

Tax Evasion : Findings Of Empirical Observations And Nepalese Context

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INTRODUCTION

Tax evasion is an illegal attempt to reduce taxes to be paid to the government through non-reporting, under reporting, making fraudulent changes in account books, maintaining multiple set of accounts, non-entering the transactions in account books, operating bank account under different names, doing business in dummy names, over reporting expenses, fragmenting income and transfer pricing (Indian Tax Institute 1997: P. 158). It is an activity of illegal, unethical and uneconomic nature. Another term somewhat different from tax evasion is tax avoidance that actually means saving taxes without breaking the law but by using the loopholes in the tax laws. However, from economists view point tax evasion and tax avoidance are of similar nature since both of them have the same effects on government tax revenue. They are not independent but a substitute to each other since both are the means of avoiding taxes and awareness of one induces a person to follow other. A word similar to tax evasion or avoidance is tax delinquency. Although, tax delinquency means the failure to pay tax due to lack of sufficient fund, it also covers the non-payment at the time of having fund (Herber 1999). It is a temporary deceiving of taxes by the taxpayer although he cannot escape in long term.

In a country, where enterprises are relatively of small size, people are relatively poor and tax morale is relatively low, taxpayers use evading practices where as in a country where business houses are comparatively of large size, tax discipline is relatively strict and people are relatively wealthy, taxpayers are more inclined tax avoidance. In essence, tax evasion is more common in developing countries where as tax avoidance is usual in developed world.

Whether it is a developed country or developing world, basically, there are three types of effects of tax evasion in the economy consisting loss of revenue to the state, redistribution of income which affects the efficiency of resource allocation in the economy and creating wrong statistics leading to errors in government policies. Evasion of income tax is also associated with the evasion of sales tax, excise duty, customs duty and so on. Since government imposes higher tax rate to fulfill the growing need of the revenue, it is the honest taxpayers who really bear the the burden of tax evader's shoulder.

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As in other developing countries, tax evasion is a major problem to the government in Nepal. There are several types of tax evasion in Nepal—unilateral : taxpayer himself, bilateral : with the connivance or assistance of government official as coined by Shoup and quoted in Herschel (1978, P. 34), trilateral, from the collusion of tax officers, tax auditors and taxpayers, and multilateral : all parties from government to taxpayer. In a world of tax evasion, it is very difficult to choose between, businessman, professional, a person in service, or a politician who is not a tax evader. Tear the mask; the face looks alike (Srinivasan 1980.)

The main objective of this article is to analyze the main determinants of tax evasion in the context of Nepal and world at large. The rest part of the article are divided into three, Determinants of Tax Evasion covering the reasons- tax related and non-tax related-of tax evasion shown by empirical and theoretical studies, Tax Evasion and Nepalese Context covering the determinants of evading taxes in Nepal and the Conclusion.

DETERMINANTS OF TAX EVASION

Basically, the reasons of tax evasion can be divided into two-non-tax factors and tax factors. Non-tax factors include sex or educational background, price policies of the government, government rules and regulations, public sector salaries, government's expenditure policy and others. Tax factors include tax rate, tax base, tax structure, penalty system, probability of detection, magnitude of the strictness of penalty and possibility of applying penalty if evasion is detected. Mainly, tax factors are more concerned with the tax evasion on income from legal activities where as non-tax factors are related with illegal activities. However, this clasification is not cent percent correct because non-tax factor like corruption of public funds may lead to taxpayers' decision to evade tax by under reporting income from legal activities. Since tax factors affecting the evasion are discussed later, non-tax factors having impact on tax evasion are presented here, in brief.

Non-tax Factors

There are several non-tax factors that affect the tax evasion practices. Firstly, government regulation can be taken. Complex rules and varieties of regulations of the government related to the business tends to increases tax evasion. Where there are too many complicated rules and regulations, businesses cannot follow these rules and regulations and use to conduct the business illegally. The forms of such rules and regulations are import licensing, quotas, high custom duties, prohibitions, rationing, town and city planning regulations, factory acts, permits to produce certain goods etc. Secondly, very low level of salary scale of the public sector employees which is not sufficient to maintain reasonable standard of living also increases the tax evasion since they seek the legal or illegal means to

supplement their regular expenditure. If such means are adopted by tax officials, it may have indirect as well as direct effects in increasing tax evasion. Thirdly, government's expenditure pattern affects the level of tax compliance. If the taxpayers judge that government is spending their contribution lavishly to pay to public servants or politicians or defence or anywhere else, they start to seek the ways of reducing the tax liabilities through both the legal and illegal ways. Such evasion is based purely on political considerations. Fourthly, some times the price control policies exercised in goods and services market, the factor market, the money market or the foreign exchange market leads to the evasion of tax. For example, if there is rent control policy of the government, it leads to understatement of rental income in tax return which ultimately leads to tax evasion. Fifthly, the level of education of the people also affects the tax evasion by two ways, (1) increasing compliance due to social status and understanding of tax law, and (2) increasing avoidance due to their better understanding of the tax loopholes. Sixthly, the stage of the development of economy also is responsible to determine the extent of tax evasion. If the economy is developed, most part of the GDP is covered by monetized sector that in turn means the economy where the tax law can be enforced. Contrary to it, if the economy is of subsistence type, most part of the economy is covered by the sector where the enforcement of the law is very difficult. This means, tax evasion is high in non-monetized sector. Seventhly, the group behaviour of the taxpayer also affects the tax compliance. Taxpayers usually use to evade taxes if their peer groups evade taxes.

Tax Factors

There are various studies related to the tax evasion. They cover both the measuring of the magnitude of tax evasion and the reasons of tax evasion. While measuring the magnitude of tax evasion economists basically have used gap approach, tax amnesty approach, tax elasticity approach and survey approach to measure the extent of tax evasion in a country. Musgrave Commission in Argentina (Shoup quoted in Herschel 1978) used all these approaches at first. Accordingly, for measuring the factors affecting the tax evasion, two approaches-simulation and survey-are used. Those who have done research through simulation approach are Friedland et al. (1978) and Spicer and Becker (1980). Those who found the factors affecting the tax evasion through survey method are Spicer and Lundstedt (1976), Mork (1975) and Enrick (1963). Beside these approaches, there are two studies which have used mathematical approaches-utility maximisation approach of Alingham and Sandmo (1972) and income maximisation approach of Srinivasan (1973)- to analyze the factors affecting tax evasion. These two studies are the path breaking works related to the study of the determinants of tax evasion either of which are followed by

most of the researchers of later period. Among these two, the first one advocates that the objective of the tax evader is to maximise utility where as the second one emphasises on the income maximisation. The detail discussions concerned with the determinants of tax evasion related to tax factor are presented below:

Tax Rate

It is believed for many years that tax evasion is the function of high tax rate. Such belief is supported by observations, reports and studies of experts and tax policy makers. Kaldor (1956) in his report on Indian tax reform states that the extent of evasion depends on the marginal rate of taxation. Supporting the Kaldor's view, Direct Taxes Administration Enquiry Committee in India (1960) also emphasises that high personal income tax rates are one of the major reasons for tax evasion. Once finance minister of India claimed that the tax rate is reduced to reduce tax evasion (Gupta 1974). Mork (1975), Crane and Nourzad (1990) and Clotfelter (1983) also claim that higher tax rates tend to increase evasion. However, there are persons who reject the plea that high tax rate induces the tax evasion. These researchers are Alingham and Sandmo (1972), Yitzhaki (1974), McCaleb (1976), Sandmo (1981) and Koskela (1983a). Among these economist's Alingham and Sandmo (1972) showed that the effect of tax rate on evasion is indeterminate. McCaleb (1976) claims that the impact can be either positive or zero or negative. Sandmo (1981) could not find the stimulation of underground economy due to high tax rate. Yitzhaki (1974) found the effect of tax rate on evasion only on the assumption of the imposition of penalty on the evaded taxes. Accordingly, Koskela (1983a) showed that the extent of tax evasion depends on tax rate only if the penalty is imposed on the amount of evaded income. As above, other economists also have disagreed regarding the versions that increase in tax rate increases evasion. Gupta (1974) says tax evasion is the propensity born of greed and therefore, the decrease in tax rate cannot decrease evasion.

From the above observation, it is seen that the effect of tax rate on tax evasion is indeterminate requiring more works. Only in case of penalty imposed on evaded tax or evaded income, the tax rate induces to evade taxes.

Penalty Rate

In a tax system, incorporation of penalty means discouraging tax evasion. It is generally believed that the penalty deters the tax evasion. There are different studies that have examined the effect of penalty on tax evasion. Among them, the major studies are Alingham and Sandmo (1972), Singh (1973), McCaleb (1976), Sandmo (1981), Koskela (1983b) etc. As regards to the effect of penalty on tax evasion, there is no debate between the economists. Almost all of them have accepted that penalty rate and

magnitude of tax evasion has negative relationship. In this respect, Alingham and Sandmo's finding was that an increase in penalty rate always increases the fraction of income declared. In Singh's view, the higher the penalty rate, the lower is the extent of tax evasion. McCaleb declared that the increase in penalty leads to the increase in the tax payment. Accordingly, Sandmo found proportion of unreported income decreased with the increase in penalty rate and Koskela saw penalty as a deterrent to tax evasion. In such way, it can be concluded that effect of penalty rate on tax evasion is negative.

Probability of Detection

It is assumed that the probability of detection has the effect on the magnitude of tax evasion. In economists' view, the effect must be negative. Different empirical studies like Alingham and Sandmo (1972), Srinivasan (1973), Singh (1973), McCaleb (1976), Sandmo (1981) and Koskela (1983b) etc. also have supported this hypothesis. In this respect, Alingham and Sandmo say there is effect of an increase in probability of detection on the increase in reported income. Srinivasan shows the decrease in optimal proportion of understated income due to increase in the probability of detection. Singh (1973) proved that the higher the value of the probability of detection, the lower is the proportion of income understated. McCaleb found increase in the tax payment due to increase in the probability of detection. Accordingly, Koskela saw increase in the probability of detection as a deterrent to tax evasion. Thus, the survey of empirical studies says that the higher the probability of detection, the lower is the tax evasion.

Other Tax Factors

Besides discussed above, there are other tax factors having impact on tax evasion. These factors are tax-withholding scheme, locking scheme in tax system, honesty of tax department etc.

Withholding system of tax can be an effective tool for avoiding the evasion of taxes. Many, countries of the world have made their tax systems efficient by using tax withholding system. Basically, withholding system happens to be effective when there are small number of payers and large number of receivers. However, this scheme cannot function for the income received by professionals, rental income, income from small business, agricultural income and so on. Besides these, Yaniv (1988) who have made work on withholding tax evasion has shown some other demerits too of the withholding system. Firstly, if the withholding rate is less than the income tax rate, there is possibility of not filing the final return by the taxpayer. Secondly, due to the same reason, the taxpayer can hide his income from other sources. Thirdly, the employer can remit less amount of withheld tax to the government than the actual one if the penalty rate is not high. Furthermore, Yaniv comparing between the magnitude of tax evasion in

both the absence and presence of withholding system has shown that a withholding system cannot guarantee a reduction in the amount evaded (1988).

The extent of tax evasion depends on interlocking within the tax system also. Kaldor (1956) recommended joint filing of the returns of income tax, capital gain tax, wealth tax, personal expenditure tax and gift tax to hook to all incomes within the tax net. Accordingly, Higgins (1992) emphasised to file joint return of personal income tax, corporation income tax, turnover or sales tax, wealth tax, tax on excess inventory and personal expenditure tax. However, Kaldor and Higgins' system are not practical in real life due to several reasons although they have self-checking features. In this respect, one of the purposes of imposing value added tax system is also the self-enforcement of tax system where actual transaction could be seen due to tax credit provision.

The other factor having impact on the magnitude of tax evasion is the simplicity and stability of the tax law and the extent of honesty of the tax personnel. If the tax law is complex in nature and uses to be changed frequently, taxpayers use to evade taxes. Because when tax law changes, people may alter their consumption basket, give new directions to their accounts, change reports to be given to tax office and under take a range of other activities (Slemrod and Yitzhaki 2000). Certainly, these changes in taxpayer's behavior are directed to tax evasion. Similarly, the guidelines for improving tax administration in developing countries published by UN declares,

"...the most formidable obstacles to the improvement of revenue collection performance have been unsuitable administrative techniques and methods".

Thus, a major cause of tax evasion in developing countries lie on administration itself and its behaviour towards taxpayers. According to Chandler and Wilde (1992), as the percentage of bribe paying taxpayer and bribe accepting tax auditor decreases, the performance of the tax system increases. Chu (1981) found 94 percent of taxpayer and 46-54 percent of accounting professionals paying bribes in Taiwan. Milliron (1985) stated that if the tax administration is efficient and honest, its treatment to taxpayer would be fair. Instead, if it is inefficient and corrupt, it will create unnecessary complexity to taxpayer and the result becomes the influence on the magnitude of tax reporting. This unnecessary complexity on the other hand increases the tax evasion directly or via collusion of taxpayer and tax official or taxpayer, tax official and tax auditor. It should be noted that the bigger the corruption, the larger is the shadow economy (Ernest and Schneider 1998) and the richer the taxpayer, the greater is the gain to him (Hindriks 1999).

TAX EVASION AND ITS CONTROL IN NEPALESE CONTEXT

In Nepal, tax evasion has been a major problem ever since the inception of the tax system. HMG/N (1988/89) has stated this problem. Hundreds of thousand of revenue is leaked every year, although there is not any empirical study regarding the loss of revenue through tax evasion. The income tax base of Nepal is very small in comparison to other developing countries. In terms of GDP it is only around 1 to 2 percent. Only one percent of the economically active people pay taxes. HMG/Nepal (1995) has stated that 40 percent of the present revenue is leaked and if the system is improved it can be collected. One of the reasons of being so small tax base is also the tax evasion.

The mechanism to combat against the tax evasion is also devised from time to time in Nepal. In this regard, Income tax Act 2031 has been amended many times making it compatible to present situation. Self-assessment system was introduced ten years ago to make the taxpayers, tax auditors and the tax officials responsible while assessing the tax. House rent tax rate was reduced to flat 15 percent altering from global to scheduler system. Considering the high tax rate as the main cause of tax avoidance and evasion, the marginal rate was reduced to 20-30 percent from 55-60 percent. *Revenue Group* within Ministry of Finance was created to make the employees more efficient and safe in their job. Full tax exemption system, especially, the tax holiday was abolished since 1997 to close the loopholes in the tax system. But after all these activities too, there is no sign of substantial increase in the number of taxpayers and the amount of revenue collected from income tax in Nepal. The number of taxpayers is still low in comparison to economically active population. The rate of increase in taxpayers is disappointing. The amount of income tax collected is still less than 2 percent of GDP. According to Harvard University Study Group (1997), even if 20 percent of the GDP is taxed at a rate of 15 percent the revenue would be 3 percent of the DGP or almost double of the current yield. All these factors indicate that there are some problems in Nepalese tax system, among which tax evasion is the major one. Earnest and Schyneider's (1998) finding that there exists 39.2 percent underground economy in developing world supports the Nepalese condition also very nicely.

From the observation of findings of different studies stated in earlier pages, it is known that within tax regime; penalty rate, probability of detection, magnitude of withholding, coordination and fairness in tax administration etc. have effect on tax evasion. Tax rate on the other hand have indeterminate effect. While reforming the tax system to reduce tax evasion, Nepal has done the work going to just opposite direction of the

above findings. Tax rate whose effect is still not clear on tax compliance, is reduced but the penalty system, probability of detection, and administration system that have direct effect on tax evasion are not improved as required. For example, Nepal's penalty provisions for not complying with tax rules are very minimal such as the penalty for those who do not keep the account books properly is Rs. 5000/-, for those who do not deposit the tax withheld is Rs. 500/-, for those who shows fake documents is the amount equal to the loss occurred in revenue due to submission of fake document or two years' imprisonment or both, for those who violates Income Tax Regulations 1982 is Rs. 1000 etc. The probability of detecting the evaded tax is also very low in Nepal. Although, Revenue Investigation Department has been established to find out such type of fraud committed by taxpayer himself or in collusion with others, it has not been able to perform its duty properly. There are only a few cases where Revenue Investigation Department has been successful in detecting the fraud. The revenue administration system in Nepal is neither fair nor efficient. Usually, the tax assessment is made either in ad hoc basis or in collusion. There are only a few officers who perform their duty transparently. Self-assessment system is not working properly. Accordingly, there is lack of coordination and efficient communication between inter and intra offices within Ministry of Finance. Besides these tax factors, there are some non-tax factors are the unequal treatment of one section of taxpayers in comparison to others. The exemptions and deductions provided in past is the example of unequal treatment to different section of taxpayers differently in Nepal. In one survey, it was found that a taxpayer wishes to evade is determined on the basis of his perception of the fairness of fiscal treatment, with respect to both governmental supply of public goods and the perceived behavior of other taxpayers. The coercive powers of the State and the taxpayer's attitude toward risk determine the extent to which this desired level is undertaken in practice (Bordignon 1993). Accordingly, inefficient and lavish expenditure from the revenue collected through tax also another cause inducing tax evasion. Although, there is no such empirical study in Nepal showing these factors as the determinant of evasion, one can reach to these conclusions from the study made abroad.

As already stated, there are no such empirical studies which have examined the factors leading to tax evasion in Nepal nor is easy to do due to unavailability of the authentic data of the related field. However, some Tax Inquiry Committees and Study Teams have give some spaces to state the tax evasion problem. In this respect, HMG/Nepal Tax Clearance Commission 1990 (1992, pp. 3-5) has shown ineffective penalty system, lack of efficient withholding system, lack of enforcement of self declaration system, frequent changes in tax system, lack of good information system etc. as the causes of low tax reporting. HMG/N (1991) suggests the ways to

enhance productive sector of the Nepalese economy and states lack of information system lack of interlocking system lack of enforcement, high tax rate and lack of effective system of appeal as the main problems of the Nepalese tax system. In the observation of HMG/N (1995), unscientific tax assessment, traditional administration, weak information channel, impractical rules and regulations and lack of reward and punishment system are the main responsible factors for small base of income tax in Nepal. Harvard University Study Group also has similar views emphasizing more on arbitrary penalty system, ineffective appeal system, corruption in administration etc. as the responsible factors to erode the tax base. Dahal (1991) pinpoints the administration system for taxation problem in Nepal. To summarise, the main determinants of tax evasion in Nepal can be categorized into three parts viz. lack of efficient and transparent administration, lack of strict penalty and legal system and lack of efficient information and coordination system.

Recently, HMG/Nepal has brought new Income Tax Bill named Income Tax Act, 2000 in public for discussion. The main purposes of the proposed act are to broaden tax base, make self-assessment system effective, reduce discretionary right and define authority of tax administration, separate administrative and judicial rights. The meaning of the changes in the provisions of present tax law means old provisions in this regard are insufficient. However, the success of the new act depends on many factors like strictness in penalty system, high possibility of detection of fraud, fairness and efficiency of the government employees, efficient and coordinated system of the government branches and the behaviour of the government associated with its self-discipline in making proper use of the public fund.

CONCLUSION

Evasion can occur where evasion opportunities exist. Evasion is determined, basically, by tax factors such as penalty rate, probability of detection; magnitude of withholding, coordination, information and interlocking system within tax collecting offices and the magnitude of the corruption in tax offices and non-tax factors such as price policy, expenditure pattern, education level of the taxpayer, pay scale of the tax collecting employees and complexity of the law. It is not clear whether the tax rate has impact or not on tax avoidance. In Nepal, tax environment characterised with low level of penalty rate, low level of detection possibility, lack of good coordination and information system, low level of pay to tax employees, high level of corruption, and lack of self-disciplined government expenditure pattern are the factors inducing high level of evasion. In the context of pay level increase of the government employees, the government should improve the assessment and collection system, use strict penalty to all parties which help in tax evasion, improve the

assessment and collection system, use strict penalty to all parties which help in tax evasion, improve administration and information system and convince the taxpayer by its equitable collection and expenditure policy to reduce tax evasion. Only if these policy measures are adopted in new tax law, the government can make false the expression of Plato's that where there is an income tax, the just man will pay more and the unjust less on the same income.

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