TAX EVASION AND ITS IMPLICATION ON NATIONAL DEVELOPMENT IN NIGERIA

BY

ISAH MOHAMMED DAMAGUM

ABSTRACT

Tax avoidance and evasion are often used interchangeably. They are serious economic issues across the developing world. Many countries have taken several measures including tax reforms to close the loopholes in tax laws in order to ensure that all cases of tax evasion are uncovered. Accordingly, this article reviewed and examines literature on tax evasion and as a hindrance to national development; this article is aimed at developing a deeper understanding of the problem of tax evasion in developing countries. Against the background of growing interest by international development agencies, and developing countries this article shall contribute to the systematization of knowledge. It becomes apparent that although there is a theoretical basis explaining tax evasion we know little about the reasons, the patterns and its effects on national development hence the motivation for this article.

Keywords: *Tax Evasion, Implication, National and Development*

INTRODUCTION

Tax, as a compulsory levy is an obligation on every citizen and company. A company tax is a tax levy on company's profit based on certain percentage the revenues provided by taxes strengthen, not weaken, our nation's economy. They fund essential public goods and services, they contribute positively to national saving, and many of the things that they fund from highways and schools to biomedical research and national parks indirectly create private wealth as well. On the other hand, tax evasion by companies can increase budget deficit, reduced national saving, and made it more likely that our children and grandchildren will face a weaker economy and lower standard of living than would otherwise be possible (Gupta and Tareq, 2011).

Tax evasion is perpetrated through such acts as incorrect presentation of statement of accounts, false entries or alterations of account balances, destruction of books or records, concealment of assets or covering up sources of income among others. These entire have devastating implications on national development (Baker, 2010) argued as governments rely on revenue from taxes to finance their expenditures, any avoidance or evasion of tax by companies will make it difficult for them to discharge their constitutional responsibilities. On the other hand, where taxes are avoided or evaded, governments' objective of facilitating growth and development of the economy will be jeopardized.

Theoretical Review

There are no universally accepted definitions of tax avoidance and tax evasion. However authorities like UN and Oxfam define tax avoidance as an activity that a person or a business may undertake to reduce their tax in a way that runs counter to the spirit and the purpose of the law, without being strictly illegal. Tax evasion, in contrast, is usually defined as a violation of the law (Slemrod and Yitzaki, 2002).

Department of Accountancy, Federal Polytechnic Damaturu, Yobe State, Nigeria

To drawing the line between legal tax avoidance and illegal tax evasion is sometimes difficult. One way of distinguishing the two would be to argue, along the lines of the definitions, that tax avoidance comprises activities which exploit weaknesses in the tax system but run counter to the purpose of the law whereas tax evasion describes illegal activities that involve elements of concealment. From this perspective therefore, non-declaration or underreporting of income, which characterizes the shadow economy, would clearly be classified as tax evasion. This would also apply to income from financial assets held abroad and not reported to domestic tax authorities. International income shifting by firms may include both the element of tax avoidance and tax evasion. A case in point is where; multinational corporations have to set transfer prices for intra firm trade in order to split profits generated in different countries.

Tax evasion is one of the major societal problems affecting global development and eroding the existing global welfare of many countries. Report credited to Tax Justice Network indicates that in 2010, about (£13.5tn) of untaxed revenues was invested in global tax heaven, which is more than one quarter of the total global GDP. This has led to a growing attention among policy makers, western countries, international agencies and scholars.

An enviable society can only be visible when domestic revenue can be mobilized for her social obligation such as pollution and other environmental hazards control to the citizens. Tax evasion is so rampant, and not many of these governments have made an effort to measure the ethical reasons, that is why when required revenue for smooth operation cannot be raise through taxation, these countries often times resort to borrowings which may not only crowd out the private sector of their economies but also lead them to debt traps. Additionally, tax evasion has the effect of disrupting the principle of perfect market resources allocation and income redistribution.

Shome and Tanzi (1993) argued that corporate tax evasion can lead to economic growth stagnation which may have far reaching socio-economic repercussions on the country and it developmental efforts.

Most studies on tax evasion and avoidance in developing countries focus on the international component only however Cobham (2005) addresses the combined impact of domestic and international tax evasion, with a focus on the domestic component. Cobham's study assumes that income generated in the shadow economy enhances the national tax gap because this income would be taxed by the government if perfect tax auditing was possible.

In contrast Auriol and Warlters (2005) argue that many developing countries deliberately create costs of entry into the formal economy in order to reduce competition and create economic rents, which may then be taxed. According to their view, the size of the shadow economy is endogenous, a result of tax policy trying to adjust to the specific difficulties of raising tax revenues in developing countries. They show in their empirical analysis that the negative correlation between the size of the shadow economy and tax revenue ratios disappears if the endogeneity of the shadow economy is accounted for.

Global Financial Integrity (2005) calculates that developing countries loose between $859 billion to $1.06 trillion a year through illicit financial flows. By their definition this includes the transfer of money earned through illegal activities such as corruption, transactions involving contraband goods, criminal activities, and efforts to shelter wealth from a country's tax authorities. Their new study estimates that African countries have lost US$854 billion in cumulative capital flight over the period 1970-2008 (GFI, 2010).

Oxfam (2000) estimates a sum of US$50 billion per year due to corporate profit shifting. Baker (2005) calculated the extent of capital leaving through mispricing of international trade and fake transactions adding up to US$350 billion per year in developing countries.

These studies certainly reveal the importance of the issue and might even provide a rough indication of the size of the problem. However, it should be noted that underlying definitions and assumptions differ widely and the estimates are, therefore, neither comparable nor reliable (shitu at el, 2008).

Tanzi (2009) claims that in some countries like India, the courts have considered tax avoidance with the intention of evading taxation as tax evasion. This suggests that drawing the line between the two is not always easy.

Why Do Individuals and Corporations Evade Tax?

Tax revenue losses due to tax avoidance and tax evasion can occur for a number of reasons. The existing estimates of these revenue losses help in distinguishing between a domestic and an international component of tax avoidance and tax evasion.(Slemrod and Yitzaki,2002).

Empirical research indicates that taxpayers throughout the world pay more taxes (Alm, et al. 2007). However, the morale to pay is not easy to establish especially in countries without a deep-rooted 'culture' and habit of paying taxes. These may be as a result of; Low quality of the service in return for taxes i.e. if the government fails to provide basic public goods and services or provides them inadequately, the citizens may not be willing to pay taxes and tax evasion may be the consequence (Lieberman, 2002; Brautigam et al., 2008).

Secondly the tax system and perception of fairness suggest that high tax rates foster evasion and increase the tax burden and hence, lower the disposable income of the taxpayer (Chipeta, 2002). However, the level of the tax rate may not be the only factor influencing people's decision about paying taxes. For example the overall structure of the tax system has a significant effect on the disposition to either pay or evade tax.

In addition, (Kirchler et al.2007) Claims that Lack of transparency and accountability in the use of public funds contributes to public distrust both with respect to the tax system as well as the government. This, in turn increases the willingness to evade taxes. Furthermore due to high levels of corruption particularly in developing countries like Nigeria citizens cannot be certain whether the paid taxes are used to finance public goods and services or not as such their willingness to pay suffers and it becomes more likely that they evade their tax liabilities.

Finally, Lack of rule of law and weak fiscal jurisdiction, high compliance costs as well as insufficiencies in tax collection, can be an additional reason for tax evasion (World Bank, 2008). The reasons for tax evasion as listed above are in most cases mutually enforcing, often, tax evasion and avoidance are by-products of deficient socio- political and economic problems of governance in a country especially developing once.

There has been a current discussion about the impact of democracy and democratic institutions on economic growth and development Besley and Burgess (2013) find a positive impact of democratic institutions on economic growth and development. Glaeser, et'al (2009) argue that less-developed countries which achieve economic success do so by pursuing good policies, often under dictatorships, and democratize at a later stage in the development process (Dixit, 2005).

The tax gap in a country may also be diminished by economic growth this depicts a negative correlation between the size of the shadow economy and economic development. For a given tax system economic growth results in higher tax revenues which then pay for a more capable public administration and better public goods and thus may give rise to a virtuous circle of development and state building (Everest-Phillips, 2008).

Method of Tax Evasion in Developing Countries

It is not possible here to provide a comprehensive list of all possible modes of tax evasion but rather the article would focuses on the most relevant ones in terms of tax losses in developing countries and these include misreporting and non-declaration of personal income or corporate profits to circumvent direct income taxation or tax obligations resulting from sales of goods and services. In this context, holding offshore financial accounts to conceal taxable income from tax authorities in the country of residence allows tax evaders to benefit from low or zero taxes abroad, exploiting bank secrecy and poor financial regulation abroad (Baker, 2005),

Trade mispricing through faked invoices between colluding exporters and importers serves as a commonly used way to illegally transfer money from developing countries to financial accounts abroad usually with the purpose to evade taxes (GFI, 2010). In the past, developing countries like Cote d'Ivoire, Ghana and Nigeria fell prey to substantial illegal capital outflows that where based on deliberate over-invoicing of imports or under-invoicing of exports (TJN Newsletter, 2006).

False statements of business transactions subject to VAT represents a type of tax evasion that has attracted increased attention in the course of broader adoption and rising rates of VAT or goods and services taxes (GST) in developing countries. For example, Sri Lanka which introduced the VAT system in 2002 had to incur major revenue losses (approximately 10 % of its net VAT (Keen and Smith, 2007) from a single case of VAT fraud. the collection of VAT payments without remitting them to the corresponding tax authority (missing trader fraud) followed by illegitimately claiming a tax refund for the good that is exported is a common form of tax evasion.

Another source of tax evasion stems from the misclassification of commodities subject to different VAT rates with the purpose to reduce tax liabilities or increase claims for tax refunds. Related to revenue losses stemming from tax evasion activities is the smuggling of goods across borders as a way of evading not only VAT liabilities but also other forms of indirect taxes such as customs and excise duties.

In addition developing countries that suffer from inefficiencies in the administration and enforcement of taxes are exposed to bribing activities by companies as for example in the case of Bangladesh where sugar importers evaded 90 % of excise taxes in collaboration with corrupt tax officials (TJN, 2003) and Nigeria where importers collude with officials to evade almost all the available taxes (Karimu, 2011).

It is important to note that the above described modes of tax evasion are not mutually exclusive but may also result as a consequence of one another. For instance, illicit financial flows that are directed to offshore accounts may result from proceeds that are realized through criminal activities such as the smuggling of goods or fraudulent manipulation of VAT records or bribery. Profit shifting can be achieved by manipulating transfer prices that is pricing of goods and services traded within the group.

The MNE can engage in tax planning activities to shift profits within the affiliated group from high tax to low tax countries. This allows not only to identify profitable parts within the group, but also to avoid double taxation. Apart from that, MNEs can distort transfer prices to reduce the group's overall tax burden manipulating the allocation of profits in particular high- and low-tax jurisdictions. Consequently, to reduce its overall tax burden the MNE can try to set higher transfer prices for products and services that are transferred to divisions located in high-tax countries whereas low transfer prices are used for transactions with low tax countries. That way, costs for inputs are overstated and taxable profits generated in high-tax countries can be artificially minimized.

Implication of Tax Evasion to National Development

Svensson and Fisman (2000) posit that corruption retards development even more than tax evasion does. Thus, they found that both the rate of taxation and the rate of bribery are negatively correlated with firm growth. Odusola (2006) asserts that as an economic development tool, taxation provides the financial base for providing and maintaining, among others, infrastructure such as roads, electricity, telecommunications, and water that have direct impact on living conditions therefore where tax is evaded, the living conditions of the citizen would be negatively affected the resulting effect would be low level in national development.

It is not only in developing countries that tax evasion deterred development but also in developed once for example in China, Lai (2007) examined the use of tax incentives in attracting foreign direct investment to China and assesses its impact on the development of China's market economy, he noted that tax policy has had a positive impact on the development of rule-by-law in China, thus, he suggests that a well-developed tax system devoid of evasion problem may be an impetus for the development of rule of law in China, in this regards a well developed tax system would help reduce tax evasion and increase effort towards nation building.

Gupta and Tareq (2011) tested the relationship between taxation, economic stability, and national development, based on data from 1981 to 2002; they found that full tax payment taxation provides policymakers with the ability to conduct countercyclical fiscal policies, which in turn contributes significantly to national development. According to Amable and Chatelain (2001), taxation finances financial infrastructures and decreases the private productivity of capital. But where it is evaded, it may hinders the potentials of financial infrastructures in fostering economic development, thus, it may reduce the efficiency of the banking sector and decreases the market power of the financial intermediaries.

Brauner (2010) examines the potential use of taxation to generate development funds in connection with the immigration of skilled immigrants from developing into developed countries if designed according to the principles of the new development agenda. He argued that designing such a tax according to the principles of the new development agenda by tying together the collection procedures and use of the revenue functions, is essential for the tax to be justifiable and effective for nation development.

Conclusion

This article gives a theoretical overview of the available knowledge on tax evasion in developing countries. Although issues on tax evasion and tax avoidance represent a problem for developed countries as well, literature and data concerning tax evasion are still limited as such the extent of tax evasion and avoidance is hard to estimate. In addition, there are no consistent empirical findings which portray a clearer picture and size of the problem or the relative importance of different kinds of tax evasion and avoidance.

However there are various reasons and factors as listed above for tax evasion and tax avoidance which negatively affect taxpayers' compliance with tax legislation on one hand and the reasons explaining the weak capacity of tax administration and laws to enforce tax liabilities on the other hand.

Recommendations

In line with the discussion of this write-up and in order to develop methods and instruments for fighting tax evasion, the following recommendations are forwarded;

1) Taxpayer education: The importance of taxes for the development of a nation is not always perceptible to the taxpayer. In addition, individual tax liabilities as well as requirements to comply with the tax system such as filling out different tax forms might be difficult to understand. By educating the taxpayers and improving the service, citizens can be informed about the tax system and be assisted in their attempts to comply with the tax system. Efforts in this direction have been successfully conducted by the Rwandan and Peruvian Revenue Authority. This strategy covers the quality of public services, the transparency and control of the public budget and the fight against corruption.

2) Tax compliance and administrative costs: To promote voluntary tax compliance, governments in developing countries should concentrate on measures that reduce taxpayers' costs of fulfilling their tax liabilities. To this end, revenue authorities must be aware of the importance of acting service oriented and should therefore endeavour to monitor customer contentment with tax services. In this regard, all measures to simplify the taxpaying process and promoting service oriented tax administration must be design to include a reduction of the number of tax forms and officers assisting clients in filling out documents or the introduction of online services.

3) As an effective strategy to strengthen the enforcement of tax laws at the national level, tax administration needs to be reform, Measures in this area include different approaches of organisational reform such as the creation of semi-autonomous revenue authorities, setting-up of Large taxpayer Units as well as capacity development such as training on specialized courses in the area of detecting illegitimate profit shifting activities or tax fraud, also the restructuring of the wage schedule to offer sufficient incentives in order to attract and recruit capable staff in order to reduce the risk of corruptive behaviour would go a long way in reducing the incidence of tax evasion.((Mann, 2004).

4) Furthermore, since the possibility to detect and prosecute tax violators depends to a larger extend on the availability of data and its quality, there is need to ensure the collection of sufficient information in this regard effort should be geared toward the procurement of technical equipment and the establishment of good performing statistic divisions with competent staff members to collect data and keep records. On the other hand, good technical equipment and technically educated staff are also a prerequisite for a well functioning information exchange. Along these lines, automation of tax collection procedures e.g. through online tax assessment payment and monitoring opportunities may serve as an efficient way to reduce the scope for tax evasion and avoidance (Golob, 2011).

5) Since tax evasion and tax avoidance occurred as a result of a weak judiciary system, addressing the legislative system would strengthen the rule of law. This would give room for insufficient punishment and prosecution of violators where detected tax criminals face harsh penalties that are effectively executed by courts. As shown by Fishlow and Friedman (2013), higher penalties act as a deterrent and help to improve tax compliance. To achieve this goal governments have to strengthen the rule of law and develop capacities of investigation authorities. Moreover, investigators as well as courts and judges should receive greater support by politicians in order to emphasize the importance of this issue.

6) There is the need for further elaboration by researchers, practitioners and policymakers for more detailed research on tax evasion and avoidance in developing countries. Deeper knowledge that is produced on the basis of common, comparable academic standards and with the aim of collecting reliable cross-country data is of paramount importance in this regard.
7) Major Activities of multi - National Corporation should be promoted in such a way that its levies would not have such a negative impact on development through a sound system that could guarantee the full potential of taxation in achieving developmental targets and a strategy that would create national awareness programmes for the potentials of these taxes towards achieving the desired level of development in the short and long-run is highly desirable.

References

Amable, B. and Chatelain, J. (2001). *"Can Financial Infrastructures Foster Economic Development?"* Banque de France Working Paper 80.

Auriol, Emmanuelle and Michel Warlters (2005), Taxation base in developing countries. *Journal of Public Economics 89, PP 625-646.*

Besley, Tim and Robin Burgess (2002). The Political Economy of Government Responsiveness: Theory and Evidence from India, *Quarterly Journal of Economics 117 (4), pp. 1415-1451*

Baker, Raymond (2005), *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System.* John Wiley & Sons Inc. Hoboken, United States.

Besley, Tim and Thorsten Persson (2009). The *Origin of State Capacity: Property Rights, Taxation and Politics.* American Economic Review 2(9) PP.245-266.

Brauner, Y. (2010). "*Brain Drain Taxation as Development Policy"* University of Florida Levin College of Law Research Paper 20 PP.10-17

Dixit, Avinash (2005), Evaluating Recipes for Development Success, mimeo

Everest-Phillips, Max (2008), Business Tax as state building in developing countries: applying governance principles in private sector development, International Journal of Regulation and Governance 8, PP. 123-154.

Fishlow, A. and J. Friedman (2013). Tax evasion, inflation and stabilization, *Journal of Development Economics, 43(1) pp. 105-123.*

Golob, E. (1996). *How Would A Flat Tax Affect Small Businesses*?, Economic Review, Federal Reserve Bank of Kansas City 81(3) pp. 5-19.

Grubert, Harry and John Mutti (2004), Empirical Asymmetries in Foreign Direct Investment and Taxation, Journal of International Economics 62(2), pp. 337-358.

Gupta, Sanjeev and Shamsuddin Tareq (2008). *Mobilizing Revenue, Finance and Development* 45, p. 44-47.

GFI, (2009). *Illicit Financial Flows from Developing Countries* 2002-2006, Global Financial Integrity Executive Report, Washington

IMF (2009). IMF Country Report 09/62 (Philippines).

Keen Michael and Mario smitt (2007). *Revenue Mobilisation in Sub-Saharan Africa*, IMF Fiscal Affairs Department.

Karumi Mansour (2011). *Revenue Mobilisation in Sub-Saharan Africa*, IMF Fiscal Affairs Department.

Lieberman, Evan (2002), *Taxation Data as Indicators of State-Society Relations:* Possibilities and Pitfalls in Cross-National Research, Studies of Comparative International Development 36(1), pp. 89-115

Lai Lan (2007) Tax avoidance and anti-avoidance measures in major developed economies, Westport.

Odusola, A. (2006): "Tax Policy Reforms in Nigeria," United Nations University-World Institute for Development Economics Research (UNU-WIDER) 03.

Oxfam (2009), Tax haven crackdown could deliver 120 bn a year to reduce poverty – Oxfam. Retrieved 20/9/2014 online//http://www.oxfam.org.uk/applications/blogs/pressoffice/?p=3912.

Shome, Paarthasarathi and Vito Tanzi (1993). A Primer on Tax Evasion, IMF Staff Papers 40 pp. 807-828.

Svensson, J. and Fisman, R.J. (2000). "*Are Corruption and Taxation Really Harmful to Growth?* Firm-Level Evidence," World Bank Policy Research Working Paper. 2485

Slemrod, Joel and Shlomo Yitzhaki (2002). Tax Avoidance, Evasion and Administration, *Handbook of Public Economics,* in: A.J. Auerbach and M. Feldstein,

Tanzi, Vito (1983). *The Underground Economy in the United States*. Annual Estimates, 1930-1980, IMF Staff Papers 30(2), pp. 283-305 .

TJN (2009). *Magnitudes: Dirty Money, Lost Taxes and Offshore.* Retrieve 15/9/2014 online/ http://www.taxjustice.net/cms/front_content.php?idcat=103.