TAX EVASION AND FISCAL CORRUPTION
Essays on compliance and tax administrative practices in East and South Africa

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Table of Contents

Introduction

No underdeveloped country has the manpower resources or the money to create a high-grade civil service overnight. But it is not sufficiently recognized that the revenue service is the 'point of entry'; if they concentrated on this, they would secure the means for the rest.
(Nicolas Kaldor, 1963: 417).

Compliance and tax administrative practices

Tax evasion and fiscal corruption have been universal and persistent problems throughout history with manifold economic consequences. Two thousand five hundred years ago, Plato was writing about tax evasion, and the Ducal Palace of Venice has a stone with a hole in it, through which people once informed the Republic about tax evaders (Tanzi, 2000a).[1] The classic document of Hindu statecraft, the *Arthasastra*, advises kings of Mauryan India in the third century B.C. to maintain personal control of government finances in order to protect themselves from treachery.[2] The basic assumption was that without control man, self-serving by nature, would appropriate more than his share of the king's revenue:[3]

> *Just as it is impossible not to taste the honey or the poison that finds itself at the tip of the tongue, so it is impossible for a government servant not to eat up at least a bit of the king's revenue.*

Today, corruption and tax evasion seem to take place in practically every country in the world, and should be considered a potential problem everywhere. Still, evasion and fraud in tax administration are phenomena which hit developing countries hardest.[4] Firm evidence on the extent of such illegal practices is naturally hard to come by. But anecdotal evidence from different developing countries indicate that half or more of the taxes that should be collected

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[1] A modern version of this technology is found in Uganda: On a special telephone hot-line people can report corrupt tax officials or tax dodgers. They get a reward, usually around 10%, of the tax recovered (*The Economist*, July 17th 1996: 38).
[2] Mauryan India was contemporary with the empire of Alexander the Great. After the Hellenistic armies invaded India there were periodic contact between India and the older monarchies to the north and west. Some scholars believe that the *Arthasastra* reflects the influence of Egyptian, Persian and Hellenistic ideas of the monarch's central authority and role in government (Webber and Wildavsky, 1986:62).
[3] Ibid, p. 82.
[4] Klitgaard (1994:1) asserts that corruption is 'clearly one of the two or three major problems holding back economic and political advancement in most developing countries'.

cannot be traced by the government treasuries due to corruption and tax evasion.[5] This erosion of the tax base has several detrimental fiscal effects. The consequences of lost revenue to the funding of public services are of special concern (Tanzi, 2000a). In addition, corruption and tax evasion may have harmful effects on economic efficiency in general (Chand and Moene, 1999; Tanzi, 2000b), and income distribution in particular because the effective tax rates faced by individuals and firms may differ due to different opportunities for evasion (Hindriks *et al*, 1999). Thus, tax evasion and corruption can make the real effects of the tax system very different from those that the formal system would have if honestly implemented.

In-depth knowledge about who actually are caught and escapes the tax net – and why – and how relations between taxpayers and tax authorities are affected by revenue mobilisation efforts – is scarce in sub-Saharan Africa. There is also limited knowledge about the impacts of recent tax administrative reforms on revenue collection and corruption. This thesis is an attempt to narrow this knowledge gap by analysing tax compliance and revenue administration in three African countries: South Africa, Tanzania and Uganda. Such knowledge is required in a situation where the public sector in most poor sub-Saharan African countries is not sustainable at present levels of domestic resource mobilisation, as reflected in often substantial budget deficits and high levels of aid dependency (OECD-DAC, 2006). Aid alone now accounts for almost half the income of many governments of low-income countries. The Poverty Reduction Strategy processes adopted in a number of poor countries (Dijkstra, 2002) are likely to exacerbate the public finance and aid dependency crises due to the future financial obligations thereby created.

According to the *International Monetary Fund*, African countries 'have significant potential for raising tax receipts by broadening the tax base, improving tax administration, and rationalising the tax system' (Hadjimichael *et al.* 1995: 44). This view underpins the rationale for many ongoing tax reforms.[6] Attempts at improving revenue collection have also brought

[5] For instance, in 2003 the Guatemalan revenue administration (SAT) estimated the total tax evasion to more than two-thirds of actual collections (Mann, 2004). For India, Mookherjee and PnG (1995) report a confidential survey finding that 76% of all government tax auditors took bribes, and that 68% of taxpayers had paid bribes. According to a study from Tanzania, official import statistics underreported the value of imports by as much as 70% (ESRF, 1996). Evasion of other types of taxes was also reported to be widespread. In a business survey conducted in Uganda in 1998, which covered 243 firms, as many as 43% said they were paying bribes to tax officers occasionally or always (Gauthier and Reinikka, 2001:22).

[6] Some of the early literature in development economics addressed similar issues. In 1966, for instance, Arthur Lewis argued that 'most developing countries need to raise at least 17 per cent of gross domestic product in

local government taxes in focus (Bird and Vaillancourt, 1998). They typically affect millions of people directly, while central government taxes influence relatively fewer citizens. This puts new demands on tax authorities as many more people – including the poorer segments of the population - become liable to contribute financially to the public sector (Fjeldstad and Moore, 2006). However, in the current debate on revenue mobilisation, few concrete suggestions are presented on how to increase the tax effort, except for improving the effectiveness of the tax administration. Obviously, as shown is this thesis, tax administrations in many African countries are weak, inefficient and corrupt. But merely offering wage incentives to tax collectors as a way of increasing revenue generation can actually lead to more corruption (see Essays 4, 5 and 6). Furthermore, the emphasis on revenue targets does not seem to acknowledge other major impacts of the tax system. Many revenue bases in Africa perform poorly with respect to the basic principles of taxation: They are often distortive, costly to administer, and exacerbate inequity. Attempts to squeeze additional revenues from poorly designed taxes may, therefore, have negative effects on the economy and society in general.

A main finding of the thesis is that tax administration decisions and practices – as much as declared tax policies and legislation – shape how taxation affects different groups of taxpayers. Tax administration practices refer to the interactions between taxpayers and tax authorities concerning identification of tax liabilities, actual tax payment and collection, and prosecution and penalty of tax evaders (Das-Gupta & Mookherjee, 1998: 28). Some of these practices share two key features. They are transaction intensive, often involving face to face contacts between taxpayers and tax officers. Furthermore, revenue authorities at both central and local government level have considerable discretionary powers *vis-à-vis* taxpayers. Some powers are defined in the tax legislation and operational rules, but these are often contradictory and/or unclear and they may be violated. Moreover, their organisational capacity is usually limited and they have insufficient information about taxpayers. They are at the same time both weak and powerful.

Whether tax administration practices are compliance enhancing in poor countries depends on how the tax law is enforced, the honesty of tax collectors and government trustworthiness

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taxes and other government revenues, taking central and local authorities together' (Lewis, 1966: 129). Today, 40 years later, many African countries south of the Sahara are not even close to this. In fiscal year 2005/06, Tanzania's tax take was around 14% of GDP (URT, 2006: 11), and in Uganda it was less than 13% in 2004/05 (RoU, 2005: 44).

with respect to service delivery. In circumstances where citizens perceive taxes to be unfair and receive few tangible benefits in return for taxes paid, only coercive methods of enforcement can generate revenues (see Essays 1 and 2). Roadblocks manned by soldiers, police and militia and physical punishment of suspected tax defaulters have become common. At times taxpayers reciprocate violently with ‘counter-attacks’ on collectors or by burning tax offices (see Essay 3). People have various resources to draw upon in dealing with tax authorities and revenue officers: political connections, social networks (‘know-who’), and actions through collective organisations (e.g., business associations, religious organisations, NGOs etc). Tax evasion and fiscal corruption must therefore, at least to some extent, be understood in the context of a political economy in which social relations may rule out the formal bureaucratic structures and positions. As a consequence, reforms that otherwise seem consistent with principles of good public administration are undermined. Moreover, if taxpayers’ rights are unclear for both taxpayers and for tax authorities, tax compliance and accountability will be affected. As long as excessive use of force is accepted as an integral part of tax collection it is unlikely that state-society relations can become more accountable. Thus, the challenge for African states is to increase their ability to collect more revenue with greater efficiency and less public resistance.

One ought to be cautious to offer general policy recommendations based on individual case studies. However, the essays included in this thesis point in some directions which might be worth to consider when designing reforms to addressing tax evasion and fiscal corruption in poor countries. The essays emphasise that as long as tax administrative practices in East Africa, and to some extent also in South Africa, are perceived by taxpayers to be influenced by extortion, corruption, and nepotism, it is unlikely to contribute to the fostering of a more conducive taxpaying culture. Tax legislation is unclear and causes random and partly *ad hoc* collection procedures. Assessors often have wide discretionary powers to interpret tax laws, for instance, to allow or disallow expenses or charges, or to exempt items from import duties. These factors, combined with a perception of limited tangible benefits in return for taxes paid, seem to legitimate tax evasion. In such circumstances it is not surprising that taxation often takes place in an atmosphere of distrust and fear between taxpayers and revenue officers. Thus, the government’s credible commitment about the use of tax revenues and its procedures to design and implement tax policy non-arbitrarily are crucial to regain legitimacy. The credibility or trustworthiness of the revenue administration’s sanctions against tax defaulters is also important in this context. Reforms of tax legislation and collection procedures, including measures to improve transparency in the taxpayer-tax officer relations, should therefore take place concurrently to reduce opportunities for corruption and the demand for corrupt services. When the government decides what measures to take as part of its tax reform programme, it should bear in mind the state of the economy and the resources at hand. Tanzania and Uganda, like most poor countries, but also a middle income country like South Africa, have neither the political capital nor the administrative capacity to sustain more than a limited range of concurrent initiatives. Nevertheless, an incremental process of change can add up to a radical transformation if it is sustained for long enough.

The thesis

The thesis is organised in three parts, each containing two essays: Part I examines factors determining citizens' compliance in local government authorities in Tanzania (Essay 1) and South Africa (Essay 2), respectively. The research finds that the way taxes and charges are collected may impact significantly on taxpayers' compliance. Excessive use of sanctions and force are likely to fuel tax resistance. This finding leads to Part II of the thesis, which focuses on different tax enforcement regimes and what factors determine the extent of coercion practised in revenue collection. Essay 3 analyses tax collection in local government authorities in Tanzania, the stakeholders involved and the impacts of their relative bargaining powers on revenue collection. In Essay 4, strategies that aim to reduce tax evasion and improve revenue collection by strengthening the bargaining powers of corrupt tax officers are critically assessed. The studies conclude that although corrupt and extortive tax collection may raise revenues in the short run, sustained development cannot occur in an institutional framework that fosters corruption and extra-legal tax enforcement. Thus, a starting point for policy debates in this area is to design and implement measures to fight fiscal corruption. Such measures are analysed in Part III, which explores recent experiences to fight corruption in the Tanzania Revenue Authority (Essay 5) and the Uganda Revenue Authority (Essay 6).

PART I: TO PAY OR NOT TO PAY?

What factors determine citizens' decisions on whether to pay taxes (or services charges) or not? Based on survey data from Tanzania and South Africa, essays 1 and 2 apply the analytical frameworks suggested by Levi (1988, 1997) and Slemrod (2003), to examine the impacts of three variables on taxpayers' compliance behaviour: (1) coercion; (2) fiscal exchange; and (3) social influences.

Essay 1 Why people pay taxes. The case of the development levy in Tanzania

Published in *World Development,* Vol. 29, No. 12 (Dec 2001), pp. 2059-2074.
Co-authored with Joseph Semboja.

This paper examines factors determining tax compliance behaviour in local authorities in Tanzania. The poll tax - locally named 'development levy' - is used as case. The study finds support for the hypotheses that tax compliance is positively related to factors such as ability to pay, the (perceived) probability of being prosecuted and the number of tax evaders known personally by the respondent. Oppressive tax enforcement, harassment of taxpayers and discontent with public service delivery seem to increase tax resistance and may explain the widespread tax evasion observed.

Essay 2 What's trust got to do with it? Non-payment of service charges in local authorities in South Africa

Published in *The Journal of Modern African Studies*, Vol. 42, No. 4 (2004), pp. 539-562.

A major financial problem in many municipalities in South Africa is the inadequate collection of service charges due to widespread non-payment. The prevailing view is that non-compliance is caused by poverty and the existence of an 'entitlement culture'. However, huge variations in compliance exist both within poor communities and between communities with similar socio-economic characteristics. How can these differences be explained? Moreover, what factors determine citizens' compliance? The paper argues that non-payment is not only related to inability to pay and 'a culture of entitlement', but also to whether citizens perceive the local government to act in their interest. In particular, three dimensions of trust may affect citizens' compliance: (1) trust in the local government to use revenues to provide expected services; (2) trust in the authorities to establish fair procedures for revenue collection and distribution of services; and (3) trust in other citizens to pay their share.

PART II: TAX ENFORCEMENT AND THE BARGAINING POWER OF COLLECTORS

Why do the tax enforcement regimes differ between local government authorities in Tanzania? Who are the stakeholders involved in the domestic tax enforcement process, and what is their relative bargaining power? Recent literature on incentives in tax administration, argue that increased fiscal corruption in some contexts may contribute to reduced tax evasion and thereby increased tax revenues. Does this justify a policy to improve revenue collection by strengthening the bargaining power of corrupt tax officers *vis-à-vis* taxpayers? These are some of the questions examined in essays 3 and 4, using arguments put forward by Moore (1998) and Mookherjee (1997) as points of departure for the analysis.

Essay 3 Taxation, coercion and donors. Local government tax enforcement in Tanzania

Published in *The Journal of Modern African Studies,* Vol. 39, No. 2 (2001), pp. 289-306.

This paper presents three propositions about tax collection by local authorities in Tanzania. First, revenue performance depends on the degree of coercion involved in tax enforcement. Reciprocity does not seem to be an inherent component of the state-society relationship in connection with local government taxation. Second, the extent of coercion depends on the bargaining powers of the stakeholders involved in the tax enforcement process. In particular, coercive tax enforcement is facilitated when the ‘bargaining powers’ with respect to tax collection favour the council administration, and the elected councillors have no direct influence on collection. Third, the presence of donors in a local authority may be crucial by changing the ‘balance of power’ in favour of the council administration, with implications for accountability, responsiveness and democratic development. These results may explain why widespread differences in revenue performance between local authorities are observed.

Essay 4 Fiscal corruption: A vice or a virtue?

Published in *World Development,* Vol. 31, No. 8 (August 2003), pp. 1459-1467.
Co-authored with Bertil Tungodden.

Recent literature on tax administration in poor countries suggests there are virtues of allowing fiscal corruption. By strengthening the bargaining power of corrupt tax officers, it is argued that tax evasion may be reduced and tax revenues increased. But does such an intriguing paradox justify policies that stimulate corruption? Our answer is no, and this paper puts forward three arguments to support our view. First, while an increase in corruption may raise revenues in the short run, in general the opposite will be the case in the longer run. Second, the instrumental value of reducing corruption goes far beyond its effects on tax evasion and tax revenues. Accepting corruption as a policy strategy to increase tax revenues may undermine values of democracy and good governance. Third, eliminating corruption should be considered an end in itself. Thus, contrary to recent suggestions on incentive reforms in tax administration, the reasonable starting point for policy debates in this area should still be that an increase in fiscal corruption is not an appropriate instrument for raising tax revenues. Sustained development cannot grow from an institutional framework that fosters corruption and extra-legal tax enforcement.

PART III: CONTROLLING FISCAL CORRUPTION

What factors explain the patters of corruption observed in revenue administrations in East Africa? What are the impacts of incentive schemes introduced to curb corruption? Essays 5 and 6 explore the above questions, drawing on recent economic literature on corruption (Rose-Ackerman, 1998, 1999), incentives in revenue administrations (Chand and Moene, 1999; Das-Gupta and Mookherjee, 1998), and anthropological literature on patronage (Smith, 2003).

Essay 5 Fighting fiscal corruption: Lessons from the Tanzania Revenue Authority

Published in *Public Administration and Development,* Vol. 23, No. 2 (May 2003), pp. 165-175.

Over the past two decades many developing countries have implemented comprehensive reforms of their tax administrations in order to increase revenue and curb corruption. This paper examines recent experiences in the fight against corruption in the Tanzania Revenue Authority. Two lessons of broader relevance are highlighted. Firstly, even with relatively high wages and good working conditions, corruption may continue to thrive. In a situation where there is high demand for corrupt services, it is unrealistic to provide tax officers with pay rates that can compensate for the amount gained through bribery. Without extensive and effective monitoring, wage increases may produce a highly paid but also highly corrupt tax administration. Secondly, hiring and firing procedures may lead to more corruption. Corrupt tax officers often operate in networks, which also include external actors. These corruption networks seem to have been strengthened because many of those fired were recruited to the private sector as 'tax experts'. This partly explains why the positive process experienced in the initial phase of the new revenue authority was later reversed.

Essay 6 Corruption in tax administration. Lessons from institutional reforms in Uganda

Forthcoming as Chapter 17 in Susan Rose-Ackerman ed. (2006) *International Handbook on the Economics of Corruption*. Cheltenham, UK/Northampton MA, USA: Edward Elgar.

The Uganda Revenue Authority (URA), established in 1991, is the oldest integrated revenue authority in sub-Saharan Africa. The revenue authority model aimed to limit direct political interference in day-to-day operations by the Ministry of Finance and to free the tax administration from the constraints of the civil service system, especially by paying salaries above civil service pay scales and to more easily recruit, promote and dismiss staff. Such steps were expected to provide incentives for greater job motivation and less corruption. After marked success in the first years after its creation, revenue has dropped as a share of GDP, and corruption is believed to be pervasive. The paper shows that the establishment of the URA with comparatively generous remuneration packages and substantial budgets has not protected it from political interference. To the contrary, it has made the revenue administration a more attractive target because the authority offers both relatively well paid jobs and considerable rent-seeking opportunities. Further, the paper argues that the motives of individual actors are often inextricably tied to the interest of the social groups to which they belong. Tax officers are often seen by their families and networks as important potential patrons who have access to money, resources, and opportunities that they are morally obliged to share. People in positions of power are expected to use that influence to help their kin and community of origin. Hence, increased salaries may lead to increased social obligations, which again may push tax officers into taking bribes to accommodate the growing expectations around them. This implies that such social relations may rule out the formal bureaucratic structures and positions. Fiscal corruption must therefore, at least to some extent, be understood in the context of a political economy in which access to social resources depends on patron clientilism. If these problems, which are rooted in social norms and patterns of behaviour rather than administrative features, are overlooked, the result may be to distort incentives. As a consequence, reforms that otherwise seem consistent with principles of good public administration may be undermined.

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