution, undeveloped Tax Administration, and public distrust of government institutions. Tax liabilities were frequently negotiated, and there was lack of connection between statutory tax bases and actual tax liabilities. Actually, through negotiated taxes and soft budget constraints companies were virtually protected from the bankruptcy risk. In that sense, under the Yugoslav system, the central bank provided loans to banks which funded companies that are favoured but not profitable. In the context of fiscal policy, that produces lack of fiscal discipline and implementing of soft budget constraints toward these companies (Murphy, 2006; Mihaljek, 2001). The legacy of negotiated taxes continues to limit the efficacy of tax reform and Tax Administration effort in transition countries. There was lack of transparency in Tax Administration activities and enterprises did not know what other companies in similar circumstance paid. This creates a culture of tax evasion because people do not believe in fairness of system. Also, tradition of **unsophisticated Tax Administration in transition countries left 'dramatically unprepared to enforce tax collection in a market economy with a manifold increase in the number of taxpayers, the abolition of the official payments system, and other institutional changes'** (Martinez-Vazquez&McNab, 1997: 7).

In order to explain dependent variable, the level of underground economy, desirable organizational and management state structure in Tax Administration, explained in previous Chapter, will be compared with current organizational and management state structure in Croatian and Slovenian Tax Administrations. Actually, the higher gap between desirable and current organizational and management state structures in Tax Administration will lead to a higher level of the underground economy. In that sense, focus is on the following

organizational and management state structures in these two countries: clear positioning of Tax Administration within the overall government structure, level of Tax Administration autonomy, internal organizational structure within the Tax Administration, the set up of Large Taxpayer Units (organizational state structure), human resource capacity, and the focus on taxpayers (management state structure). Establishing desirable state structures will overcome issues identified in Street-level Bureaucracy theory and Tax theory. Namely, according to Street-level Bureaucracy theory, different attitudes of tax administrators for different companies and weak position of tax administrators in respect to taxpayers are result of inadequate organizational and management state structure in Tax Administration. Also, weak enforcement strategy and weak focus on taxpayers are result of inadequate state structures and characteristics of Tax Administration in transition countries explained by Tax theory. As a result, weak Tax Administration was not able to bear with taxpayers and a high level of the underground economy was expected consequences. In order to decrease level of the underground economy, Organizational theory defined the following desirable organizational and management state structure that has to be established in Tax Administration in transition countries: positioning of the Tax Administration inside the Ministry of Finance, a high level of the Tax Administration autonomy inside the Ministry of Finance, internal organizational structure based on functional line, establishing and strengthening Large Taxpayers Units (organizational state structure), strong human resource capacity, and focusing on taxpayers (management state structure). These desirable elements will be compared with current organizational and management state structure in Croatian and Slovenian Tax Administration. As was mentioned, the gap between desirable and current state structure will explain a different level of the underground economy in these two countries. In other words, a higher level of the underground economy signalizes that the gap between desirable and current organizational state structure is larger.

Data regarding current organizational and management state structure (institutional arrangements for Tax Administration, autonomy of Tax Administration, organizational structure of Tax Administration, Large Taxpayer Units, human resource capacity, and focus on taxpayers) in Croatia and Slovenia will be collected using the primary and secondary sources. Documentary analysis will be used, the archival technique, documents, and media as methods to collect data (Grix, 2004). The documentary analysis will point to specific sources, such as written documents and texts. The aim is to gain information from people or organization's viewpoint regarding the organizational and management structure in these two countries. Another source of information will be official documents issued by Croatian and Slovenian Tax Administrations, characteristics of Tax Administration system during the planned socialism period and viewpoints of experts regarding current situation in Tax

Administration in these countries. Furthermore, newspaper articles and reports can be very useful complement to documents analysis. In addition, Slovenia is a member of EU and looking into the official documents of EU can be very useful. Another very important question is how to measure current organizational and management state structure in Croatian and Slovenian Tax Administration? In other words, what are the indicators of organizational and management state structure in Tax Administration in these two countries? In that context, it will be looked into the following elements for aforementioned organizational and management state structure in Croatian and Slovenian Tax Administration:

- *Positioning of the Tax Administration within the overall government structure* – looking into the official government structure and formal position of the Tax Administration inside the structure. Tax Administration can be positioned as an independent body or as a part of the Ministry of Finance,
- *Level of Tax Administration autonomy* – independently of formal positioning of Tax Administration inside the overall government structure, autonomy of Tax Administration should be granted. In that sense, level of the Tax Administration's independency from the higher authority in making decisions, which are crucial for improving effectiveness and efficiency of organization, will be analyzed. In such decisions we can include activities as, organizing internal organizational structure, influence on staff recruitment criteria, hire and fire of staff, etc,
- *Internal organizational structure within the Tax Administration* – type of criteria that Tax Administrations have established for internal organizational structure – 'type of tax' criteria, 'functional' basis criteria, or 'taxpayer segments' criteria. Internal organizational structure has strong influence on quality of human resources in organization,
- *Set up of Large Taxpayers Units* – looking into the formal organizational structure of Tax Administration and position of these units inside the organization,
- *Human resource capacity* – level of tax administrator's readiness to bear with tax evaders on one side and to help taxpayers in paying taxes on the other side. Characteristics of tax administrators, such as professionalism and level of skills, will be taken into the consideration. Also, as was argued, internal organizational structure that is adopted has strong influence on specialization and professionalism of employees (quality of employees),
- *Focus on taxpayers* – it refers to a readiness of Tax Administration to help taxpayers in fulfilling their duties. Focusing on taxpayers is strongly connected with human resource capacity. The assumption is that higher trained staff will be more successful

in helping taxpayers to pay taxes. Furthermore, internet website has important role in focusing on taxpayers and increase of knowledge, awareness and willingness of taxpayers to pay taxes.

Based on collected data regarding these elements, current state of organizational and management state structure in Croatia and Slovenia will be identified. Afterwards, comparison with the desirable state structure will be done. In the end, the gap between desirable and current organizational and management state structure will explain different levels of the underground economy in Croatia and Slovenia.

As was mentioned, in this Master Thesis, level of the underground economy will be used as a parameter to measure the gap between desirable and current organizational and management state structure in Croatian and Slovenian Tax Administration. As was said, the larger gap between desirable and current organizational and management state structure in Tax Administration, will lead to a higher level of the underground economy. One of the questions is how to measure the level of underground economy (or how to measure unknown)? The underground economy exists for the sole purpose of avoiding detection and direct methods for measuring its size are not so popular. Therefore, researchers rely upon indirect methods for measuring its size. According to Brooks we can use several methods to measure the underground economy: surveys, tax audits, currency demand approach, discrepancy between national expenditure and income statistics, physical input (electricity consumption) method. The first two are direct methods for measuring the underground economy and the last three are indirect methods. Also, for the accession countries to the European Union, Eurostat exhaustiveness program is established to measure levels of the underground economy (Lovrinčević, etc, 2006). We have to be careful in using these methods, because different methods do give different results. In order to have relevant comparison between the level of underground economy in Croatia and Slovenia, we need to use the same methods for both countries. The level of tax evasion is closely connected with the level of underground economy. Actually, the level of underground economy will be used as a proxy of tax evasion in Croatia and Slovenia.

The first method to measure the underground economy is surveys. Under the surveys, as a method to measure the underground economy, a sample of individuals are simply surveyed and asked a series of questions relating to the tax system and their payments of taxes. Based on results, researchers attempt to divide the sampled population into evaders and non-evaders. The main advantage of this method is that good information can be received from individuals (their attitude toward government and the tax system) and used to draw inference of the salient differences between evaders and non-evaders

(Brooks, 2001). On the other side, the main disadvantage of this type is that both average precisions and results depend upon the cooperation of the individuals questioned (Schneider&Enste, 2002). The problem is that taxpayers do not want to confess their fraudulent behaviour or taxpayers do not know how they behaved in the past. This method is likely to confront with problems and difficulties of no responsiveness, evasiveness, or misrepresentation (Cowell, 1990: 18).

Second method (tax audits), measures the discrepancy between incomes declared for tax purpose and actual earnings, through the use of selective audits (Schneider&Enste, 2002). The Tax Administration needs to have authority and to carry out investigation in order to estimate extent of underreporting of incomes (Cowell, 1990: 18). One of the most important programs to measure tax gap in the USA, which has been used in past years, is the Taxpayer Compliance Measurement Program (TCMP). The TCMP is a tax audit programme that from 1963 until 1988 was conducted about every three years. The audit was based on the examination of a stratified random sample of 50,000 returns. Samples of returns were selected for examinations randomly from each of a number of defined income classes. The purpose was not to maximize revenue collection, but instead to obtain a statistically valid profile of the type and magnitudes of errors in each income class. This method has been extremely valuable in empirical research. It was used to estimate tax gap and to discover places where there is the greatest amount of tax cheating. However, due to high costs for implementing this method, and **unpopularity with taxpayer's audited**, the TCMP method was suspended (Brooks, 2004). In addition, one of disadvantages of the audit data is that it may **not be very reliable**. Estimates of tax evasion based on audits rely on auditors' ability to identify under-reporting and interpret the tax laws as they pertain to tax deductions and tax credits. It is highly unlikely that income-tax auditors are able to identify is all income that is concealed from the tax authorities (Schuetze&Bruce, 2004).

Third method is currency demand approach. This method is the most popular method used to estimate the size of the underground economy, because the requisite data is readily available in all countries across considerable periods of time, and because the method is relatively simple to implement. This method is commonly referred to as the monetary aggregates method. Basically, it involves two steps (Brooks, 2001): first, estimation is made of the amount of money that is used in the underground economy and then, secondly, this amount is converted into an estimate of the amount of unreported income based upon how frequently this money is likely to turn over during the course of a year. The main disadvantage is that this method relies upon a whole series of improvable assumptions (that currency is the exclusive medium of exchange for unreported transactions; that the ratio of currency to checkable deposits is affected only by the growth of unreported

transactions; that the income velocities of reported and unreported transactions are identical; and, that in some base period unreported income was zero (Brooks, 2001).

Fourth method measures the discrepancy between national expenditure and income statistics. The gap between national expenditure and income statistics can be used as an indicator of level of the underground economy (Schneider&Enste, 2002). Every government collects data that enables an estimate to be made of the size of the output of the economy using two approaches: estimating the amount spend by all economic agents on goods and services or estimating the total payments that economic agents receive in exchange for goods and services they produce. This data can be used in different ways to estimate the size of the underground economy (Brooks, 2001): to the extent that estimated national income falls short of estimated national expenditures, discrepancies might be regarded as a rough approximation of the size of the underground economy; data on income drawn from taxation statistics might be compared to data collected for national accounting purposes and, again, discrepancies attributed to the underground economy; national accounting data might be used to draw inferences about the size of the underground economy is by examining all of the components of expenditure-based GDP, for example, and attempting to determine how much spending might be missed, at a maximum, given the sources of information and statistical methods used to compile those numbers.

Physical Input (Electricity Consumption) Method is the simplest method of measuring the size of the underground economy and one that has been used in studies across the greatest number of countries. Electricity consumption is the single best indicator of economic activity. In most countries in the world economic activity and electricity consumption appear to correlate relatively closely. A percentage increase in electricity consumption indicates a similar percentage increase in economic activity. Thus, electricity consumption can be used as a proxy measurement for the size of the economy. By subtracting the size of the official economy from the estimated size of the economy based upon electricity consumption an estimate of the size of the underground economy can be obtained (Brooks, 2001). The main disadvantages of this method are: supposed elasticity of electricity consumption is 1, and energy intensiveness of production is unchanged. These assumptions are not realistic in practice. Also, Schneider&Klinglmair (2004: 36-39) criticised using this method on various grounds: not all the underground economy activities require a considerable amount of electricity (e.g. personal services), and other energy sources can be used (gas, oil, coal, etc); over time, there has been considerable technical progress, so that both the production and use of electricity are more efficient than in the past, and this will apply in both official and unofficial uses; there may be considerable differences or changes in the elasticity of electricity/GDP across countries and over time; the underground activities

do not take place only in the household sector; it is doubtful whether the ratio of social welfare expenditures can be used as the explanatory factor for the underground economy, especially in transition and developing countries; and other explanations. When we applied this method to transition countries, it provides highly overestimated and unreliable data on the size of the underground economy (Lovrinčević, et al, 2006).

Eurostat exhaustiveness program is the method designed to measure the level of underground economy for the group of candidate countries. The reason for establishing Eurostat exhaustiveness program was to harmonise system of national accounts with the ESA 1995 methodology. Besides that, the aim was to include the underground economy into official GDP figures. That will change the obligations and claims of new EU member states with regard to EU funds: increasing their obligations towards the EU, and decreasing their claims from EU funds. The estimation of the underground economy was based on following elements (Lovrinčević, et al, 2006): the labour force input method (administrative sources and labour force survey); results of tax audit; comparison of indicators of gross production, intermediary consumption and value added per employee for various groups of entrepreneurs, depending on their size and business activity; estimated income from illegal activities (expert analysis); detailed valorisation of statistical sources for GDP calculation and their comparison with alternative sources; and adjustment of methodology of calculation of imputed dwelling rents.

As was argued, using the different methods will produce different results regarding level of the underground economy. Using some methods is not suitable for different reasons. Some of them are not reliable enough, such as surveys and tax audits. Some of them are not suitable in transition countries because of the remonetisation process and the significant deepening of the financial market (currency demand approach). Some of them are still developing (national accounts method) (Lovrinčević, et al, 2006). In that context, two approaches may be used to measure the level of underground economy in Croatia and Slovenia: Electricity Consumption Method and Eurostat approach method. In this research Eurostat approach method will be used to measure the level of underground economy, and compared to Electricity Consumption Method. It was recognised that other methods provide imprecise results of levels of the underground economy in transition countries. More precise, other methods provide highly over-estimated and unreliable data on the size of the underground economy. Eurostat exhaustiveness is introduced as the most appropriate method to measure levels of the underground economy in transition countries. Using this method data will be more reliable and a better comparison between countries can be made and analyzed.

Chapter 4 - Tax Administration in Transition Countries

Starting position for Tax Administrations reforms in transition countries is different than in developed countries. General conclusion is that transition countries have a worse starting position for reforming Tax Administrations than developed countries. The reasons for that we can find in planned socialism legacy that largely determined the path of tax reform during the transition period. The legacy from planned socialism produced numerous negative consequences for Tax Administration in transition countries, such as an intervention tradition, negotiated taxes, public distrust in of government institutions, etc (Martinez-Vazquez&McNab, 1997). Beside the planned socialism legacy, as a reason for difficult situation in Tax Administrations in transition countries, the major mistake in tax reform was focusing primarily on modernizing tax policies and relegating Tax Administration and taxpayer issues to a remote second place. Reforming the tax policy and leaving Tax Administration in current position can result only in increasing level of tax evasion. Reforming Tax Administration is an important element to decrease a high level of the underground economy in transition countries. Weak organizational and management state structure in Tax Administration in transition countries produced inadequate treatment of taxpayers, weak enforcement strategy and weak focus on taxpayers.

As was mentioned, economic structure of transition countries was characterized by state-owned enterprises. Based on Street-level bureaucracy theory, the impact on tax administrator's autonomy is depicted through pressure for more lenient inspection toward state-owned enterprises. In other words, tax administrators had different attitude for different enterprises, their position in respect to taxpayers was weak, and culture where cheating government is not punishable is established. Also, based on Tax theory, it was concluded that the main elements for decreasing level of tax evasion are strong enforcement strategy and clear focusing on taxpayers. Both elements were weak in transition countries. Using the both theories together, Street-level bureaucracy theory and Tax theory, the reasons for aforementioned shortcomings are in inadequate organizational and management state structure in Tax Administration in transition countries. In that sense, Organizational theory defined state structure that is desirable in transition countries. Accordingly, positioning of Tax Administration inside the Ministry of Finance, a high autonomy of Tax Administration inside the Ministry of Finance, internal organizational structure based on functional line, establishing Large Taxpayer Units, strengthening human resource capacity, and focusing on taxpayers are the main elements that have to be established. Looking into the gap between desirable and current organizational management state structure will explain different level of the underground economy in transition

countries. In this Master Thesis, focus is on Croatian and Slovenian Tax Administration. Data regarding current organizational and management state structure in Croatia and Slovenia will be collected using the primary and secondary sources. For that purpose, it will be looked in the following: formal positioning of Tax Administration within the overall government structure, level of Tax Administration autonomy, internal organizational structure, Large Taxpayers Units, human resource capacity, and focusing on taxpayers. Beside the viewpoint of a person's or organization's regarding the organizational and management structure in these two countries, the official documents issued by Croatian and Slovenian Tax Administration will be used too. Comparing the desirable with current organizational and management state structure will show which country is closer to the desirable state. It is assumed that a lower gap between desirable and current state structures will result in a lower level of the underground economy.

One of the major tasks that every government has to do is a successful provision of public services and implementation of welfare programs. In order to do that, a sufficient level of public revenues is essential. The main part of public revenues is tax revenues. The level of collected taxes is crucial for every government. High level of tax evasion has a significant influence on the level of public revenues. In that sense, every government tries to minimize levels of tax evasion in order to collect sufficient amounts of public revenues. The main tools to decrease levels of tax evasion are an adequate Tax Administration and adequate tax policies. Level of tax evasion is especially high in transition countries. However, other topics were much more discussed in transition countries in the last fifteen years than tax reform issue. For example, 'changes of ownership, the building of democratic institutions, problems of macroeconomic stability and monetary policy' (Grabovski&Tomalak, 2005: 253) were more attractive for discussion than tax system reform. In addition to that, only one page in World Bank summary is devoted for achievement in tax system reforms in the last ten years in transition countries (World Bank 2002: 67). Nevertheless, transition countries realized that only with substantial tax reforms desirable results can be achieved. Due to difficult circumstances in which transition countries operated during the planned socialism period, tax reforms were limited and slow. One of the most difficult situations was in the countries created after the breakup of Yugoslavia (Grabowski, 2005). The new independent countries had, among other things, to establish modern tax system in order to regularly serve their obligations toward citizens.

One of the reasons that enterprises operated in the informal economy was that benefits of such mode of operations outweighed the costs associated with moving to the formal economy. However, benefits for being in formal economy are wide, such as access to loans or access to the justice system. The aim of enterprises should be to stay in formal

economy and to have access to different important institutions in the state. However, 'weakness of government structures, inefficient administration and poorly developed services in the business sector imply that the benefits of the full legislation of activity are low' (Grabowski&Tomalak, 2005: 289). In that context, economic and political environment in countries provide conditions to support enterprises to operate in formal economy. There is a positive relation between the level of economic development and the level of formal economy. The higher economic development leads to the higher level of formal economy and, as a result, the lower level of underground economy. Situation in transition countries was characterised with a low level of economic development and a high level of the underground economy. The Tax Administration was undeveloped and not able to operate efficiently. As a result, we had a high level of tax evasion in transition countries. Low levels of effectiveness and efficiency are characteristics of Tax Administration in transition countries. In order to increase effectiveness, Tax Administration in transition countries should do the following (Hogue, etc, 2000): increase voluntary compliance, implement principles of self-assessment and self-payment, inform taxpayers, focus on quick discovery of problems connected with tax returns and payment, improve control and supervision, and establish appropriate penalties. On the other side, efficiency in Tax Administration is stimulated by establishing special units for the largest enterprises, defining the minimum threshold for certain taxes, introducing alternate taxation for small taxpayers, modernizing customer services, etc.

Based on the aforementioned, transition countries require new tax systems in order to collect sufficient amount of revenues to serve public services. Weakness of institutions to collect taxes and a high level of the underground economy were serious obstacles for the budget revenues. During the planned socialism period, 'resources for production of public goods were channelled primarily form state-owned enterprises to government budget' (Trasberg, 2004: 2). In that context, Tax Administration as an institution was not so important because taxes were collected from a few big state-owned enterprises. On one side, we had a low number of taxpayers (state-owned enterprises) and a high scope of discretion of tax administrators on the other side (Grabowski&Tomalak, 2005). Economy in ex-Yugoslavia republics was characterized by the dominant role of big enterprises. In the pre-transitional period in Croatia, Slovenia and Serbia enterprises were state-owned (Malenica, 2004). Planned socialism period was characterized with soft budget constraints toward these enterprises. In that context, taxes were not collected on the basis of tax rules and regulation but on the basis of negotiation between governments and enterprises (Gandullia, 2004). According to Trasberg, post-communist legacy in transition countries

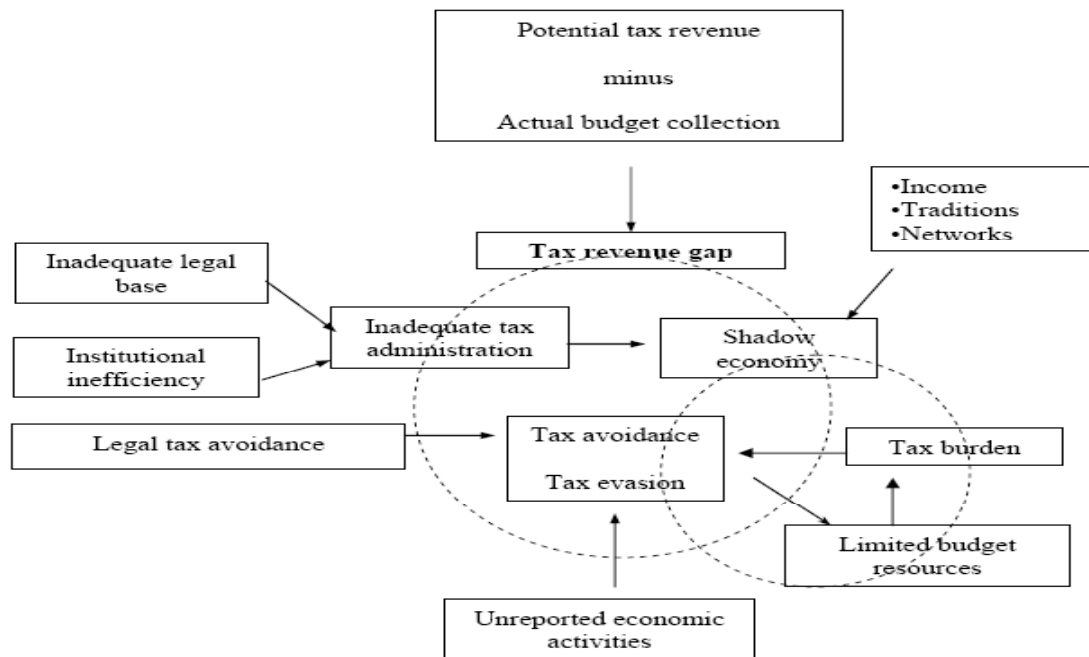
produced mutual mistrust between taxpayers and the tax authorities, which materialized on absence of tradition of voluntary compliance with tax liabilities.

In transition period, state-owned companies were privatized and necessity for efficient Tax Administration was obvious. In that context, transition period changed the relationship between enterprises and the State. However, state-owned companies still enjoyed a high level of state subsidies in the form of transfers and tax arrears (Hellman&Schankerman, 2000). In the context of Tax Administration accommodation to new situation characterized with market economy was necessary. According to that, Tax Administration has to implement methods and principles used in running modern companies, because they had to collect taxes in accordance with the law on one side and to provide optimum public services with low administrative and compliance costs of taxation on the other side (Hogue, etc, 2000). In transition countries, focus was more on tax policies reform than on Tax Administration reform. However, only with radical Tax Administration reform, the level of underground economy can decrease. Otherwise, focusing only on tax policies reform without Tax Administration reform will result in increasing levels of the underground economy and tax evasion. Tax laws and tax policies are as good, as Tax Administration is. Many tax reforms failed because of inefficient Tax Administration and the tax systems cannot work better than its Tax Administration. There is no good tax policy without efficient Tax Administration (Bejakovic, 2000).

The most important task of Tax Administration is to collect planned amounts of tax revenues to cover needs for public expenditures. But, in reality, 'tax administrators in many countries are struggling with revenue administration inefficiencies, which do not allow collection of predicted amounts of tax revenues (tax gap). Therefore, Tax Administration should be improved continuously or reshaped totally as in the case of transition economies' (Trasberg, 2004: 4). Tax gap is a result of inefficiency of Tax Administration on one side and scope of the underground economy activities on the other side. In all transition countries Gross domestic product (GDP) failed in the previous period, and with serious limitations of Tax Administration resulting in significant tax gap. In these countries, taxes were collected from big, state-owned companies. State-owned companies had a privilege tax status in that period. After the privatisation, the new private owned companies were main source for collecting taxes. But, due to inadequate Tax Administration taxes were not collected in sufficient amounts and it resulted in a high tax gap. In the newly established conditions, Tax Administration has to change significantly the way of collecting taxes. There is a shift from relatively simple way of collecting taxes through redistribution of money from state firms to state budget, toward very complex system of collecting taxes from private enterprises (Bejakovic, 2000). Private companies use very sophisticates tax evasion schemes and Tax

Administration has to establish new organizational structure with highly skilled and motivated tax administrators. Figure 8, presents basic relations for creation of tax gap (Trasberg, 2004: 5).

Figure 8. Tax Administration and the underground (shadow) economy



Source: Trasberg (2004: 5)

Based on this Figure we can conclude that tax revenue gap (potential tax revenue minus in actual budget collection) is the result of inadequate Tax Administration and the underground economy activities, which both materialize on tax avoidance or evasion. Tax evasion is directly related to potential budget revenue shortage. There is negative correlation between tax evasion and level of budget revenue. Higher level of tax evasion leads to a lower government budget. Lower government budget means that state cannot serve all public services and welfare programs. The empirical analysis shows that there is a strong positive correlation between the reduction of the underground economy and collected tax revenue. The significant reduces in the level of underground economy leads to significant increase of the level of tax revenue and improves the level and quality of public services, crucial for economic growth (Lovrinevic, etc, 2006). According to Trasberg, improvements in quality of Tax Administration in the new EU member states have been going hand-in hand with the decline in the underground economy. Accordingly, in order to decrease levels of tax evasion, Tax Administration should be well organized, properly

managed and capable. 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' (Trasberg, 2004: 6). Furthermore, state-owned companies are privatized and the new established private companies had strong incentives to evade taxes. The main reason to evade taxes is weak Tax Administration that cannot bear with new sophisticated tax evasion schemes.

Tax evasion is not a problem only in transition countries. Developed countries confront with the same problem like transition countries. They are trying to make Tax Administration more efficient in order to cope with this problem. However, Tax Administrations in transition countries have some unique features of the post communist legacy (Dabrowski, etc, 2003: 161): culture of mutual mistrust between taxpayers and the tax authorities and absence of traditions of voluntary compliance with tax legislation. In addition, difference between transition and development of countries is a time limit. Transition countries do not have time for gradual improvement of their tax system. They have to establish new, effective system promptly in order to evade institutional vacuum. Building a new administrative system is a very difficult task and one of the explanations why transition countries mainly focus on tax policies reform. In order to decrease levels of tax evasion Tax Administration should have appropriate autonomy and responsibilities and organizational structure exactly defined (Hogue, etc, 2000; Trasberg, 2004). Strengthening the organizational and management capacity of new Tax Administration will not result immediately in a higher level of tax collection. This process demands a long term approach and effects will be visible after several years. However, moving towards contemporary organizational and management desirable state structure is the right way to decrease levels of tax evasion.

4.1 Croatian Tax Administration

4.1.1 Introduction

Croatian tax system reform was shifting from former socially planned economy, when it was a socialist federal republic, toward independent country by adopting Western models. Croatia was a member of former Yugoslav federation which defined initial conditions for Tax Administration reform. Generally, Croatia's economic conditions were characterized by effects and consequences of the civil war and other factors (GTZ, 2006). Tax reform in Croatia started as new independency was achieved on one side, and the necessity to set up a new market-oriented system, compatible with tax systems of developed countries on the other side. The main goal was to increase effectiveness and maximize degree of neutrality of the tax system (Bratic&Urban, 2006). It was noticed that without a strong institution for collecting taxes the level of collected taxes could not increase. The planned socialism legacy, explained in previous Chapter, produced institutional weakness that resulted in a high level of tax evasion in Croatia. Based on Figure 7, planned socialism legacy is standardized variable that explained starting position for Tax Administration reform in Croatia. In that context, Croatian Tax Administration shares the same legacy of planned socialism like other transition countries. The legacy of negotiated taxes limits the efficacy of tax reform and Tax Administration effort in transition countries. There was lack of transparency in Tax Administration activities and enterprises did not know what other companies in similar circumstance paid. This creates a culture of tax evasion because people do not believe in fairness of tax system. Low levels of effectiveness and efficiency of Croatian Tax Administration were the main characteristics. The reason for this situation we can find in inadequate organizational and management state structure in Croatian Tax Administration. Actually, inadequate state structures produced unequal treatment of the taxpayer and weak position of tax administrators in respect to taxpayers (Street-level Bureaucracy theory) on one side and weak enforcement strategy and weak focus on taxpayers (Tax theory) on the other side. As a result, the level of underground economy was on a high level.

In order to decrease the level of underground economy, efficient and effective Croatian Tax Administration is necessary. In that sense desirable organizational and management state structures, based on Organizational theory, for the Croatian Tax Administration is: positioning Croatian Tax Administration inside the Ministry of Finance, a high autonomy of Tax Administration inside the Ministry of Finance, internal organizational structure based on functional line, establishing Large Taxpayer Units, strengthening human resource capacity, and focusing on taxpayers. It will be analyzed how far is Croatian Tax

Administration from establishing a desirable organizational and management state structure. As was explained in Chapter 3, data regarding organizational and management structure will be collected using the primary and secondary data analysis. For formal position of Tax Administration in the overall government structure it will be looked into the official government structure and positioning of Tax Administration inside it. Autonomy of Croatian Tax Administration will be analyzed through the level of Tax Administration independency in making crucial decisions such as, remittance penalties and/or interest, establishment of internal design/structure, influence on staff recruitment criteria, hire and fire of staff, or staff salary levels (OECD, 2006). Regarding internal organizational structure, type of criteria that Croatian Tax Administration has established ('type of tax' criteria, 'functional' basis criteria, or 'taxpayer segments' criteria), is basis for making conclusions. For position of Large Taxpayer Units, it will be looked into the organizational structure of Croatian Tax Administration. Also, human resource capacity will be measured through the level of tax administrators' readiness to bear with taxpayers. Characteristics of tax administrators, such as professionalism and level of skills, will be taken into consideration. In addition, type of internal organizational structure that Croatian Tax Administration has adopted has strong influence on the quality of tax administrators. Focus on taxpayers refers to readiness of Tax Administration to help taxpayers in fulfilling their duties. In that context, focusing on taxpayers is strongly connected with human resource capacity. It was assumed that higher trained staff will be more successful in implementing this principle. In addition, quality of internet web site, as a tool to increase focus on taxpayers, will be analyzed.

Based on collected data, the current state of organizational and management state structure in Croatian Tax Administration will be identified. Afterwards, conclusions regarding the difference between desirable and current organizational and management state structure will be provided. In that sense, looking into the gap between desirable and current organizational management state will explain level of the underground economy in Croatia and provide opportunity to compare with the level of underground economy in Slovenia.

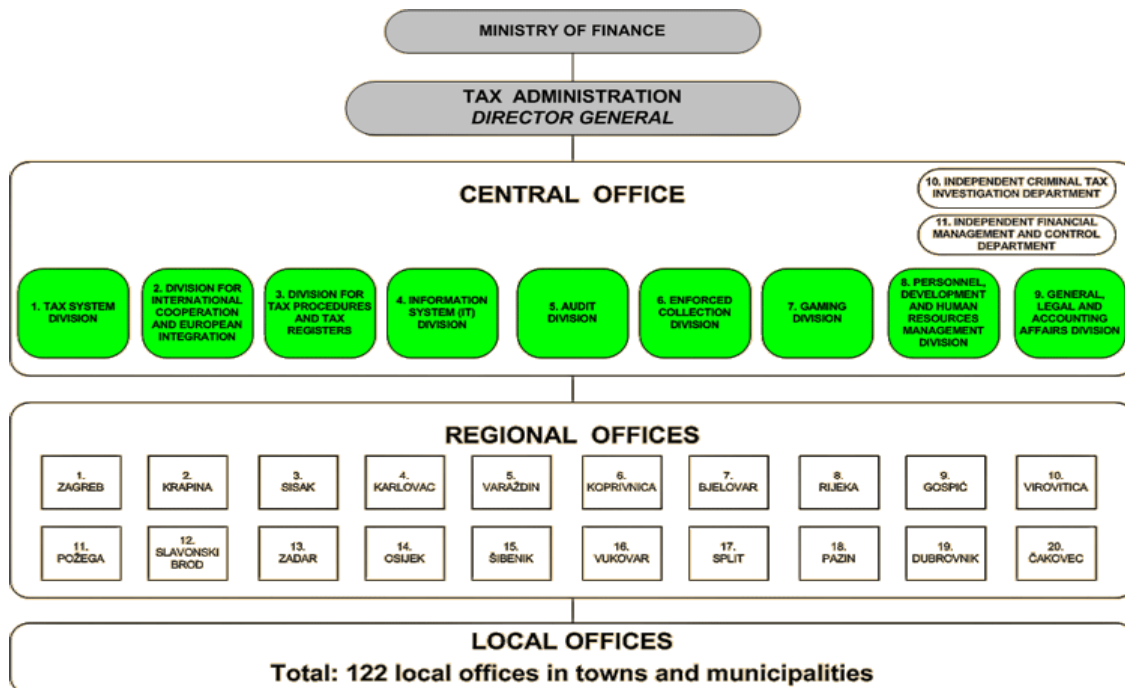
4.1.2 Organization and main tasks of Tax Administration in Croatia

The Croatian Tax Administration is an administrative organization within the Ministry of Finance whose basic duty is to implement tax regulations and regulations concerning the payment of obligatory contributions. The main tasks of Croatian Tax Administration are⁶: receiving tax returns, entering tax liabilities in tax accounts, collecting and refunding taxes; establishing the timeliness, lawfulness and regularity of submitted tax returns; establishing tax base and tax liability; carrying out inspection supervision; conducting the seizure of assets in order to collect taxes; filing charges in order to initiate misdemeanour and criminal proceedings; pursuing cases at the misdemeanour courts due to violations of tax regulations; providing official position papers on the enforcement of regulations in individual tax matters; international legal assistance in tax matters; studying tax systems and co-operating with tax authorities in other countries; monitoring the enforcement of international contracts relating to taxes; issuing documents on facts maintained by the Tax Administration in its official record; development and use of the tax information system; authorizing and supervising games of chance, entertainment games and game shows; issuing authorizations, stamps or other labels for marking, production surveillance, turnover and use of individual products, in line with the special law specifying individual kinds of taxes; carrying out the seizure of assets in order to collect other public taxes upon the request of government bodies and courts and in line with special laws.

Tax Administration is organized on three levels: Central Office of Tax Administration, Regional Offices and Local Offices. The organizational model provides the base for the quality work of the Tax Administration (Bejakovic, 2000). Figure 9, provides organizational structure of Tax Administration in Croatia.

⁶ www.porezna-uprava.hr

Figure 9. Organization of Croatian Tax Administration



Source: www.porezna-uprava.hr

4.1.3 Organizational and management state structure of Tax Administration in Croatia

Croatian Tax Administration is a part of the Ministry of Finance, as we can see in Figure 9. In that context, Croatian Tax Administration is 'neither independent, nor particularly autonomous' (Ott, 1998: 22). We should analyze two things in this case:

- One question is the formal position of Tax Administration in the overall government structure, and
- The other is the real autonomy inside the Ministry of Finance.

Regarding the first question, it was argued that Tax Administration should be part of the Ministry of Finance. The main reason is fear of political influence on Tax Administration. According to Ott, there is a link between level of independency on one side and level of democratisation in political system on the other side. Higher level of independency can be allowed only if there is a higher level of democratisation in political system. Otherwise, we will have situation that Tax Administration is instrument in the hands of political elite. In that sense, it is better for Croatian Tax Administration to be part of the Ministry of Finance than

independent body. In the future, with progress in democratisation in political system, position of Tax Administration may be changed. The high level of democratisation will be a guarantee that Tax Administration will not be used as a tool for achieving better political position.

Second question is autonomy of Tax Administration inside the Ministry of Finance. The more autonomous Tax Administration leads to better results regarding the tax collection. In other words, that will contribute to decreased levels of tax evasion. Fiscal dependency on the budget produces a lot of problems for Croatian Tax Administration. Salaries in Tax Administration are lower than in private sector and it is very difficult to employ young educated people or to keep the best employees in Tax Administration in Croatia (Brcic&Janicev, 1998). Tax experts in Croatia agreed that autonomy of Tax Administration is on a low level (Ott, 1998; Brcic&Janicev 1998; Bejakovic, 2000). Even though they did not explicitly mention in which areas autonomy of Tax Administration is a low, we can easily recognise it. Using the OECD (2006) criteria regarding the power of Tax Administration inside the Ministry of Finance we can realize weaknesses of Croatian Tax Administration. These criteria refer to the following areas: remittance penalties and/or interest, establishment of internal design/structure, allocation of budget, maintaining of own IT operations, setting up of service performance levels, influence on staff recruitment criteria, hire and fire of staff and staff salary levels. Based on these criteria, the Ministry of Finance has a strong influence on Croatian Tax Administration. Croatian Tax Administration is not independent enough from higher authority and as a result, autonomy of Tax Administration in making own decisions, crucial for efficient and effective doing business, is on a low level. Establishing strong enforcement strategy and focusing on taxpayers is possible only when Croatian Tax Administration can define internal organizational structure based on own criteria, when is financially independent from the Ministry of Finance, when can define criteria to hire/fire employees, or when can define staff salary. Also, IT divisions are strongly dependent from external sources and with limited internal capacity to guarantee the continuity of IT services (Commission of the European communities, 2006). In a situation when Tax Administration does not have possibility to influence on abovementioned elements, and when it is dependent on the Ministry of Finance in that context, it is very difficult to increase efficiency and effectiveness. It is necessary to strengthen autonomy of Tax Administration inside the formal organizational structure. On one side, positioning Tax Administration inside the Ministry of Finance is a good decision, as was explained in previous Chapters, but autonomy inside the Ministry of Finance is still on a low level on the other side. Low level of Tax Administration autonomy inside the Ministry of Finance is a big obstacle for Croatian Tax Administration to improve quality of work.

Croatian Tax Administration, as shown in Figure 9, is organized along the functional lines on the level of the Central Office. According to the theoretical and empirical debate that is a very positive approach. However, on the level of Departments, these functional principles are dividing various taxes into appropriate Departments. In addition, in Local Offices, instead on functional lines Departments are organized by the type of taxes and the number of taxpayers (Ott, 1998). Internal organizational structure of Croatian Tax Administration is a big obstacle for decreasing levels of tax evasion. Internal organization of Departments and Local Offices in Croatian Tax Administration based on type of tax criteria has many shortcomings. The major shortcomings are the following (OECD, 2006): duplication of functions leads to inefficiency, taxpayers with multiple tax dealings have to deal with different departments on similar issues, **complications regarding taxpayers' compliance**, increased likelihood of uneven and inconsistent treatment of taxpayers across taxes, necessity to have staff whose skills are largely confined to a particular tax, and unnecessarily fragmented overall management of Tax Administration. Establishing functional organizational structure in the whole Tax Administration will lead to a lower level of tax evasion. Based on the theoretical discussion in Section 2.3, using the functional principle will increase quality, specialization, and professionalism of tax administrators. That will result in high skilled employees ready to bear with tax evaders on one side and ready to help taxpayers in fulfilling their duties on the other side. **Combining the two principles, 'type of tax' criteria and 'functional' criteria, is not** a good decision. The abovementioned shortcomings will appear and produce a weak institution for collecting taxes. Establishing audit, services, archiving and enforcement departments is a much better decision than to organize Tax Administration into VAT, income or excise departments. In this way, shortcomings will be eliminated and a stronger institution for collecting taxes will be established.

The Croatian Tax Administration, led by proper modern models, which advise that establishing of the Large Taxpayer Units in Tax Administration, is a tool to increase the levels of tax compliance in countries and that large taxpayers contribute with significant percent of all collected taxes. Tax Administration in Croatia established the Large Taxpayer Unit inside the audit division of the Central Office of Tax Administration. Also, Large Taxpayer Units are to be established in Regional Offices in Zagreb, Split, Rijeka and Osijek⁷. The Department inside the Central Office has a role to coordinate functions of Large Taxpayer Units in

⁷ Uredba o unutarnjem ustrojstvu Ministarstva financija, 2008

Regional Offices. In such way, much better coordination may be achieved and better results can be reached. It is necessary to have a coordination body that will monitor the whole process of control of large taxpayers. Croatian Tax Administration recognises necessity to establish such units. They understood that large companies are the most important source of all collected taxes. Furthermore, these units are consisted of the best employees in Croatian Tax Administration. This is according to leading principles in developed countries and according to suggested organizational and management state structure in transition countries. Actually, Large Taxpayer Units in Croatian Tax Administration should be a role model for other departments in the organization. High professionalism and specialization is something that has to characterise all departments in organization.

Strong human resource capacity and focus on taxpayers is something still missing in Croatian Tax Administration. The reasons for inadequate human resource capacity, we can find in a low autonomy of Tax Administration on one side and internal organizational structure on the other side. Increasing the autonomy of Tax Administration and establishing the internal organizational structure based on functional criteria is a way to improve the quality of tax administrators. Inadequate state structures produced a low level of specialization and professionalism in Croatian Tax Administration. In order to overcome these issues, and to increase capability of tax administrators, adequate internal organizational structure is necessary. Otherwise, Croatian tax administrators will not be ready to bear with taxpayers and with highly sophisticated tax evasion schemes. 'Type of tax' criteria produced all aforementioned weakness and inadequate specialization of tax administrators (Brcic&Janicev, 1998). Furthermore, regarding the focusing on taxpayers, the only part in Law on Tax Administration that suggest friendly behaviour towards taxpayers is **Article 3, Paragraph 11** of the Law. It says that Tax Administration is 'concerned with the development and improvement of the tax system' (Ott, 1998). Generally, Croatian Tax Administration is mainly focused in implementing enforcement strategy in collecting taxes (audit control and penalties) and less focused on taxpayer rights and how to help taxpayers in fulfilling their duties (Ott, 1998; Kopriv, 1998). Also, internet website has to be more client-oriented and to provide all necessary information to taxpayers. Opportunity to ask questions regarding tax issues, and to have professional tax assistance, is an important step in focusing on taxpayers. Providing information 24 hours, on time and prompt is clear signals that focus on taxpayers is implemented. Furthermore, information regarding taxpayer's rights is still missing and providing them will be helpful and useful. In that sense, Croatian Tax Administration should be more focused on taxpayers (Bratic&Bronic, 2004) and to permanently improve skills of tax administrators. Taxpayer-oriented approach and better trained staff are still missing.

Tax Administration in Croatia follows the principles regarding the organizational and management state structure in developed countries. It is widely recognized that establishing such principles is the right way to decrease levels of tax evasion. However, some big problems still exist. The biggest obstacle in decreasing levels of tax evasion is lack of autonomy of the Tax Administration (Drezgic, 2006; Bratic&Bronic, 2004), lack of focus on taxpayers, as well as internal organizational structure and management state structure. According to Bratic&Bronic, autonomy of Tax Administration should be increased in order to improve effectiveness of the organization. It should have a wide autonomy inside the Ministry of Finance in order to improve performances. Higher autonomy of Croatian Tax Administration will help in efforts to hire and keep the best employees. In that context, higher salaries, possibilities for specialization and promotion will attract employees to stay or to start to work in Tax Administration. Due to inadequate internal organizational structure, specialisation of tax officers is still missing. With increasing specialization, autonomy of tax administrators will be increased and lead to a lower level of tax evasion. Furthermore, organizational improvements are necessary from the point of view of financial independence and the distribution of human resources (Brcic&Janicev, 1998). Strengthening the autonomy of Tax Administration is the right way to improve effectiveness of Tax Administration and to decrease levels of tax evasion.

Based on previous discussion, Croatian Tax Administration has established the following organizational and management state structure: positioning of Tax Administration inside the Ministry of Finance, a low level of Tax Administration autonomy inside the Ministry of Finance, internal organizational structure is characterised by combination of functional criteria and type of tax criteria, Large Taxpayers Units are established, human resource capacity needs significant improvements, and focusing on taxpayers is on a low level. As we can see, there is a large gap between organizational and management state structure in Croatian Tax Administration and a desirable organizational and management state structure. As was assumed, the larger gap between desirable and current organizational and management state structure in Tax Administration, will lead to a higher level of the underground economy. Weak Tax Administration and different treatment of taxpayers encourage taxpayers to cheat government. Actually, taxpayers recognize that probability to be caught is low and that time length between the act of evasion and the act of detection is long. As a result, the gain of non-compliance is high. Also, different attitude of tax administrators for different enterprises have negative influence on the level of collected taxes. Different treatment of taxpayers' increased resistance for paying taxes. Furthermore, an inadequate quality of employees and a low level of implementing taxpayers-oriented approach are additional reasons for a high level of the underground economy in Croatia. In

order to overcome these issues, moving towards desirable organizational and management state structure is necessary. That will help Croatia to increase capacity of Tax Administration and to decrease the level of underground economy. In the end, we can conclude that even the efforts to improve performance in Croatian Tax Administration are obvious, the overall administrative capacity of Tax Administration remains limited and preparation is only starting (Commission of the European communities, 2006).

4.2 Slovenian Tax Administration

4.2.1 Introduction

The tax reform in Slovenia has started in 1990, a parallel process with Slovene independency. The main goals after declared independency were to establish an independent state in the areas of politics, economy, and finance. The set up of Tax Authorities, together with establishing of the Slovenian currency, negotiations for separate agreements with foreign creditors of the former SFR Yugoslavia, etc, was among the top of priorities in the newly established state (Mrak, etc, 2004). The main aim was to establish a tax system and Tax Administration compatible with tax systems in developed market economies⁸. Like in Croatia and in other transition countries, a strong institution for collecting taxes was important to be established. The planned socialism legacy had strong negative indication regarding the position of Tax Administration. Weak institutions to collect taxes together with economic structure characterized by state-owned companies produced a high level of the underground economy in Slovenia. Radical reforms in Tax Administration and change to adopted principles in developed countries were necessary.

Slovenia shared the same characteristics with other transition countries regarding the starting position for reforming Tax Administration. Based on Figure 7, like in case of Croatia, planned socialism legacy is standardized variable that explained starting position for reform in all transition countries. In that context, Slovenian Tax Administration shares the same legacy of planned socialism like other transition countries. Weak position of tax administrators in relation to taxpayers resulted in a high level of tax evasion. In addition to that, taxpayers did not have the same treatment and some of them were in more privileged position than others. Also, taxpayers make a rational calculation that weighs the gains from successful non-compliance against the expected loss for being caught. In that context, tax authorities should establish adequate audit rate and the penalties (enforcement strategy), in order to limit tax non-compliance to a desired level. Enforcement strategy in Slovenian Tax Administration was on a low level. Furthermore, helping taxpayers in fulfilling their duties is additional element to increase the level of tax compliance. Like in the case of enforcement strategy, focus on taxpayers was weak too. The reason for that we can find in inadequate organizational and management state structure in Slovenian Tax Administration. As a result, level of the underground economy was on a high level. Establishing the desirable

⁸ Tax auditing: an European perspective, from: www.mfcr.cz

organizational and management state structure is very important in order to decrease the level of tax evasion. In that sense, desirable organizational and management state structure, based on Organizational theory, for the Slovenian Tax Administration is: positioning Slovenian Tax Administration inside the Ministry of Finance, a high autonomy of Tax Administration inside the Ministry of Finance, internal organizational structure based on functional line, establishing Large Taxpayer Units, strengthening human resources, and focusing on taxpayers. These elements will be analysed according to the methodological explanation and implemented on the same way like in the case of Croatian Tax Administration. For position of Slovenian Tax Administration in the overall government structure, it will be looked into the official government structure and position of Tax Administration inside it. Using the OECD (2006) criteria, such as remittance penalties and/or interest, establishment of internal design/structure, influence on staff recruitment criteria, hire and fire of staff, or staff salary levels, will provide opportunity do define the level of Tax Administration autonomy in making crucial decisions for own development. Depending of type of criteria that Slovenian Tax Administration has established ('type of tax' criteria, 'functional' basis criteria, or 'taxpayer segments' criteria), conclusion regarding internal organizational structure will be made. For position of Large Taxpayer Units, it will be looked into the organizational structure of Slovenian Tax Administration. Level of tax administrator's skills and professionalism in order to bear with taxpayers will define level of human resource capacity in the organization. As was mentioned, type of internal organizational structure that is adopted has strong influence on the quality of tax administrators. Also, helping taxpayers to pay taxes (focus on taxpayers) is strongly connected with quality of employees in organization. In that sense, high skilled tax administrators will be more capable to focus on taxpayers than less skilled employees. Quality of internet web site, as a tool to increase focus on taxpayers, will be taken into the consideration.

Based on collected data, current organizational and management state structure in Slovenian Tax Administration will be identified. After that, conclusion regarding the difference between the desirable and current organizational and management state structure in Slovenian Tax Administration will be provided. In that sense, looking into the gap between desirable and current organizational management state will explain the level of underground economy in Slovenia and provide opportunity to compare with the level of underground economy in Croatia.

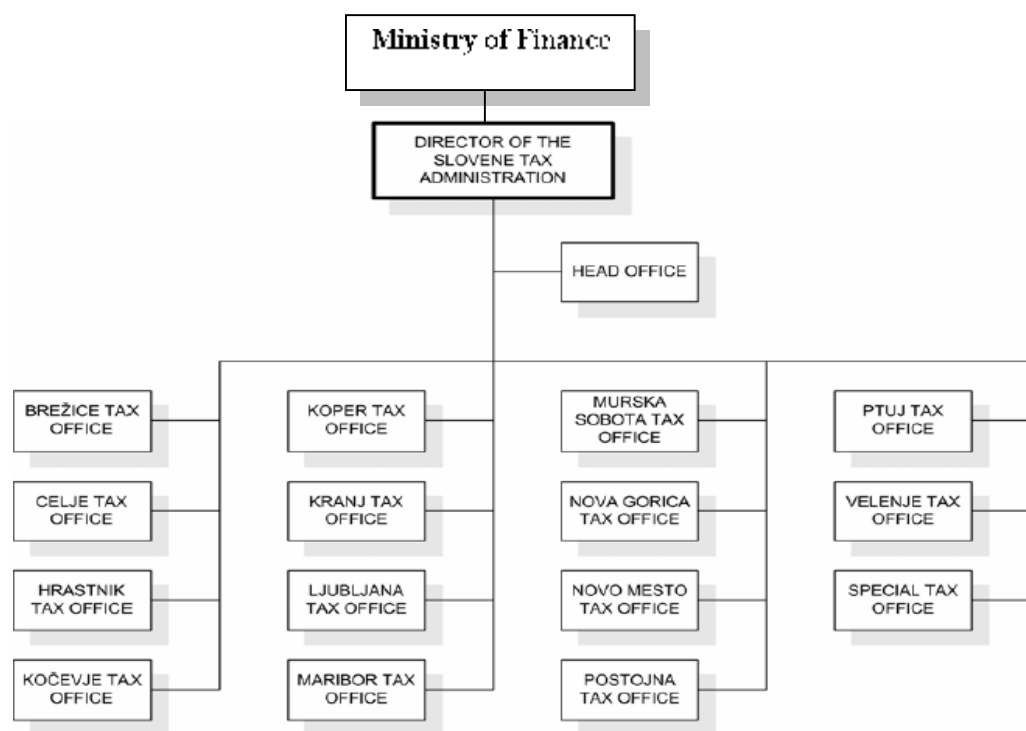
4.2.2 Organization and main tasks of Tax Administration in Slovenia

The Tax Administration of the Republic of Slovenia is a constituent part of the Ministry of Finance. The main tasks of Tax Administration in Slovenia are⁹: timeliness of meeting of tax obligations, defined with taxation regulations; prevention and discovering of tax offences and other cases of criminal conduct, defined in regulations, supervision over the implementation, which Tax Administration is responsible, and the management of the procedure for offence's (body for offences); forcible collection of pecuniary claims of the state and self-governing local communities on the basis of the act, which arranges the general administrative procedure, and on the basis of the act, which arranges offences; implementation of European Community regulations and international agreements, which oblige Slovenia in connection with Tax Administration's work field, co-operation and exchange of data with Community's bodies, competent bodies of EU Member States and with competent bodies of other states; co-operation with international organizations and professional associations from the field of taxes; examination and analysis of tax system's operations and tax policy's measures and submitting of initiatives for solving of matters in this field; performing of other tasks, defined with the act or with regulations on the basis of the act.

Slovenian Tax Administration consists of the Head Office, the Special Tax Office (STO) and tax offices for individual tax areas. Figure 10, provides the organizational structure of Tax Administration in Slovenia.

⁹ www.durs.gov.si

Figure 10. Organization of Tax Administration in Slovenia



Source: www.mfcr.cz, modified by author

4.2.3 Organizational and management state structure of Tax Administration in Slovenia

In the context of the position and the autonomy of Tax Administration within overall government structures in Slovenia, we have to analyze two things like in the case of Croatia:

- One question is the position of Tax Administration, as an independent body, or a body as a part of Ministry of Finance, and
- The other is the level of Tax Administration autonomy inside the Ministry of Finance.

As we can see in Figure 10, Slovenian Tax Administration is a part of the Ministry of Finance. Arguments are similar like in the case of Croatia. It seems that the better option for Tax Administration in Slovenia is to be a part of the Ministry of Finance, than to be an independent body. In the future, with strengthening democratisation in political life, new organizational options may be discussed. For now, in order to avoid situation of political influence on Tax Administration, current position is preferable.

On the other side, autonomy within the Ministry of Finance is another question. As was discussed, more autonomous Tax Administration will produce much better results. In that context, Tax Administration in Slovenia enjoys a high level of autonomy. Tax Administration in Slovenia has autonomy in the following areas: remittance penalties and/or interest, establishment of internal design/structure, allocation of budget, maintaining of own IT operations, setting of service performance levels, influence on staff recruitment criteria, hire and fire of staff, and staff salary levels (OECD, 2006). Changing the tax law rulings is in the scope of duties of Ministry of Finance. As was explained in the theoretical part, a high level of Tax Administration autonomy should be granted because of the specific position in society. Based on aforementioned elements of autonomy of Tax Administration, we can conclude that autonomy is on a high level. Tax Administration can establish internal organizational structures independently from the Ministry of Finance. Employees, who are working in Tax Administration, know what the best organizational structure for their own organization is. To allocate the budget according to the main priorities is a very important element in increasing efficiency of the organization. Also, opportunity to manage human resources is one of the characteristics of Slovenian Tax Administration. In that sense, starting from recruitment criteria, through opportunity to hire and fire staff, and defining staff salary levels are the most important elements for human resource department in every organization. Actually, Slovenian Tax Administration has control on the whole process and result is expectable: high trained, professional and specialized employees. Furthermore, maintaining own IT operations increase capability of Tax Administration in controlling taxpayers on one side and in helping them to pay taxes on the other side. Performances of internet web site, that will be explained later, is result of applied IT technologies and additionally increases the quality of employees in organization. Overall, high autonomy is one of the most important reasons for high performance of Slovenian Tax Administration. They can arrange the organization in such a way, to make the dream come true: Slovenian Tax Administration to become one of the best in the world (Tax Administration, 2005).

Slovenian Tax Administration is organized according to the functional model. This organizational structure standardizes the work process in Tax Administration and increases the level of professionalization and specialization. Increasing the knowledge of tax administrators, will result in their better position in respect to taxpayers. That will produce a higher autonomy of tax administrators and lead to a lower level of tax evasion. The main shortfalls of tax of type criteria are avoided. Established functional principle for internal organizational structure in whole Slovenian Tax Administration improved performances such as providing single points of access for tax inquires, unified system of taxpayer registration, common tax payment and accounting approaches, and more effective management of tax

audit and debt collection function (OECD, 2006). The positive consequences on the level of underground economy are obvious. Strong Tax Administration with strong organizational structure leads to a lower level of tax evasion. Functional organizational structure implemented in Slovenian Tax Administration increased professionalism, specialization and quality of employees. Actually, it is organized into audit, services, and enforcement departments. This has crucial impact on qualities of employees and their readiness to bear with taxpayers. As was assumed, type of internal organizational structure that is adopted in one organization has a strong influence on the quality of employees. Slovenian Tax Administration established internal organizational structure according to the leading principles in developed countries and according to defined organizational and management structure for transition countries.

Slovenian Tax Administration partly implements the 'taxpayer segment' criteria, established in the Large Taxpayer Units within the organizational structure. As we can see from Figure 10, Special Office for large enterprises is positioned on the level of Regional Offices. These units employ the best tax administrators within the Tax Administration because large enterprises have some specific characteristics compared with other enterprises (multiple operating entities that are widely dispersed geographically; high volume of transactions in the course of day to day business activities; use of complex financing arrangements; use of professional tax advisers, part of whose brief is to minimize their exposure to taxation, etc). Depending on the level of total revenues that enterprises make during the year, they will be under the control of Special Office or Regional Office. Slovenian Tax Administration realized importance for establishing such units. Even though some experts are against establishing such units, theory and practice showed completely different. Every Tax Administration that established special departments for large enterprises received positive results for such decision. Implementing special strategy for these companies brings a lot of benefits and, in the end, increases the level of collected taxes. Large Taxpayer Units in Slovenian Tax Administration are consisted of the best employees in the organization. This is because large enterprises have much more complicated tax affairs than other companies and deserve special attention. Actually, these units have to be an example how other departments in Slovenian Tax Administration should look like. High trained, professional and with clear focus on taxpayers, these departments are role models for all other departments in Slovenian Tax Administration.

Another very important question in the context of strengthening of Tax Administration is the quality of employees. Recruiting the best and permanently improving their skills and knowledge, is one of the most important tasks in every organization. It seems that Tax Administration in Slovenia recognized the importance of the role of Human

Resources Department. They are independent from the Ministry of Finance regarding defining of staff recruitment criteria, 'hire and fire staff', and in negotiating staff salary levels. Actually, they established an organization like in private companies. They can hire and fire employees like in private companies. Employees who are under performance or who infringe company's rules can be fired and instead of them new employees can be hired. Even more important is the fact that Tax Administration can define the criteria for hire of new employees. In that context, they can hire employees with specific skills and knowledge and avoid situations to hire employees with inadequate characteristics. Quality of employees has a strong influence on the quality of auditing and inspection of taxpayers. In that context, there is clear evidence that productivity of tax audit increased. According to Klun (2004), inspection coverage and the number of inspections per inspector were continually increasing. Employees are well trained and ready to confront with sophisticated tax evasion schemes. High level of autonomy inside the Ministry of finance and internal organizational structure based on functional line are one of the main reasons for that. Actually, as was argued, implementing functional criteria for internal organizational structure Slovenian Tax Administration has two positive effects. On one side, such organization increased professionalism and quality of employees. On the other side, as a result, strong enforcement strategy and focus on taxpayers are implemented. In that sense, only high trained employees are ready to implement these two approaches. Slovenian Tax Administration is a clear example how organization can effectively implement audit control and penalties on one side and how can help taxpayers in fulfilling their duties on the other side. The necessary and crucial conditions are well trained employees. Slovenian Tax Administration realized that necessity and through adequate organizational structure and adequate level of autonomy, this condition is fulfilled.

On the other side, focus on taxpayers is on a high level. The taxpayer-oriented approach is applied and relations between tax administrators and taxpayers are on a high level. Explaining to citizens that paying taxes brings benefits for all members of the society and high belief in fairness of the tax system, leads to a lower level of tax evasion. Clear example that Slovenian Tax Administration has implemented focus on taxpayers is the official website. On the internet website, the Tax Administration published 280 explanations and 60 news items, updated 160 forms or life events and 137 legal bases, on the basis of which the Tax Administration operates. In the same time, the Slovenian media sent approximately 1800 questions to the Tax Administration (about 7.2 per working day). In addition, Slovenian Tax Administration received about 200 questions from taxpayers directly

and 115 questions from taxpayers via e-government portal. The most important is that Tax Administration's answers were correct, on time, and prompt¹⁰. Furthermore, Slovenian Tax Administration has implemented Virtual Tax Assistance (VTA) project as a tool to help taxpayers in fulfilling duties. VTA answers Slovenian taxpayers' questions on-line, deal with phone queries, answering simple questions on income tax 24 hours a day. VTA is clear example of Tax Administration behaviour towards taxpayers. Also, on the official website there are lists of rights that taxpayers enjoy: right to be informed and assisted, right to certainty, right to impartiality, right to privacy, right to confidentiality and secrecy, right to appeal, right to representation and courtesy right¹¹. Based on aforementioned, high trained employees and client-oriented internet website have resulted in a clear orientation of Slovenian Tax Administration to help taxpayers in paying taxes and to implement taxpayers-oriented approach. Actually, high trained employees in Slovenian Tax Administration are ready to focus on taxpayers to implement taxpayers-oriented approach. Otherwise, this approach will not be possible to implement with inadequate and low skilled employees. Because of that, in order to avoid this situation, high trained, professional and specialized tax administrators are characteristics of Slovenian Tax Administration and clear focus on taxpayers was expected consequences.

Based on aforementioned, Slovenian Tax Administration has established principles like in developed countries. It was noticed that membership in European Union (EU) brings a lot of benefits for all countries. In the context of Tax Administration, membership in EU or moving towards EU, results in establishing contemporary Tax Administration ready to confront with tax evaders. In the end, it will result in decreasing levels of tax evasion and increasing levels of tax collection. Capacity of Slovenian Tax Administration is on a high level and capable to ensure efficient collection, application and inspection of taxation. Administrative structure is adequate and employees are well trained and educated. Enforcement strategy is strong and together with focus on taxpayer's results in a low level of the underground economy. As was assumed in Chapter 2, high trained employees are assumption for successfully implementing taxpayers-oriented approach. Focus on taxpayers is on a high level and tax administrators try to help taxpayers in fulfilling their duties. Internet site is very useful and provides all necessary information regarding taxpayers. That is a confirmation that Slovenian Tax Administration focuses on taxpayers and tries to be a facilitator in the whole process. Besides the strong enforcement strategy, focus on taxpayers is a necessary condition to decrease level of tax evasion. Based on that, it is not a surprise

¹⁰ Tax Administration of the republic of Slovenia (2007). *Annual report for 2006*, from www.durs.gov.si

¹¹ www.durs.gov.si

that Slovenian Tax Administration is marked as a high professional and well established organization¹².

Based on the previous discussion, Slovenian Tax Administration has established the following organizational and management state structure: positioned inside the Ministry of Finance, a high level of Tax Administration autonomy inside the Ministry of Finance, internal organizational structure is based on functional criteria, Large Taxpayers Units are established, human resource capacity is characterised by high trained staff, and focusing on taxpayers is on a high level. As we can see, organizational and management state structure in Slovenian Tax Administration is in line with the desirable organizational and management state structure. By establishing such organizational and management state structure, Slovenian Tax Administration has overcome the issues recognized in the Street-level Bureaucracy theory and in the Tax theory. High probability that tax evaders will be caught and short time length between the act of evasion and the act of detection (Tax theory) and equal treatment of taxpayers (Street-level Bureaucracy theory) are results of established state structures (Organizational theory). This means that strong enforcement strategy is established. Also, high trained staff and clear focusing on taxpayers are additional elements for increased level of tax compliance in Slovenia. Overall, we can conclude that enforcement strategy and taxpayers-oriented approach are established and they are very efficient. There is no gap between desirable and current organizational management state structure and, as a result, the level of underground economy is on a low level.

¹² Taxation, Slovenia – adoption of the community acquis, from www.europa.eu

4.3 Comparison between Croatian and Slovenian Tax Administration

Tax policy reform in every country is one of the most important tasks in the transition period. Establishment of a stable tax system is crucial in every society. Collected taxes are the main component of country's budget. The level of collected taxes has the main impact on the size of budget. In that sense, tax evasion is the main threat for every government. Higher tax evasion produces a lower level of tax collection and that will prevent the government to accomplish all obligations. Accordingly, the main interest of every government is that level of tax evasion should be as low as possible. It was noticed that levels of tax evasion were much higher in transition than in developed countries. The reasons for that are to be found in the past. The consequences of planned socialism legacy were explained above. Economic structure characterized with state-owned companies and soft budget constrains toward them, result in weak government institutions for collecting taxes. The taxes were a matter of negotiating and low autonomy of tax administrators' resulted in a high level of tax evasion. Because of that, the main task for the government in transition period is to establish a strong and responsible Tax Administration. In order to do that, the countries in question, followed the leading principles adopted in developed countries. The results were positive. The lower is the gap between desirable and current organizational and management state structure in transition countries, lower is the level of underground economy. In this Thesis the focus is on Croatian and Slovenian Tax Administration. It was assumed that planned socialism legacy produced the same conditions for all transition countries, including Croatia and Slovenia. Regarding the position of Tax Administration in government structures, and dependant on differences in organizational and management state structure, the outcomes will be different levels of tax evasion.

Based on explanation in Section 4.1.3 and Section 4.2.3, Croatian and Slovenian organizational and management state structure are in line with situations in a developed country. However, there are some significant differences between them, which result in different levels of underground economy. Table 3, presents comparative analyzes between Croatian and Slovenian Tax Administrations regarding organizational and management state structure. In this sense, focus was on the following elements: institutional arrangements for Tax Administration, level of Tax Administration autonomy, internal organizational structure of Tax Administration, Large Taxpayer Units, human resource capacity, and focus on taxpayers.

Table 3. Comparison between Croatian and Slovenian Tax Administration – organizational and management state structure

	Croatia	Slovenia
1. Institutional arrangements for Tax Administration	Single directorate in the Ministry of Finance	Single directorate in the Ministry of Finance
2. Autonomy of Tax Administration (inside the Ministry of Finance)	Low	High
3. Internal organizational structure of Tax Administration	Functional/ type of tax criteria	Functional criteria
4. Large Taxpayer Units	Yes	Yes
5. Human resource capacity	Significant improvements are necessary	High trained staff
6. Focus on taxpayers	Low level	High level
Overall level of administrative capacity	Low	High

Based on previous discussion regarding organizational and management state structure in Croatian and Slovenian Tax administration, comparative analysis is provided. As we can see from Table 3, the position of Tax Administration within overall government structure is the same. They are a part of the Ministry of Finance. As was argued before, that situation is acceptable in current situation. Their Tax Administrations are protected from becoming tools in the hands of politicians. With strengthening democratic control of political parties, the position of Tax Administration may be discussed again. Another, even more important, question is a level of autonomy of Tax Administration inside the Ministry of Finance. Here are the main differences between Croatian and Slovenian Tax Administration (besides the internal organizational structure, quality of employees and focus on taxpayers):

- Slovenian Tax Administration enjoys a high autonomy inside the Ministry of Finance.
- Croatian Tax Administration has a low level of autonomy.

As was discussed in theoretical part, whether Tax Administration is an independent body or not, the level of autonomy has to be on a high level. The specific role of Tax Administration in the government structure must define that. The higher autonomy of Tax Administration is, the better are the results in fighting with the underground economy. Tax Administration in Slovenia has autonomy in the following areas: remittance penalties and/or interest, establishment of internal design/structure, allocation of budget, maintaining of own IT operations, setting of service performance levels, influence on staff recruitment criteria, hire and fire of staff, and staff salary levels (OECD, 2006). As was explained in Section 4.2.3, Slovenian Tax Administration has completely autonomy for aforementioned elements. Defining own organizational structure, managing whole human resource process, allocating the budget according to defined priorities, etc, resulted in a high capable and responsible Tax Administration. Slovenian Tax Administration is independent from the Ministry of Finance regarding the main decisions and that produced strong positive effects on whole organization. On the other side, tax experts in Croatia agreed that level of Tax Administration autonomy is on a low level. High level of dependency on the Croatian Ministry of Finance, regarding the aforementioned decisions, neutralise possibility to improve own capability. Croatian Tax Administration is not adequately organized and effective because of low level of autonomy. Crucial decisions for organization have to be in the hands of employees who work in the Croatian Tax Administration and not on the level of Ministry of Finance. That will help to improve quality of work and capability of organization. As a result the strong institution for collecting taxes will be established. Overall, a low level of autonomy is a big obstacle that influences efficiency and effectiveness of Croatian Tax Administration.

Another significant difference between Croatian and Slovenian Tax Administration is the organizational structure. Regarding the organizational structure, Slovenian Tax Administration implemented purely functional organization while Croatian Tax Administration is characterized by the combination of functional and tax type criteria. It is important that both administrations have the functional organizational structure as the primary method for structuring of Tax Administration operations. However, Slovenian Tax Administration went a step further. Through the whole organizational structure they implemented functional organizational structure that led to the increase professionalism and in the enhancement of skills of tax administrators regarding their ability to fight with tax evaders. Autonomy of tax administrators increased and that was a necessary condition to decrease levels of tax evasion. The main shortfalls of type of tax criteria on one side and main advantages of functional criteria on the other side are explained above. It is clear that establishing functional organizational structure increases the capacity of Tax Administration

and brings benefits to the organization. Using the type of tax criteria decreases the power of Tax Administration and results in a higher level of tax evasion.

Establishing of Large Taxpayer Units is another very important issue. The different strategy towards Large Taxpayers Units should be established for two reasons:

- First, they are the most important source of taxes. They participate in overall level of collecting taxes more than all other enterprises together
- Second, many of large taxpayers have very complex tax affairs that require high trained employees

In that sense, establishing Large Taxpayer Units is very important and these units should employ the best experts. In Slovenia coordination of Large Taxpayer Units is on the level of Regional Offices while in Croatia Large Taxpayer Units are coordinated from the Central Office. Furthermore, Large Taxpayers Units should be spread throughout the organizational structure of Tax Administration. As we can see, both organizations realized necessity for establishing such units. Strengthening capacity of these units will help Croatian and Slovenian Tax Administration to additionally increase the level of tax compliance. They have to strive to permanently increase capability of Large Taxpayers Units. Any other decision, such as abolition of these units or temporarily investing in these units because of short term goals, will be very dangerous. Large Taxpayers Units are the long term decision with a clear perspective in future organizational structure. Croatian and Slovenian Tax Administration should have to continue to strengthening these units and, as a result, higher level of collected taxes will be achieved.

In the end, quality of employees and focusing on taxpayers is significantly better in Slovenia than in Croatia. Focusing on taxpayers and implementing taxpayer-oriented approach additionally increases the level of tax compliance. In that context, Slovenian Tax Administration went a step further in comparison with Croatian Tax Administration. Slovenian Tax Administration is a more client-oriented one than Croatian Tax Administration and that is another explanatory factor for the different levels of tax evasion. Well established organizational and management structure in Slovenia results in high skilled staff and high professionalism of employees. As was mentioned, only highly skilled employees can implement taxpayer-oriented approach. Providing information on time, helping taxpayers in fulfilling their duties is possible only with highly trained employees. Furthermore, Virtual Tax Assistance implemented in Slovenian Tax Administration, is an example how Tax Administration has to treat taxpayers. Providing information 24 hours a day, on time, prompt, and correct is something that characterized Slovenian Tax Administration and that is

still missing in Croatian Tax Administration. In that sense, Slovenia implemented taxpayer-oriented approach much better than Croatia. Furthermore, level of awareness among tax administrators that taxpayers have some rights and not only duties is higher in Slovenia. Recognizing importance of implementing this approach contributes to the level of tax compliance in Slovenia, which is on a higher level than in Croatia. Internal organizational structure is an additional reason for high quality of employees in Slovenian Tax Administration. Using the functional criteria for internal organization increases quality, professionalism and specialization of employees. In that context, Slovenian Tax Administration established pure functional criteria, while Croatian Tax Administration implemented combination of functional criteria and type of tax criteria. As was explained, type of tax criteria is one of the shortcomings in Croatian Tax Administration, which significantly influences the quality of employees.

Based on Table 3 and above explanations, overall administrative capacity of Tax Administrations in Croatia and Slovenia are significantly different. Using the aforementioned elements (institutional arrangements for Tax Administration, level of Tax Administration autonomy, internal organizational structure, Large Taxpayers Units, human resource capacity, and focus on taxpayers), general conclusion is that Croatian Tax Administration is on a low level of administrative capacity while Slovenian Tax Administration is on a high level. To summarise, the main differences between these two countries are in the level of Tax Administration autonomy inside the Ministry of Finance, internal organizational structure, human resource capacity, and focus on taxpayers. Namely, Slovenian Tax Administration is characterised with a high level of autonomy inside the Ministry of Finance, internal organizational structure is based on a functional criteria, strong human resource capacity and clear focus on taxpayers. On the other side, Croatian Tax Administration is characterised with a low level of autonomy inside the Ministry of Finance, internal organizational structure is based on combination of functional criteria and type of tax criteria, weak capacity of human resources and weak focus on taxpayers. How do these differences reflect on the level of underground economy in Croatia and Slovenia is the next question, which is elaborated below.

As was mentioned, the level of underground economy will be used as a parameter to measure the gap between desirable organizational and management state structure in Tax Administration, explained in Chapter 2, and current organizational and management state structure in Croatian and Slovenian Tax Administrations, explained in this Chapter. Through the level of underground economy in both countries, it can be understood where the larger gap is between desirable and current organizational and management state structure. Actually, the larger gap between desirable and current organizational and management

state structure in Tax Administration, leads to a higher level of the underground economy. Establishing desirable organizational and management state structure will result in a strong enforcement strategy and clear taxpayer-oriented approach. Both elements, strong enforcement strategy and clear taxpayer-oriented approach, establish an environment where cheating the government is punishable on one side, and where taxpayers are treated as citizens who have to fulfil some obligations on the other side. That will result in a lower level of the underground economy on one side and increased level of the tax compliance on the other side. To summarize, the larger gap between desirable and current organizational and management state structure in Croatian and Slovenian Tax Administration is, the higher is the level of underground economy. In that context, based on Table 3, gap between desirable and current state structures is significantly larger in Croatian Tax Administration and, therefore, we can expect higher level of the underground economy in Croatia than in Slovenia. Comparison between these two countries regarding the level of underground economy is provided below.

As argued in Chapter 3, Eurostat Method and Electricity Consumption Method will be used to measure levels of underground economy. Other methods provide unreliable and inaccurate data regarding the level of underground economy. In that sense, Table 4, presents levels of the underground economy in Croatia and Slovenia using the Electricity Consumption Method (average level for different approaches used the Electricity Consumption Method to measure levels of the underground economy). Table 5, presents comparison between Eurostat Method and Electricity Consumption Method.

Table 4. Level of the underground economy in Croatia and Slovenia (as % of GDP) - estimated values of the underground economy based on Electricity Consumption Method

Country	Average – all methods	Johnson – Electrical energy input method	Kaufmann-Kaliberda	Lacko	DYMIMIC
		1994/1995	1995	1998	2000/2001
Bulgaria	34.5	32.7	-	34.5	36.4
Croatia	31.3	28.5	-	32.9	32.4
Czech Republic	16.4	14.5	12.7	19.9	18.4
Estonia	29.9	38.5	13.4	28.7	39.1
Latvia	42.5	34.8	54.6	40.8	39.6
Lithuania	28.7	25.2	27.6	32.5	29.4
Hungary	28.6	28.4	40.8	20.8	24.4
Poland	17.3	13.9	14.4	13.4	27.4
Romania	28.8	28.3	23.6	30.0	33.4
Slovakia	16.8	15.2	-	17.0	18.3
Slovenia	23.0	23.9	-	18.4	26.7
Average	27.1	25.8	26.7	26.3	29.6

Source: Lacko (1998) for the Lacko and Kaufmann-Kaliberda method, Schneider (2003) for the Johnson method and DYMIMIC, from Lovrinčević, et al (2006: 78)

Based on Table 4, we can see that using Electricity Consumption Method to measure the level of underground economy provides following data for Croatia and Slovenia: approximately 31% and 23% respectively. In Croatia, the level of underground economy is significantly higher than in Slovenia. Nevertheless, this method was criticized from many experts that it provides unreliable and highly-overestimated data regarding the underground economy in transition countries. Main advantage of this method is that data for electricity consumptions are available but using this method leads to wrong conclusions and imprecise results of levels of the underground economy.

Table 5. Level of the underground economy in Croatia and Slovenia (as % of GDP) - estimated values of the underground economy based on the Eurostat approach and Electricity Consumption Method (average level – Table 4)

Country/Method	Eurostat Method 2000	Electricity Consumption Method (average level - table 4)
Croatia	15.8*	31.3
Czech Republic	6.8*	16.4
Estonia	11.2	29.9
Latvia	15.1	42.5
Lithuania	18.9	28.7
Malta	5.8	n.a.
Hungary	11.9	28.6
Poland	14.7	17.3
Slovakia	14.8	16.8
Slovenia	8.1*	23.0
Average	12.3	26.0

*Data for 2002.

Source: Eurostat (2004), from Lovrinčević, etc (2006: 92), modified by author

Based on Table 5, we can see that using Eurostat Method to measure the level of underground economy provides different but somehow same conclusions for Croatia and Slovenia. Namely, level of the underground economy in Croatia and Slovenia based on Eurostat Method is approximately 16% and 8% respectively. Comparing with average levels of Electricity Consumption Method for these two countries we can conclude that Eurostat Method provides much more reliable and accurate data regarding the level of underground economy. The reasons for that, among others, are assumptions of Electricity Consumption Method that elasticity of electricity consumption is 1, and that energy intensiveness of production is unchanged. These assumptions are strict and not realistic. Also, other remarks, such as that the underground activities do not take place only in the household sector, and that it is doubtful that ratio of social welfare expenditures can be used as the explanatory factor for the underground economy, etc., should be taken into the consideration. Taking all remarks together and applying this method to transition countries, provides highly overestimated and unreliable data on the size of the underground economy (Lovrinčević, etc, 2006). Eliminating the shortfalls of Electricity Consumption Method, Eurostat Method provides much more consistent and trustworthy results. The level of underground economy is significantly lower when measured by Eurostat Method, than by Electricity Consumption

Method. On the other side, these two methods lead to same conclusions. Validity of data provided by these two methods is correct. Even though the differences in measuring of the level of underground economy based on Eurostat Method and Electricity Consumption Method are significant, the numbers show the same. The level of underground economy is significantly higher in Croatia comparing to Slovenia, irrespective of methods used to measure this phenomenon. The results confirm assumptions that the larger gap is between desirable and current organizational and management state structure in Croatian and Slovenian Tax Administrations, it results in a higher level of the underground economy. Based on Table 3, Croatian gap is significantly larger than in Slovenian case.

In the end, moving towards EU has significant positive influence on the level of underground economy. The closer the country is to become member of EU, the lesser is the level of underground economy. The reason for this is that countries implement principles adopted in EU. In that context, establishing the organizational and management state structure in Tax Administration like in EU countries will have strong positive influence on the level of underground economy. In than sense, Slovenia is a member of EU since 2004 while Croatia has status of a candidate country. When Croatia becomes a member of EU, we should expect that the level of underground economy would be like in Slovenia, because the gap between desirable and current organizational and management state structure will be lower.

Chapter 5 - Conclusion

Tax policy and Tax Administration are the most important part of every tax system reform. Both of them should be reformed in the same time in order to increase levels of tax collection. Reforming the tax policy is worthless if Tax Administration stays unreformed. To implement tax policies effective Tax Administration is necessary. In that context, transition countries confront with difficult tasks. Planned socialism legacy produced inadequate tax policies on one side and weak Tax Administration on the other side. Radical reforms are required in both areas. Transition countries did not have time gradually to reform tax systems, because financial system was 'ailing'. Radical changes were the only option. However, transition countries mainly decided to reform tax policy while reforming Tax Administration was not the priority. That was the major mistake. Reasons for such decisions are broad and explainable but not reasonable. Namely, reforming tax policies required less time and energy than reforming Tax Administration. Tax policy reform is a necessary short term process, while Tax Administration reform is a necessary long term process. Even the benefits from adopting modern and effective tax policy, without Tax Administration reform, are possible on short term basis, in the long term run these benefits will be neutralized. Furthermore, output of the whole process will be negative. Instead to increase levels of compliance, the country will confront with an increasing level of tax evasion and lack of money in the state budget. In order to avoid this situation, parallel process of reforming tax policies and Tax Administration is necessary. Even more, it claimed that tax policies are as good as good Tax Administration is.

Transition countries inherited some specific characteristics of planned socialism legacy. It is assumed that all transition countries, including Croatia and Slovenia, share the same problems inherited from the past. The main problems are connected with an interventionist tradition, customized and negotiated taxes, taxes hidden from the population and lack of tradition of voluntary compliance, absence of conventional excess burdens, low profile of production and trade taxes, taxes and income redistribution, undeveloped Tax Administration, and public distrust of government institutions. The taxes were subject of negotiation between the state and state-owned enterprises, which were dominant in the economic structure in transition countries. That produced soft budget constraints toward these companies and, as a result, a wide spread tax evasion. Based on Street-level Bureaucracy theory, the state-owned companies were under a more lenient inspection by tax administrators. Enterprises did not know what other companies in similar circumstances paid. Tax Administrators had different attitude for different companies and that undermined trust in the fairness of Tax Administration. Culture of tax evasion was established and

institutions for collecting taxes were not ready to bear with tax issues. In addition, based on Tax theory, tax evaders make rational calculations that weighted the gains from successful non-compliance against expected loss when caught. A weak Tax Administration can only encourage taxpayers to evade paying taxes. Accordingly, gains from successful non-compliance are much higher than expected loss for when caught. Taxpayers knew that weak institutions for collecting taxes could not bear with them and the probability of being caught was minimal. This produces environment in which taxpayers are 'encouraged' to avoid paying taxes. Not only that probability of being caught is minimal but also time length between an act of evasion and its detection is long. All of these problems resulted in a high level of tax evasion in transition countries. Based on previous discussions, we realized why reform of Tax Administration was important and why tax policies are as good, as good Tax Administration is. Based on these two theories, Street-level Bureaucracy theory and Tax theory, low capability of Tax Administrators to bear with taxpayers was result of an inadequate organizational and management state structure in Tax Administration. In that sense, Organizational theory defined what desirable organizational and management state structure in Tax Administration in transition countries is: positioning of the Tax Administration inside the Ministry of Finance, a high autonomy of Tax Administration inside the Ministry of Finance, internal organizational structure based on functional principle, establishing of Large Taxpayer Units, well trained and professional tax administrators, and clear focus on taxpayers. Only Tax Administration that realizes importance to establish such organizational and management state structure can achieve the main goal to decrease levels of tax evasion. Tax Administration that is closer to these principles can expect better results. Otherwise, focusing only on tax policy reform and keeping inadequate organizational and management state structure will result in increasing levels of tax evasion. Planned socialism legacy produced many significant, negative consequences for Tax Administration but that can not be an excuse not to reform Tax Administration. Even more, moving toward effective and efficient Tax Administration is the only possible way to decrease levels of tax evasion and to provide government with enough resources to serve public services and implement welfare programs. Taxpayers have to know that every experiment in evasion of taxes is detected and penalized. That will increase expected loss for being caught and minimize gains from successful non-compliance. Fairness of the system and a culture of paying taxes is established when taxpayers believe in it.

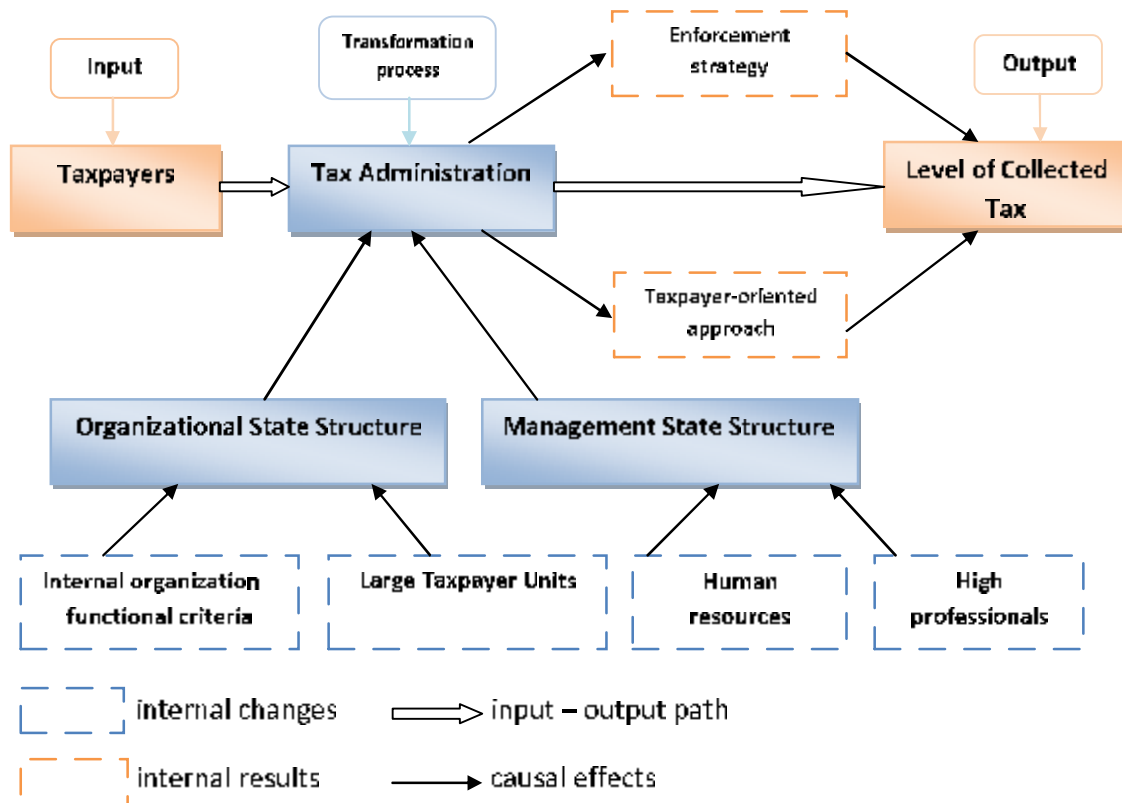
In this Master Thesis, focus was on Croatian and Slovenian Tax Administration. Reasons for that were double. First, they have the same historical background placed in planned socialism legacy, which provides possibilities to look into the differences in organizational and management state structure in Tax Administration in order to explain

different levels of tax evasion. Second, based on comparison between these two countries some recommendations may be designed for Serbian Tax Administration. Planned socialism legacy is like in Croatian and Slovenian case, because the three countries were members of former Yugoslavia. They have very similar historical background and we can assume that planned socialism legacy produced the same consequences for all of them. Data regarding current organizational and management state structure in Croatian and Slovenian Tax Administration were collected using the primary and secondary data analysis. Based on collected data, the gap between current and desirable organizational and management state structure is larger in Croatia (see Table 3). As a result, the level of underground economy is significantly bigger in Croatia than in Slovenia (see Table 5).

The level of underground economy is a big obstacle for improving Serbian economy and a big threat for its sustainable growth. In that sense, decreasing the level of underground economy is one of the major priorities in Serbia. Establishing adequate organizational and management state structure in Serbian Tax Administration is equivalent to quick and systematic leaving of inadequate ways to collect taxes and inadequate structure to fight with tax evasion. Slovenian Tax Administration should to be a model how Serbian Tax Administration must look like. In order to decrease the level of underground economy, general recommendations for Serbian Tax Administration would be to establish organizational and management state structure like in Slovenian Tax Administration. This recommendation is based on a comparison of current state structure in Croatian and Slovenian Tax Administration, with a desirable organizational and management state structure. Increasing capacity of Serbian Tax Administration is very important in order to decrease the level of tax evasion. Figure 11, presents organizational and management state structure that has to be established in Serbian Tax Administration in order to increase levels of tax collection. This model has a theoretical background in the Congruence Model (see Figure 5). As was explained in Chapter 1, Congruence Model is input-output model where organization efficiency in achieving goals depends on the congruence or fit between different parts of the model. The main parts of the model are: input (taxpayers), transformation process (Tax Administration - organizational and management state structure), and output (level of collected taxes). In that sense, where there is a gap between different parts it will result in inadequate performance. In other words, inadequate organizational and management state structure (transformation process) will result in a lower level of collected taxes (output) because Tax Administration is not ready to bear with taxpayers (input). Improving the organizational and management state structures will increase capability and capacity of Tax Administration and result in higher level of collected taxes. Accordingly, adequate enforcement strategy and taxpayers-oriented approach, as

essential elements to increase levels of tax collection, are result of adequate organizational and management state structure in Tax Administration. Equal treatment of taxpayers, adequate tax audit control and penalties, and focusing on taxpayers will lead to a lower level of tax evasion and increasing level of tax collection in Serbia.

Figure 11. Recommendation for organizational and management state structure in Serbian Tax Administration



Based on Figure 11, and previous discussions, organizational and management state structure that Serbian Tax Administration has to establish is the following:

- Positioning of the Tax Administration inside the Ministry of Finance,
- High level of the Tax Administration autonomy,
- Implementing the functional basis criteria as the main criteria for internal organizational structure,
- Keeping and strengthening Large Taxpayer Units,
- Strong human resources are depicted in a high skilled and capable tax administrators (well trained staff), and

- Highly professional tax administrators ready to help taxpayers in fulfilling their duties (focus on taxpayers).

Establishing such organizational and management state structure, presented in Figure 11, Serbian Tax Administration will increase professionalism, specialization, and capability of tax administrators. As was argued, there is a link between level of independency on one side and level of democratization in political system on the other side. A lower level of democratization in the political system can be a threat for independent Tax Administration to become a strong instrument in the hands of politicians'. With progressing in democratization of the political system, position of Tax Administration in overall government structure may be added to the agenda again. Serbian Tax Administration as a part of the Ministry of Finance is the best current solution. On the other side, Serbian Tax Administration has to enjoy a high level of autonomy within the Ministry of Finance. Only with a high level of autonomy, it may be expected that significant improvements in performance of Serbian Tax Administration can be achieved. Granting the high level of autonomy, Serbian Tax Administration will have the opportunity to increase effectiveness and efficiency. Making own decisions regarding the crucial decisions for own development is an important element to increase capability of Tax Administration. This will bring many benefits and result in increased levels of tax collection. Furthermore, establishing internal organizational structure based on functional criteria will increase specialization of tax administrators, increase productivity, increase standardization and, in the end, decrease levels of tax evasion. Even though organizing Tax Administration on functional basis is a long term process, this is the right way to increase efficiency and effectiveness of Serbian Tax Administration. In addition, type of criteria that Serbian Tax Administration is to adopt has strong influence on quality of employees and their readiness to bear with tax evaders on one side and to help taxpayers in paying taxes on the other side. Functional criteria will increase the capacity of employees and establish strong institution for collecting taxes. Furthermore, establishment of Large Taxpayer Units is recognized as an important element to increase levels of tax compliance. Serbian Tax Administration has to keep Large Taxpayer Units inside the Tax Administration structure. Removing such units is very dangerous and provides many negative consequences for the organization itself. Moreover, strengthening Large Taxpayer Units with new educated and highly qualified employees is the right way to decrease overall levels of tax evasion in Serbia. Actually, Large Taxpayer Units in Serbian Tax Administration have to be a model for other departments in Tax Administration. Highly professionalized, with highly trained and skilled employees, the Large Taxpayer Unit is an example how other departments should look like. In addition, capacity of human resources is an important

element in every organization. In Tax Administration, human resources issue has to be on high level of priorities. Hiring new, qualified employees and improving skills of current employees is very important. Moving toward highly trained and skilled employees, Serbian Tax Administration will be ready for new challenges in the future. Serbian Tax Administration should also focus on taxpayers in order to encourage them to pay taxes. Strong enforcement strategy is necessary, as a main tool to decrease levels of tax evasion, but using a taxpayer-oriented approach is an important addition to this strategy. When information is always available, when advice is provided on time, and when tax administrators are ready to help taxpayers in fulfilling their duties, the high quality of Tax Administration services will be achieved. Establishing Virtual Tax Assistance is something that will help Serbian Tax Administration to increase level of tax compliance. Also, this approach will help to change the whole picture of Serbian Tax Administration as a repressive body whose main aim is to punish taxpayers. As was explained, quality of employees has strong influence on possibility to focus on taxpayers. Highly skilled and professional employees will be more successful in focusing on taxpayers than the less skilled ones. In that sense, Serbian Tax Administration has to strive to increase the capability of tax administrators and then adequate focus on taxpayers will be achieved.

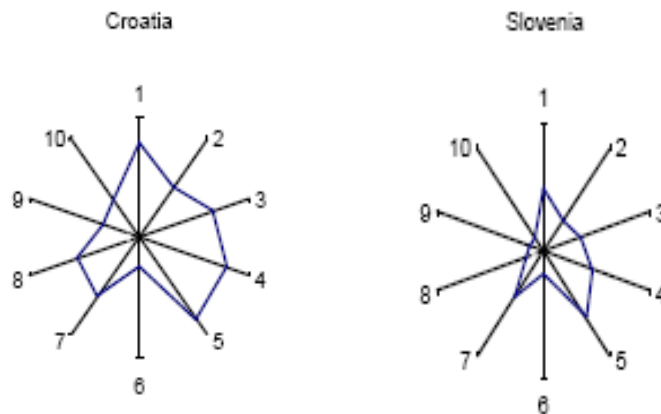
Adequate and responsible Serbian Tax Administration will establish an environment where cheating government is punishable and create culture where paying taxes brings benefits for all citizens. Well established organizational and management state structure will successfully implement enforcement strategy and taxpayer-oriented approach. As a result, the level of tax collection will increase and benefits of increased state budget will be recognised by all citizens in Serbia. Strong enforcement strategy, through adequate audit control and penalties, will discover and punish tax evaders. This strategy will deter other taxpayers to evade paying taxes. Taxpayer-oriented approach will increase level of tax collection through helping taxpayers to pay taxes. Implementing this approach will increase reputation of Serbian Tax Administration. Serbian Tax Administration has to treat taxpayers like citizens who have to fulfil some obligations, and not like criminals whose main aim is to avoid paying taxes. Establishing and implementing both elements, enforcement strategy and taxpayer-oriented approach, will result in a lower level of tax evasion in Serbia. We should be aware that implementing these principles is a long term process which requires difficult decisions by reform leaders. However, this is the right way to establish modern and efficient Serbian Tax Administration, ready to bear with complex tax issues.

5.1 Tax Administration and direct investments

Based on previous Chapters, the level of underground economy is one of the parameters of a state in economy. We can say that there is a connection between business environment regulations and the level of underground economy. Better environment regulations lead to a lower level of the underground economy because enterprises do not have incentives to go in the underground economy on one side and going into the underground economy is punishable on the other side. Adequate environment in which enterprises operate will encourage them to stay in formal economy. In other words, the level of underground economy is lower and enterprises are more responsible to pay taxes in a more regulated business environment. That creates culture where cheating the government is not acceptable and even more than that, it is punishable. Figure 12, presents results of surveys¹³ regarding the main obstacles for operating businesses in Croatia and Slovenia.

¹³ This survey is based on the 1999 Business Environment and Enterprise Performance Survey (BEEPS), developed jointly by the EBRD and the World Bank. The BEEPS survey was conducted on the basis of personal interviews with high level managers or owners of firms in site visits in the following 20 countries: Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Lithuania, Moldova, Poland, Romania, Russian Federation, Slovak Republic, Slovenia, Ukraine and Uzbekistan. In each country, between 125 and 150 firms were interviewed, except in three countries where larger samples were used: Poland (250), Russia (550) and Ukraine (250).

Figure 12. Dimensions of governance, by country (Croatia and Slovenia)



Source: Hellman, Schankerman (2000: 550-551)

- | | | | |
|----------------------|-------------------------|-----------------------------------|---------------------------|
| 1 Policy instability | 4 Finance | 7 Functioning of the judiciary | 10 Organised crime/ mafia |
| 2 Inflation | 5 Taxes and regulations | 8 Corruption | |
| 3 Exchange rate | 6 Infrastructure | 9 Street crime / theft / disorder | |

Notes: Survey Question: "How problematic are these different factors for the operation and growth of your business?" Categories listed above. Response categories: No obstacles, Minor obstacles, Moderate obstacles, Major obstacles.

This survey mainly includes privately owned firms, privatised and start-ups. In addition, minimum quotas were used to ensure representation of state-owned companies and firms with foreign ownership. Enterprises are fairly representing domestic economies, with specific quotas placed on firm size, sector, location, and export orientation. In total the survey covered more than 3,000 firms. The surveys investigate extent and nature of the relationship between firms and the state, including sensitive questions on corruption, state intervention in enterprise decision-making, and the influence of firms on government policy-making. Based on that, there is unique opportunity to compare the relationship between firms and the state across transition countries and across firms with different characteristics within a given country. In order to evaluate the quality of governance, the survey asked firms to assess the extent to which different functions of the state posed an obstacle to their business. Nine key functions were rated by firms on a scale of 1 (no obstacle) to 4 (major obstacle). The functions fall into four main areas: macroeconomic governance (policy instability, inflation and exchange rate), microeconomic governance (taxes and regulations), physical infrastructure, and law and order (corruption, organised crime, street crime and the functioning of the judiciary).

Focus is on Croatia and Slovenia for the purpose of this Master Thesis. Figure 12, presents summarised rating of each dimension of governance in the form of star diagrams, for these two countries. Each axis of the star represents one dimension of governance for that country. The length of each axis is proportional to the percentage of firms responding. The dimension of governance represented either as a moderate or a major obstacle to the operation and growth of the enterprise. To fix the scale, we identify on each star the theoretical extreme where 100 per cent of responses fall into these two categories (Hellman&Schankerman, 2000). These star diagrams allow easy comparison between Croatia and Slovenia for any given dimension of governance. As we can see in Figure 12, better condition for businesses, such as policy stability, taxes and regulations, organized crime, infrastructure, etc, in Slovenia than in Croatia result in better environment regulation. Less obstacles for operating business functions and a better regulated business environment in Slovenia than in Croatia explains a lower level of the underground economy in Slovenia. Quality of business environment in Croatia is on a lower level and to be in the informal economy is still quite attractive. Furthermore, a better regulated business environment is one of the characteristics of countries in EU, where Slovenia is now, while Croatia is still outside of the EU. In addition, quality of business environment has strong influence on the level of direct investments into every country. Having this in mind, a better regulated business environment will attract more direct investments. In that sense, transition countries have to strive to attract direct investments in order to increase quality of their economies. A better regulated business environment is one of the pillars to achieve this goal.

On the other hand, fulfilling Maastricht criteria is one of the conditions for all countries who want to be members of EU. In that context, one of the Maastricht criteria are that government deficit may not exceed 3% GDP. Tax Administration has an important role in fulfilling this criterion and in establishing of the balance in government budget. Like in the case of the level of underground economy, the role of Tax Administration is essential to decrease the level of budget deficit and to consolidate public finances in every country¹⁴. Table 6 presents levels of government deficit, as a percentage of GDP, in Croatia and Slovenia and in some EU countries.

¹⁴ Together with tax policy reform and with cutting public expenditures

Table 6. General Government deficit (-) / suficit (+), as % of GDP

Country	2003	2004	2005	2006	2007
Bulgaria	-	1.4	1.8	3.0	3.4
Croatia*	-6.2	-4.9	-4.1	-3.0	-
Czech Republic	-6.6	-3.0	-3.6	-2.7	-1.6
Estonia	2.0	1.6	1.8	3.4	2.8
Hungary	-6.3	-6.5	-7.8	-9.2	-5.5
Latvia	-1.2	-1.0	-0.4	-0.2	0.0
Lithuania	-1.3	-1.5	-0.5	-0.5	-1.2
Poland	-4.7	-5.7	-4.3	-3.8	-2.0
Romania	-	-1.2	-1.2	-2.2	-2.5
Slovakia	-3.7	-2.4	-2.8	-3.6	-2.2
Slovenia	-3.7	-2.3	-1.5	-1.2	-0.1

Source: Eurostat (2008)

* Vidovic (2007)

As we can see from Table 6, that government deficit is significantly higher in Croatia than in Slovenia. Level of government deficit in Croatia is 3% of GDP, as it prescribed Maastricht criteria. However, in order to additionally decrease the level of budget deficit, increasing capacity of Croatian Tax Administration will help to increase the revenue side of the budget. In other words, increasing efficiency and effectiveness of Croatian Tax Administration, will decrease levels of tax evasion and result in an increasing level of tax collection. As a result, budget deficit will be lower¹⁵. Maintaining the budget deficit on the level of 3% of GDP, and fulfilling other Maastricht criteria, is a very important goal for every country. In such a way, macroeconomic stability will be established and the country will be more attractive for direct investments. Higher levels of direct investments result in a higher

¹⁵ Under the assumption that public expenditures are at least on the same level

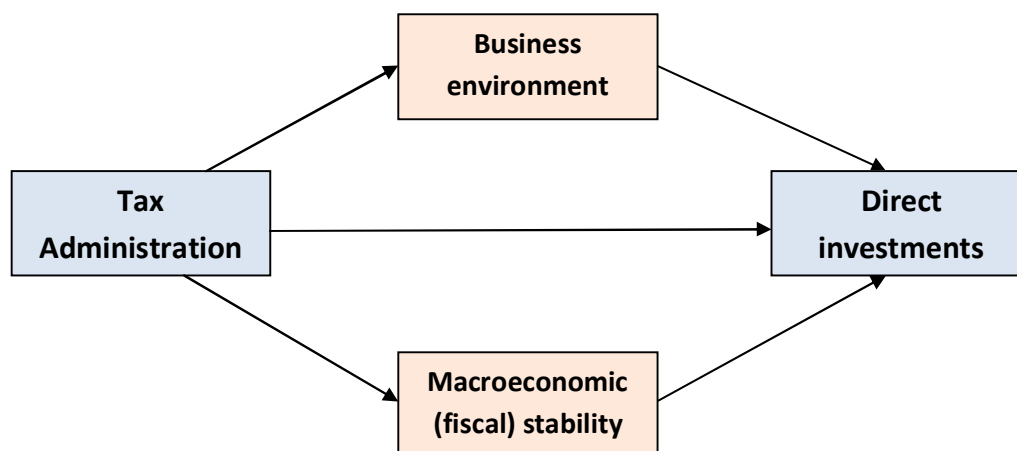
living standard for all citizens. All transition countries have to strive to attract direct investments in order to develop their economies. Establishing and maintaining stable a fiscal policy is an important element in order to achieve this goal.

Based on previously, Serbia shares the same issues with other transition countries regarding business environment and macroeconomic stability. Increasing the level of direct investments is one of the most important goals in Serbia. Establishment of an adequate business environment in Serbia is important to attract these direct investments. Investors want to be sure that their capital is protected and safe. Clear and precise rules in which enterprises operate are characteristics of a good business environment. Direct investments into Serbia are crucial for Serbian economy and its sustainable growth. To establish pro-business environment and to increase investments, an effective and efficient Serbian Tax Administration is a necessary element. The increasing efficiency and effectiveness of Tax Administration will surely be followed by decreasing level of the underground economy and a more friendly business environment for foreign investments.

On the other hand, in order to reach Maastricht criteria regarding government deficit of 3% of GDP, Serbia has to have an efficient and effective Tax Administration as well. In a situation where government deficit is higher than 3% of GDP, it implies substantial fiscal loosening and could deteriorate the pressure on the current account. Increasing the revenue side of the budget is possible only with effective Tax Administration. Effective Tax Administration will increase levels of collected taxes and the revenue side of budget will be increased accordingly. Due to fact that Serbia wants to become member of EU, condition of 3% of budget deficit has to be fulfilled. This parameter, level of budget deficit, has to show that Serbia has adequate fiscal policy and that is capable to maintain fiscal discipline. Macroeconomic stability is a clear signal that the country is stable and attractive for direct investments.

Based on previous discussion, Figure 13, presents the role of Tax Administration in establishing adequate business environment and macroeconomic stability that influence levels of direct investments.

Figure 13. Connection between Tax Administration and level of Direct Investments



As we can see from Figure 13, a better regulated business environment and macroeconomic (fiscal) stability will increase levels of direct investments. In that sense, capable and responsible Tax Administration is one of the pillars to establish such conditions. Accordingly, the role of Tax Administration in establishing attractive and stable business environment on one side, and macroeconomic stability on the other side, is essential. Actually, Tax Administration's influence on the level of direct investments is reflected through the set up an adequate business environment and in establishing macroeconomic stability. Furthermore, these two elements are complementary to each other. Namely, macroeconomic stability has a strong positive influence on business environment, and the other way around. In addition to that, both elements have positive influence on the level of direct investments in transition countries. Strong institutions and a high level of investments are the way to improve economy and to increase standard of living in Serbia. Decreasing the level of underground economy and increasing the level of investments are possible only with a strong Tax Administration. Moving Serbia towards EU will have positive influence on the capacity of the Tax Administration on one side and on the level of the underground economy (business environment) and macroeconomic (fiscal) stability on the other side. As a result, level of direct investments will increase and that will lead to higher living standard for all citizens in Serbia. Based on previous experience of new EU members, EU membership brings improvements to the capacity of Tax Administration, lower levels of underground economy and increasing levels of direct investments. Accordingly, Serbia has to follow this path in order to improve its own economy and quality of life for all citizens.

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