

# EAGER

## Policy Brief

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### Reducing Tax Evasion

**This policy brief is based on research\* that attempts to determine whether enhanced transparency in tax administration significantly increases revenue through compliance. The research suggests several ways to improve taxpayer compliance.**

Large budget deficits are the cause of macroeconomic instability in most Sub-Saharan African nations (SSA). As a first step in reducing their deficits, African governments need to address both revenues and expenditures. Increasing revenue by increasing tax rates poses a problem because trade taxes, which are a major source of government revenue, are the target of reductions mandated by structural adjustment programs seeking to improve economic growth by opening trade. Increases in other tax rates can also have a negative impact on economic growth. On the other hand, increasing revenue through a reduction in tax evasion might ease the burden on economic agents who pay taxes and, at the same time, promote growth and equity by enhancing both allocative efficiency and incentives to invest and produce. In 1996, USAID, through the Eager Project, sponsored a study to determine whether enhanced transparency in tax administration significantly increases compliance.

#### Taxpayer Compliance

The benefit of tax evasion to an individual is the value of the evaded payments. A rational taxpayer decides whether to pay or evade taxes based on his or her pretax income, the marginal tax rate, the probability of detection, penalties for noncompliance, his or her degree of risk aversion, and the extent of his or her honesty. Many economists believe that increasing the audit rate increases reported income. Recent experiments have concluded,



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however, that increasing the probability of an audit does in fact reduce the probability of evasion but does not lead to a significant increase in the amount of tax paid. Furthermore, empirical studies of tax compliance have found that the impact of quantifiable factors such as tax rates and personal income is ambiguous, although the detection probabilities associated with the visibility of higher income encourage more complete reporting of income.

By focusing on perceptions of fiscal equity as a factor that explains tax evasion, researchers have found that tax evaders justify their cheating with either the belief that everyone else cheats or the perception that the benefits they receive from the government fall below their share of the tax burden. Age is another factor predisposing individuals to evasion. Surveys investigating taxpayer attitudes toward the fiscal system found that young people perceive the tax system as unfair and believe that there are sufficient opportunities for evasion.

Tax administration determines the effective tax system, which often differs from the statutory tax system. Eliminating all tax evasion would involve an incremental expenditure of administrative resources that would far exceed incremental receipts. Still, short of

complete compliance, some improvement in taxpayer compliance would increase net revenues in most African countries.

Some cost-effective suggestions for enhancing tax compliance through improved transparency are proffered below.

#### **Improve taxpayer education and services**

In most African countries, noncompliance with tax laws has created fiscal deficits that threaten economic stability and growth. Governments need to convince taxpayers of the social benefits of taxation and the social costs incurred when governments fail to collect taxpayers' liabilities. The goal of taxpayer education should be to persuade citizens that tax evasion is not a "victimless" crime; instead, it causes inflation and impedes job creation.

#### **Recognize the extent of evasion and impose corrective measures**

Prosecution and sanctions for tax fraud are rare in SSA. Government inaction perpetuates noncompliance. Two factors influencing an individual's decision to evade taxes are low perception of risk of detection and a reduced sense of civic duty to contribute to an unfair tax system.

### **Tax income from rentals paid by foreign residents**

In many African countries, the resident foreign community pays high rents but is not asked to report such payments to the tax authority. Ironically, many foreign missions repeatedly urge their host governments to increase tax collections in order to curb inflation and augment social services. Enhancing transparency of taxation of real estate requires a systematic canvassing of the rental market, with particular attention focused on properties leased to foreign agencies and individuals.

### **Publicize tax exemptions and holidays**

Most African countries are legally bound to announce tax exemptions and holidays in the official gazette. However, they often grant exemptions and holidays on an ad hoc basis and fail to publish announcements as prescribed by law. Furthermore, many finance ministers have the authority to waive customs duties and excise taxes on particular goods or to exempt specific individuals from payment of those taxes. Effective transparency demands not merely publishing exemptions but also maintaining a cumulative account of exemptions enjoyed by specific taxpayers, relating such exemptions to

other information about the taxpayers, and disseminating the findings to the public. In cases lacking justification, exposure of all exemptions will raise the cost to grantors and recipients.

### **Establish institutions to enhance transparency**

Transparency of tax administration can be improved by creating a regulatory unit within the revenue service, establishing the position of an autonomous "tax ombudsman" to evaluate individual taxpayer complaints, and setting up a quasi-judicial body before which taxpayers can formally protest their assessments. True transparency of tax systems requires the establishment of an independent agency with a mandate to evaluate the performance of the revenue service. Such an agency should compute and publish detailed performance indicators that would permit the tax administration to compare itself with its counterparts in other countries and set targets for increasing compliance. Furthermore, the creation of an independent agency would convince citizens that the tax system is fair, thus making them more willing to comply with tax laws either out of civic responsibility or in response to a higher perceived risk of detection.

A government can enhance the transparency of its tax administration by sharing with the public reasoned estimates of the extent of evasion and credible plans to control it. By publicizing its intentions, a government can help create a civic lobby that will press for implementation of such plans.

**\*This policy brief is based on EAGER Discussion Paper Number 3, Enhancing Transparency in Tax Administration: A Survey, July 1998, by Satish C. Wadhawan [swadhawan@fac.howard.edu], Howard University; and Clive Gray [clive\_gray@harvard.edu], Harvard Institute for International Development.**

The views and interpretations in this policy brief are those of the authors and not necessarily of the affiliated institutions.

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