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**A STUDY ON TAX EVASION AND SHADOW ECONOMY:  
CAUSES AND EFFECTS**

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**ABSTRACT**

*Tax and tax evasion are two faces of the same coin. Since centuries evasion has been a part of every society, however in this 21st century the size and extent of evasion is taking a gigantic shape especially because of corruption which has spread like a cancer in all walks of life. Tax evasion is corroding the GDP of the country and its foundation has become deep-rooted in the Indian soil. Today the quantum of black economy in India is around half the size of GDP of India. Evasion has deep-rooted impact on the downtrodden and weaker section which culminates other social evils in the society. The purpose of this paper is to understand the concept and relationship of tax evasion and black economy in the Indian perspective. We have also tried to find out the effects of rising tax evasion and finally the ways by which we can reduce evasion in India. The paper uses secondary sources of data by which we try to deduce conclusions and recommend the measures to reduce the size of shadow economy in India.*

**KEYWORDS:** Tax evasion, Black economy, Shadow economy, Corruption, GDP.

## INTRODUCTION

The history of tax evasion is as old as tax system. However with passage of time there is notable inventiveness in the methods of evading taxes and duties. During the third century, many wealthy Romans buried their jewelry and earthen pots containing gold coins to evade luxury tax. Similarly homeowners in eighteenth century in England temporarily bricked up their fireplaces to escape notice of tax collectors. In twenty-first century we find wealthy people and corrupt politicians and bureaucrats stash their black money in Swiss bank accounts. When we talk of “Tax Evasion” a term quite similar to this is “Tax Avoidance”. People often use it interchangeably, but there is a stark difference between the two. While the former is illegal and therefore carries the risk of penalties and prosecutions under the tax laws the latter is perfectly legal and within the legal framework. Where Tax avoidance refers to a situation where a taxpayer reduces his tax liability by taking advantage of the loop-holes and ambiguities in the legal provisions, Tax evasion involves deliberate misrepresentation of facts with an intention to reduce down the tax liability. Therefore tax evasion leads to creation of Black Economy. Black economy comprises of all those income which has not been reported to tax authorities. The black market is created because of two reasons viz. Illegal activities (like smuggling, match fixing and underworld operations) and non-reporting of income to tax authorities. Every country has the problem of tax evasion; however the quantum of it varies from country to country. In India its size is voluminous and is increasing day by day and today we have a parallel economy which is nearing the GDP of India.

This paper is divided into four parts as follows:

1. Factors which led to emergence and growth of tax avoidance and tax evasion in India.
2. Causes of Tax Evasion.
3. Effects of Tax Evasion.
4. Measures to curb Tax Evasion.

Therefore, in this paper I will try to bring out the reasons which led to the problem of tax evasion and its corresponding effect on the GDP of India. We will try to find out how tax evasion is corroding the GDP of the country and how its foundation has become deep-rooted in the Indian soil. Finally the paper will highlight the ways and means by which we can reduce down corruption and black economy from our soil.

## EMERGENCE OF TAX EVASION

As we said earlier, the problem of tax evasion is as old as tax system. People generally evade taxes because there is no quid pro quo i.e. there is no direct benefit involved in paying taxes except the negative advantage that one shall not be subject to penalties and prosecutions. Therefore people tend to evade taxes. In the early days of operation of tax system in India, the rates of taxes were comparatively low and hence there was a low rate of evasion. However after the Second World War evasion started to grow and the situation became worse after independence because of strict controls and license raj. During 1973-74 Government started to

increase the general rate of taxes to increase tax collection and this made evasion more attractive. In financial year 1973-74 the highest rate of income tax on income exceeding Rs. 200,000 was 85 percent. In addition the assessee had to pay a surcharge of 15 percent. Thus the effective rate of tax in such cases was 97.75 percent. Till 1973-74 India was the highest taxed nation in the world. Thus the gain from tax evasion was huge and people looked for ways and means by which they can reduce their taxes. There is less chances of evasion when income is from salary and interest on securities, where a withholding tax is deducted as compared to income from business and profession where there is no such deduction of taxes. Therefore there is huge tax evasion in case of self-employed people. Self employment business income is not subject to financial reporting and hence its estimated noncompliance rate is sharply higher. Professionals like lawyers, doctors, chartered accountants evade huge taxes because of no such checks. In 1971, the Direct Tax Enquiry committee (DTEC) also known as Wanchoo Committee estimated the tax evasion for the year 1968-69 at Rs. 470 crores, income evaded from tax at Rs. 1400 crores and the money value of the deals involving black money at Rs. 7000 crores. A study conducted on the "Aspects of Black Economy in India" for the year 1975-76 pointed out that the range of Black income was between Rs. 99,580 million and 1, 18,700 million which constitutes 15 percent to 18 percent of the GDP of India.

Over the years the quantum of black money is growing at a galloping pace. The increasing number of incidents of money laundering and hawala transactions is further adding fuel to the fire. According to one estimate the range of black money in the 21<sup>st</sup> century is between \$500 billion and \$1400 billion. A study by international watchdog Global financial Integrity (GFI) estimated the illicit money outflow to be \$462 billion out of India. While the Black economy in Sweden is 2 percent of the GDP, US is 5 percent of the GDP, India's Black economy constitutes around 50 percent of the GDP. However all of these are only estimates, the real figure cannot be said with exact precision. The case of black economy is similar to the story of "7 blind men and the elephant" where each person defines the elephant as per his understanding.

### **CAUSES OF TAX EVASION**

The figures above show that since Independence the quantum of black economy is growing by leaps and bounds. There are number of factors which led to this problem of tax evasion in India. During 1970's the tax rate was exorbitantly high which made the business class adopt ways and means for evasion. However slowly people became habitual tax offenders and there are many reasons for this sorry state of affairs of our country. Let's look at these factors one by one.

The very first and the most important reason of tax evasion is Moral Crisis in India. There is rampant spread of corruption amongst the public in all walks of life and at all levels of administration. Corruption has percolated to the nerves of every person and it has become a cancer for this country. Due to corruption, benefits like permits and quotas, jobs in MNREGA and direct benefit transfers (DBT) are given to undeserving persons. Production and sales are under-recorded so that there is under assessment of taxes. Some business firms make false invoices of purchases, fake wage sheets and several bogus bills and vouchers so that they pay less taxes. Corruption has crossed all limits when it comes to government officials and tax administrators. There is considerable wastage of government funds by the administrators who many a time, spend government funds for their personal works or their own pleasure trips. Very

recently many politicians from SP, BSP and other political parties went for pleasure trips abroad in the name of study tour. Citizens now have to bribe the tax officials and Assessing officers for keeping their records clean and not sending any tax notice or not scrutinizing their books of accounts.

Another reason for rising evasion in India is Complicated tax structure. The Income tax Act, 1961 is divided into various chapters and huge number of sections. The chapters are divided on the basis of income under various heads, deductions and appeals. Each of the chapters has various sections. Each section has a sub-section. The sub-section further has clause and sub-clause. These clauses and sub-clauses have items and finally after the section one can find proviso which is further divided into first and second proviso. Therefore after reading the whole section one may find that the section is not relevant for him because of the proviso. The same is true for indirect taxes like The Central Excise Act, 1944 which contains the provisions of excise duty on production of goods while Central Excise Tariff Act, 1985 which contains the items or goods to be produced along with the relevant rate of duty. The provisions are more or less same for The Customs Act, 1962 and The Customs Tariff Act, 1975. With these spiral and complicated tax and tariff structure it becomes very difficult for the public at large to comprehend and follow the various provisions given in various acts. It is because of this complicated tax structure that tax evasion is high in India.

The third reason for tax evasion is Non-levy of Penalties and Prosecutions. This is a major problem in India. A major chunk of Indian population doesn't have their Permanent Account Number (PAN) card. Only a small percentage of Indian population files their Income tax Returns (ITR) and among them only a miniscule proportion shows their true income from all sources. According to Deccan Herald (a leading newspaper Daily), only 3.5 crore people (less than 3 percent) of the country's total population of 125 crores file their income tax returns in India. Therefore there is a lot of leakage of revenue for the government. This happens because there is not enough deterrent for tax evaders and non-tax filers. People know that chances of penalties and prosecution is way too less, and even if they are caught they can bribe the officials to get rid of scrutiny and assessment. Even the cases which are subject to penalties and prosecutions are pending since years at various levels of Income tax authorities and courts. Shockingly, in some cases the company has gone for liquidation but its case is still pending before the tax authorities.

The CAG Performance Report, 2013 substantiates this problem by bringing out some shocking facts to light. Sec. 271(1)(c) of the Income Tax Act provides that if an assessee conceals the particulars of his income or furnishes inaccurate particulars of his income then he shall be liable for penalty ranging from 100 percent to 300 percent of the tax sought to be evaded. The CAG in its report provides that there are 214 cases in 14 states involving the tax effect of 73.20 crores where the provisions of the above section were violated. Similarly, failure to deduct tax at source on taxable payments made by the assessee or failure to remit TDS would attract levy of penalty. It would further attract disallowance u/s 40(a)(ia) of the Act. Therefore the TDS officer before passing penalty orders shall intimate to the jurisdictional AO for disallowance of the expenditure in tax assessment. The CAG in its report states that there is non-sharing of information between the TDS officers and concerned AO resulting in leakage of revenue of 109.69 crores.

The last but not the least cause for rising black economy is Unconscious and Unaware citizens. A large part of our population doesn't have their PAN cards. Only 3 percent of Indian population files their income tax returns, the reason being that a large part of our population is unaware about their obligation to file their tax returns. Even the professionals and College Professors and students don't know how to fill in an income tax return. In USA, even the school going children are made aware of their responsibility to file their tax return and some special seminars and workshops are designed for senior pupils to educate them as to how they shall fill their tax returns. These reasons together lead to a voluminous size of black economy in India.

### **EFFECTS OF TAX EVASION**

Tax evasion has huge implication for the economy as a whole. It overturns the government's development policies, creates economic crisis and social unrest amongst the masses. These have a rippling effect in the economy and the lower segment of the society bears the major brunt of it. We can categorize its implications into 3 perspectives viz. Economic perspective, Social perspective and political perspective.

The economic implication of tax evasion is that it creates a parallel economy where tax evaders carry on huge transactions in the black market, pile up huge stock of goods and create artificial scarcity in the open market. This leads to rise in the price of goods in the market and leads to inflation. Inflation affects the standard of living of the citizens who then demand for higher wages and salaries to combat inflation. They in order to enforce this go for strikes and lockouts. This results in loss of work days which eventually lowers down our National income.

Black money is a major hindrance in the government's efforts to bring down the prices of goods and services. Black money and inflation goes hand in hand and they have a cause and effect relationship. Due to huge amount of black money in the economy, the open money market is tight and therefore the money supply needs to be increased to meet the increased demand. Since the collection of taxes doesn't grow fast enough to match the developmental and non-developmental expenditure of the government, government frequently resorts to deficit financing which makes the inflationary problem even worse.

The social implication of the tax evasion is that it creates class divide in the society i.e. the class of Haves and Have-nots or Rich and Poor which leads to social unrest and rising crime in the society. The sections of the society which can evade their taxes easily become rich day by day, while the counterpart becomes poor day by day. Tax evasion is rampant in the business class and professionals because of less checks and controls, while it's quite less in the salaried class who get their salaries after deduction of taxes. Therefore the salaried class becomes quite frustrated that they are paying full taxes while their friends and relatives in other professions are evading taxes. Therefore the lower segment of the society who cannot afford other luxuries in life due to high inflation and higher taxes thus becomes attracted towards short-cut methods of earning high income which eventually makes them do anti-social activities like smuggling, theft and other criminal activities.

The political implication of tax evasion is that the tax evaders donate large sums of black money in the elections to various political parties. In every general and state election we find the



political parties spending huge sums of money in their election campaign above their authorized limit. In the recent general election of 2014, it is believed that a sum of Rs. 30,000 crores was spent by government, political parties and candidates in the election campaign, out of which a sum of 7000-8000 crores was to be borne by exchequer to hold electoral exercise for the 16th Lok Sabha elections. These donations are made to get some quid-pro-quo in return from these political parties. The party which comes to power then lobby for these business houses and makes policies which either suites them or makes them aware of the proposed changes in the policies of the government. Thus they influence the policy making and functioning of the country for their personal benefits.

## MEASURES TO CURB TAX EVASION

In the preceding section we have seen how tax evasion causes a devastating effect on the economy and the society. If a country doesn't control rising evasion in the economy, it can lead to a situation of hyperinflation which has an adverse impact for the country both on national and international platforms. Therefore it is absolutely imperative to get rid of the problem of tax evasion. However, it is nearly impossible for a country to totally eliminate tax evasion; as such a much calibrated and well conceived technique must be used by which one can reduce tax evasion in India. Let us look at these measures one by one.

In India we know people think of loopholes before the provisions of an Act is enforced. Therefore the government should hit morally i.e. the emphasis should be shifted from materialistic outlook to moral and spiritual outlook. The government can also hit on the psychological thought process of the assessee. Some of the examples can be "Pay tax, karo Relax" which tries to give a sense of security to the taxpayers. Similarly other approach can be making the citizens aware that they are contributing towards the growth of the country like "Pay tax and contribute towards nation building". Other ways can be "Pay tax and be a role model in the eyes of your kids". These innovative ways of influencing the behavior of the citizens can lead to increasing the tax revenues for the government and reducing tax evasion.

The second technique of reducing evasion is to levy hefty penalties and prosecutions. The CAG in its report has provided that there are a lot of cases where the income tax department has not levied adequate penalties and cases are pending since years. This causes a huge loss to the exchequer and there is less deterrent in the minds of the people. Therefore there should be speedy disposal of cases and proper implementation of fines and penalties. Further the amount of penalties and fines must be increased. Penalties should be imposed not only for the evaders but also on the government officials who are found accepting bribes and their jobs should be terminated with immediate effect. In other cases, prosecutions should also be done so that citizens think twice before evading taxes. If these deterrents are properly implemented, evasion would be quite less and consequently the size of black economy would shrink considerably.

The third way to reduce the quantum of black economy is to ban cash donations to political parties. The election of 2014 has witnessed huge amount of spending by the political parties and the candidates. Most of the funds come from large corporate houses that have huge stock of black money with them. This is one of the ways by which they inject the money in the economy in exchange of some quid-pro-quo. Therefore one way to keep black money away from elections

in specific and the economy in general is to ban cash donations. This would reduce down the spending of the black money generated and their attempt to rig the election results.

Another way of reducing evasion in India is that a sense of uniformity is required for various types of taxes. We know that a particular entity is subjected to various types of taxes viz. income tax, excise duty, custom duty, VAT or service tax. Some of these are central taxes while others are state tax. Central government uses PAN card for registration under income tax, while for VAT state government uses TIN (tax identification number) to identify the registered dealer. So there is an urgent need for coordination amongst various departments of the central and state governments so that a fraud plugged in one department can be reported to other and consequent orders can be passed by other department as well. This will lead to a system of uniformity and consequently tax evasion would reduce.

Some other ways of reducing tax evasion are as follows:

- Make PAN a requirement in literally every possible transaction so that cash transactions can be verified.
- Audit standards should be improved so that financial frauds of MNC's can be traced easily.
- Audit Regulatory authority i.e. NFRA needs to be functional and vigilant soon.
- Training programs should be conducted for Assessing officers and tax inspectors.
- Pay scales of AO's and inspectors should be revised so that they don't accept the bribes offered by multicore firms.

These measures taken together can go a long way to reduce down tax evasion and black economy in India.

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