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Tax Evasion, Disclosure, and Participation in Financial Markets: Evidence from Brazilian Firms

THOMAS KENYON *
United Nations Industrial Development Organization, Vienna, Austria

Summary. — This paper draws on survey data and qualitative evidence from Brazilian manufacturing firms to examine the scale and consequences of tax evasion at the enterprise level. It discusses the costs and benefits of under-reporting from the entrepreneur's perspective and provides evidence that evasion of sales tax is only weakly correlated with firm size. The paper then shows that medium-sized and large manufacturing firms that evade taxes are less likely to undergo an external audit and more likely to be asked for informal payments by tax officials. It also argues that they may be less likely to participate in markets for equity finance.

Key words — tax evasion, equity markets, Brazil, Latin America

1. INTRODUCTION

This paper addresses the scale and consequences of tax evasion in Brazil at the firm level. It is concerned with what has been called the "unreported" economy—activity conducted by firms that are known to and registered with the authorities, but nonetheless keep a fraction of their activities undeclared for tax purposes (Feige, 1990). While most firms engaged in such unreported activity tend to be small, in some countries the sub-sector can also include medium-sized and even large companies, as this paper shows. Drawing on data from the World Bank's Investment Climate Survey (ICS) of Brazilian manufacturing firms, the paper analyzes the costs and benefits of tax evasion from the firm's perspective and makes two empirical points. The first is that larger Brazilian manufacturing firms declare a greater proportion of their activities to the tax and labor authorities, but that the difference is small: a doubling of firm size is associated with an increase of just 4 percentage points in the fraction of sales reported. The second is that firms that are evading taxes are less likely to undergo an independent audit and also more likely to be asked for informal payments by the tax authorities. As a consequence of the former, they may also be less likely to participate in modern capital markets.

Tax evasion matters for several reasons. It has consequences for resource allocation, enabling non-compliant firms to draw labor away from those that do pay taxes, and potentially shifting resources into sectors more amenable to evasion, such as trade, services and construction. To the extent that evading firms are constrained in their access to sources of finance, as this paper argues, they may also operate more labor-intensively than would be optimal (Eilat & Zinnes, 2002). They may also choose to operate at below optimal size, in order to avoid the attention of the authorities (McKinsey, 2004, p. 6). [1] More generally, tax evasion erodes the state's capacity to raise revenues and provide necessary public services, placing an unfair burden on those individuals and businesses that do pay their taxes. These consequences are of particular concern when evading firms compete with compliant ones, or when tax and other forms of regulatory evasion, such as smuggling,

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become a source of competitive advantage. [2] Under these circumstances, the presence of a large shadow economy can undermine the social contract that exists between the state and compliant economic actors, potentially leading to the disintegration of norms that encourage compliance (Gerxhani, 2004).

The distorting influence of tax evasion on factor markets indicates the need for a more holistic approach to microeconomic reform in developing countries. As an influential study has put it, "Another set of big think questions centers on the proposition... that the benefits from any one set of reforms are significantly enhanced when other markets are well functioning... Comparative analysis of policy changes in countries where polices toward other sectors vary may yield valuable insights" (Krueger, 2000). This is of particular interest to a country like Brazil, where access to finance is one of the most severe firm-level constraints on economic growth (World Bank, 2005). It should also be of interest to policy-makers trying to stimulate equity market development. The practical implication is that reforms to capital market regulation are unlikely to yield significant growth in financial intermediation unless policy-makers also address the causes of tax evasion. This in turn requires a careful approach that induces firms to comply with their tax and regulatory obligations while avoiding driving them out of business altogether.

2. STATES, MARKETS, AND TAXATION

In the last few years, policy-makers, and scholars have turned their attention to the micro-institutions of capitalism outside the developed world. Following a wave of macroeconomic reforms in the 1990s, many development practitioners came to recognize the importance of institutions and incentive structures in sustaining economic activity. Attention therefore focused on what has come to be called the "investment climate"—the "opportunities and incentives for firms to invest productively, create jobs, and expand" (World Bank, 2005, p. 19). Among the most important determinants of the investment climate is the scope and quality of government regulation. There is a long and distinguished literature on the ways in which state institutions support market activity: by channeling information about market conditions and participants, by defining and enforcing property rights and contracts, and by ensuring an appropriate level of competition (World Bank, 2002, pp. 5–6). Unfortunately, efficient states are a rarity in the developing world. Most governments in these countries dispose of the ability to issue regulations and commands—what Mann called "despotic power"—but have little if any capacity to enforce them (Mann, 1984). The most extreme manifestation of this failure is organized private thuggery of the sort that prevailed in Somalia in the early 1990s. But a more common outcome is the growth of the unrecorded or "gray" economy which characterizes a number of middle-income countries. In these countries much economic activity is unregulated and or untaxed. As a recent analysis put it, "The relationship between the informal economy and the state is, by definition, one of inevitable conflict. The whole point of the state is to assert the monopoly of its authority within a territory, but the whole point of informal entrepreneurs is to avoid or subvert that authority... an informal economy will develop *when and where it can*" (Centeno and Portes, 2003, p. 7).

The obvious question is what allows this situation to persist. One explanation is a simple lack of capacity. To be effective, a tax administration must both make contact with potential taxpayers and obtain information about the scale of their activities. Doing so requires a high degree of coordination and information-sharing among government departments, particularly the tax authorities and police. Even advanced industrial countries have difficulty in ensuring full compliance (OECD, 2004). Achieving anything comparable is beyond a developing country like Brazil, which spends a much smaller proportion of national income on tax collection and which lacks lawyers and judges with tax expertise (McKinsey, 2004, p. 30). The identification problem is particularly acute for smaller businesses. Survey data from transition and from some African economies show that smaller firms generally report a lower fraction of their revenues to the authorities, presumably because their size makes it easier for them to deal in cash (Gauthier and Gersovitz, 1997; Gauthier and Reinikka, 2001; Gehlbach, 2004, 22). It is also more problematic for labor-intensive businesses because they have fewer visible fixed assets than capital-intensive ones. Much unrecorded activity in developed countries consists of labor-intensive services such as construction, road haulage, contract cleaning and catering (OECD, 2004, p. 262). When enforcement capacity is limited, the tax