

An Economic Analysis of Tax Evasion

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Abstract

Tax evasion poses a challenge to economies: albeit taxation is necessary for maintaining a state that protects both collective and individual freedoms, an inefficient tax system (due to either excessive tax burdens or high compliance costs) can serve as an almost prohibitive barrier to economic activity, thereby affecting market equilibrium (such as supply and demand dynamics). In this regard, Law and Economics methods serve as a valuable tool for understanding tax evasion as an economic phenomenon. This analysis demonstrates, for instance, that taxpayers seek to maximize their well-being through their economic choices, including complying or not. Only by understanding the economic rationale behind tax evasion can we develop economic tools capable of preventing or mitigating it, such as positive incentives for compliance or stronger enforcement measures. This paper will explore the economic aspects of tax evasion, especially its main causes and some of the possible economic deterrents, emphasizing those already adopted in Brazil. The article will be organized as follows: Section 2 summarises the application of Law and Economics on taxation; Section 3 structures the dynamics of tax evasion as perceived through economic lenses; Section 4 addresses economic deterrents for tax evasion, exposing some of the tools adopted in different jurisdictions and specifically in Brazil. Section 5 concludes.

Keywords

Tax Evasion, Law and Economics, Tax Compliance, Economic Analysis

1. Introduction

The main objective of the paper is to verify, from the perspective of economic analysis of law, the main economic aspects related to tax evasion, specifically, the motivations, consequences, and most relevant deterrent tools from an economic point of view. In this paper, the object of analysis will be *tax evasion*, understood as an illegal wilful form of tax non-compliance. The intention is thus to address

the following questions: what drives taxpayers to engage in tax evasion, economically speaking? And what are the ways to deter evasion while ensuring the best economic balance?

To do so, a deductive approach method was used, as well as the method of historical and comparative procedure. In the various phases of the research, documentary and bibliographic research techniques were employed.

This study is organized as follows. In Section 1, the paper introduces the problem of tax paying and economic rationality. In Section 2, the article summarises the application of Law and Economics to tax law and taxation. Section 3 structures the dynamics of tax evasion as perceived by economic lenses. Section 4 addresses economic deterrents for tax evasion, exposing some of the tools adopted in different jurisdictions, specifically Brazil.

The paper concludes by stating that it is possible and necessary to employ the methods derived from Law and Economics to understand the economic rationale behind tax avoidance, especially tax evasion, and thus to predict and deter it by formulating adequate public policies for enforcement and punishment. Regarding Brazil, the paper concludes that while the country's tax law has been adopting several interesting enforcement policies lately, it is necessary to observe the need for a more efficient and simple tax system, so that Brazil may avoid going down the hill of the Laffer curve, losing potential investments, businesses, and tax revenue *because* of its increased tax load and compliance costs.

2. Tax Paying and Economic Rationality

Paying taxes does not seem to be rational or intuitive for the *homo economicus*, as History shows. It is a tale as old as time: from riots against taxes imposed by Rome on Judaea (Goodman, 1987) to modern-day anarcho-capitalists who keep the neoliberal motto "*taxation is theft*" (Caliendo, 2009: p. 41) alive, humankind has a troubled relationship with taxation, which could be traced to the very inner conflict between individual and collective spheres.

It is not only socially, psychologically, and philosophically that humans have a hard time accepting (and complying with) the duty of paying taxes. From an economic perspective, making a choice that will not result in an immediate gain (as opposed to paying a price for a perceivable good or service) is commonly regarded as an irrational behaviour, because, in principle, economic players tend to make decisions that maximize their well-being. Some very important and well-regarded economists, such as Amartya Sen, have stated that the self-interest is not the only behaviour adopted by human beings, that well-being is not the only value in human life, and that a non-self-interested behaviour is not necessarily irrational (Sen, 1985). This is certainly true, but it is also true that the traditional *homo economicus* behaviour is to be expected in many situations and is the basis of economic policies based on tax benefits and rises.

Not to be ignored that, in modern economies, taxes are one of the most powerful public means of interfering with private autonomy (Carvalho, 2021);

moreover, according to neoclassical economics, they produce distortions in the price systems of the market and, consequently, the balance between supply and demand (Carvalho, 2021: pp. 269-270).

In Brazil, as in many Latin American countries, it could be argued that taxes get an even worse reputation, as its imposition has once been used indiscriminately by late monarchies to exploit the colonized citizens (similarly to the exploitation of land and natural resources). It is not a coincidence that one of the most famous Brazilian historical figures, Joaquim José da Silva Xavier “Tiradentes”, was executed by Portuguese colonial rule for being a member of a revolutionary movement that envisioned independence from Portugal, fuelled by the charging of the *quinto* by the colony, a tax of twenty percent of the gold extracted from Brazilian soil (Balthazar et al., 2014).

Even as an independent republic, some of the anti-taxation *ethos* in Brazil could be credited to political conflict, recent corruption scandals, and a lack of trust in the government and its institutions. There is, however, a strong economic factor for tax evasion, like in other economies around the world.

Tax avoidance is a broad concept, that comprehends both legal and illegal methods for reducing one’s tax load. Not to be forgotten, moreover, that some tax understatement may derive from sheer error, ignorance, or confusion (Slemrod, 2007: p. 26). At this point, it is important to properly establish the difference between tax avoidance and tax evasion as categories of response to taxation.

Literature appears to have found common ground in that tax avoidance refers to reducing taxes by legal means, “for instance by exploiting tax-loopholes”, whereas evading is an illegal reduction of tax burden, by underreporting, for example (Kirchler et al., 2003).

Similarly, Brazilian doctrine addresses the matter differentiating avoidance and evasion according to the legality of each practice: whilst avoidance¹ is constituted by a licit act previous to the taxable event that aims to defer, reduce or avoid the tax burden, evasion configures an illicit act, often involving artificial businesses, illegitimate use of legal gaps, and abusive usage of legal institutes with the purpose of achieving secrecy in one’s taxable operations (Iglesias & De Oliveira, 2019: pp. 150-151).

As counterintuitive as it might seem, taxation is also vital for the very existence of civilization since economies and their laws are not free of costs, the maintenance of public services and guarantees, from law enforcement agencies and public health care to monopoly-free markets and intellectual property protection, is costly, and it is not possible to make ends meet without compulsory pecuniary contributions from citizens who benefit from them, directly or not (Torres, 1991: p. 53; Holmes & Sunstein, 1999: p. 78).

While there are plenty of reasons to *render unto Caesar the things that are Caesar’s*, tax avoidance, especially in the form of tax evasion, is a widespread

¹Brazilian literature majorly adopts the word “elision” for “avoidance”.

practice that provokes serious effects such as affecting the legitimacy of the tax system, distorting tax neutrality, violating fiscal justice and equity, and compromising the efficiency of public services (Caliendo, 2009: p. 348).

In a macroeconomic and political perspective, tax evasion may lead to a reduction in economic growth, decrease in the country's reputation, impact on moral, and even, sometimes, increase in corruption and inflation (Khanal, 2019: p. 11), in addition to compromising equality by granting the evading taxpayer illegitimate advantage.

Although there is no exact, reliable data on the extent of tax evasion since self-reports are “*vulnerable to substantial underreporting*” (Slemrod, 2007: p. 26), studies from the end of last century have estimated that the tax gap in industrialized Western countries represented 5% to 25% of potential tax revenue; those percentages might rise to 30% - 40% in underdeveloped countries (Tanzi & Shome, 1994: pp. 328-337).

3. Brief Considerations on the Economic Analysis of Taxation and Tax Law

In this section, the study will provide a summary of the most important methods and concepts of Law and Economics addressed by the literature regarding tax law, to prepare the ground for the economic analysis of tax evasion. It does not intend to be exhaustive, leaving to further studies the goal to produce a bibliographic review on the matter; it aims simply to expose the importance of wearing economic lenses to correctly comprehend taxation as a legal phenomenon, and to identify the main practical contributions and applications of Law and Economics for tax law, especially for this paper's subject.

In contrast to the traditional belief that law should be comprehended as a separate reality and an autonomous discipline, Law and Economics arrived at the scientific community claiming to be an opportunity to complement legal studies with a scientific, epistemologically objective method (Carvalho, 2021). It is generally described as “*the use of economic theories and econometric methods for the exam of Law and legal institutions*” (Caliendo, 2009: p. 14).

As complex as its postulates may be, it commonly adopts two basic approaches: positive analysis (descriptive nature; intends to explain legal dynamics under economic lenses) versus normative (what should or could be to achieve a maximum level of efficiency) (Caliendo, 2009: p. 14). In other words, the positive approach aims to predict the effects of legal rules and instruments, while the normative branch is oriented towards policy-making according to the best allocative efficiency.

An alternative division of the economic analysis for methodological purposes, which, however, could be juxtaposed to the positive versus normative structures, considers three levels: assessment of the effects of the studied norms; clarification of the fundamentals of the norms through a consequentialist analysis (that is, judging the effects of the norms); and valuation of the existing norms, as well as

making recommendations of possible more adequate norms that could be adopted (Mackaay & Rousseau, 2008: pp. 666-669). In that model, the first two stages have a positive nature, while the last level has a normative logic.

In that sense, it is fundamental to make a commentary on the concept, or to be precise, *concepts*, of efficiency for economics since it may diverge incredibly on an individual basis.

It is understood that economic efficiency is connected to maximizing certain social assets (some of the most maximized are utility, money, human wealth, and happiness) (Kerkmeester, 2000: p. 386). To quantify such maximization, the Pareto Optimal Solution is an objective criterium that considers a certain policy efficient or *maximizing* if it provokes gains for all the parties involved, that is, if said utility does not worsen the scenario of any of the impacted parties (Caliendo, 2009: p. 74).

Nonetheless, given that in contexts like public policies (such as taxation) it is nearly impossible not to produce losses for at least a group or two, a better measure of efficiency would be the Kaldor-Hicks model, which tolerates some degree of loss if the cost-benefit ratio is positive (Caliendo, 2009: p. 74). It is worth noting that the idea of efficiency has been long debated (the Posner-Dworkin debates being the warmest ones (Posner, 2003: p. 10)² (Caliendo, 2009: p. 76); even in the restricted field of taxation efficiency, studies diverge greatly. But some key factors are common ground: the tax sources vary according to each economy; administration costs matter when determining the taxation forms; the political regime may imply certain choices of taxes; fiscal turbulences and elections are correlated; there is a link between economic growth and the tax load; tax structures influence policies and economic choices; and constitutional limitations to taxation produce positive effects over economic efficiency (Caliendo, 2009: pp. 92-93).

3.1. Theoretical and Conceptual Contributions

Albeit being a movement formed by diverse scholars and schools of thought, we will summarize those whose contributions show special relevance to the phenomenon of tax evasion.

The Coase theorem: taxes as transaction costs

In his seminal work “The Nature of the Firm” (1937) and “The Problem of Social Cost” (1960), Nobel prize winner Ronald Coase built the basis of what would later be known as the Law and Economics movement by noting that transaction costs are fundamental in determining the structure and functioning of economic organizations. The author’s original goal in writing the paper was to critique the Pigouvian theory, which considered that it was necessary that the government intervened (through taxes, for example) to force the internalization

²For Posner, “*efficiency means exploiting economic resources in such a way that value, human satisfaction as measured by aggregate willingness to pay for goods and services, is maximized*” (Posner, Richard. *Economic Analysis of Law*. New York: Aspen Publishers, 6th ed., 2003, p. 10). Dworkin raises questions surrounding wealth as an end per se or a means to achieve greater social values.

of external damage by the economic agents, according to Pigou, in the absence of said intervention, the agent would be compelled to over-engage in the harmful activity (Miceli, 2017: p. 25).

However, Coase highlighted that in a world with zero transaction costs, the market would be efficient, and companies would not exist, as all transactions would be coordinated through contracts in the market. Due to the existence of transaction costs, such as information search, negotiation, and monitoring, companies emerge as mechanisms to minimize these costs and allow efficient coordination of economic activities internally (Coase, 2013). Thus, Coase's work provided a fundamental theoretical framework for understanding the nature and function of businesses in a market economy.

Although there are no significant in-depth studies applying the Coase theorem implications to the field of taxation, Caliendo notes that taxes can be comprehended as transaction costs, both *stricto sensu* and *lato sensu* (that is, according to Coase). The first, because it constitutes a cost for legal transactions; the latter, for being "a cost that is verifiable by using market mechanisms" (Caliendo, 2009: p. 22).

The author concludes by stating that taxation must be treated as a transaction cost (as in the Coase theorem) especially when it comes to themes such as tax incentives, bureaucracy, sanctions for tax-related infractions, and tax evasion (Caliendo, 2009: p. 23).

Richard Posner: taxation and wealth maximization

Prolific author, legal scholar, and former judge Richard Allen Posner posed a crucial role in the Law and Economics movement by publishing the very first systematic work on economic analysis of various legal fields. His academic work emphasizes the importance of economic efficiency in the formulation of laws and the interpretation of judicial decisions, arguing that legal rules should be evaluated based on their impact on incentives and the efficient allocation of resources, which constitutes a criterium of intrinsic rationality (Caliendo, 2009: p. 47).

Posner also addressed specifically the taxation subject by opposing pure formalist understandings of tax-related events, such as the discussion of the business purpose *versus* the substance over form (protagonist of the *Gregory v. Helvering* case in 1935) (Caliendo, 2009: pp. 51-52).

New Institutional Economics (NIE): the institution of taxation

The two main postulates of NIE, "*institutions do matter*" and "*the determinants of institutions of institutions are susceptible to analysis by the tools of economic theory*" (Williamson, 2000: pp. 595-613), are evidence of its rupture with Neoclassical Economics.

It proposes an evolutionary focus on the economy by studying the institutional environment (the "rules of the game" that guide individual behaviour) and institutional arrangements (that drive the choices and objectives in specific economic relations, such as contracts and firms) (Caliendo, 2009: p. 54). Those arrangements reduce uncertainty by "*providing a structure to everyday life*"

(North, 1990: p. 3) and are spontaneous; moreover, social conventions are non-cooperative Nash-equilibrium solutions, given their lack of mutual commitment (Caliendo, 2009: p. 54).

The NIE school has a very prolific contribution to tax law and economics. One of the main contributions is known as the “*free rider problem*”, which will be addressed later in this paper.

A game theory of taxation

Game theory as an economic model³ is a simplified form of social reality applied to study the strategic interaction between rational agents, by modelling situations in which the decisions of one agent directly affect the results of other agents. According to the theory, players seek to maximize their own results, taking into account the choices of others (Caliendo, 2009: p. 60).

Game theory analyses different types of games, such as zero-sum games, collective action, and cooperative bargaining games, and seeks to identify optimal strategies for each player, as well as stable equilibria where no unilateral change brings an advantage (Caliendo, 2009: pp. 61-63).

It is widely applied in various fields, including economics, political science, biology and, more recently, law, being especially helpful to the field of tax law as a tool for the proper understanding of taxation, tax evasion, and tax policies.

Public choice school: taxation through the lenses of collective choice models

Public choice refers to a school of social science that adopts economic and behavioral methods to collective institutions, formal or informal, based on key elements such as “*methodological individualism, constrained utility maximization for all human agents, high transactions costs, and incomplete and/or asymmetric information*” (Munger, 2015: pp. 534-535).

In the field of taxation, public choice postulates are especially useful to policy making through normative and positive analyses of collective choice in public economy, assessing predictable policy outcomes and eventual theoretical problems related to stability of equilibrium (Hettich & Winer, 2004).

It should be noted that authors diverge on which approach to adopt concerning the efficiency of taxation in a public economy perspective, illustratively, Shaviro points out that “*the aim of efficiency analysis of taxation is to minimize the harm done, rather than to achieve a first-best optimum*”, which may observe two alternative approaches: tax neutrality or differential taxation in response to distinct rationales (Shaviro, 2017: p. 111).

3.2. Economic Instruments for the Analysis of Taxation

Having summarized relevant considerations of some of the main branches of Law and Economics movement applicable to tax law, we now proceed to briefly address key rules and tools derived from economics that greatly contribute to an economic analysis of taxation.

³Not to be forgotten that game theory is also a branch of mathematics.

Relevant public economy rules for tax efficiency

Considering the correlation between tax evasion, tax policies and public economy, for a normative analysis, it is important to briefly summarise the economic rules applicable to the basic elements of public finance, which are discussed by authors.

In a more consequentialist perspective, Hettich and Winer list as outcome-oriented efficiency rules the lump-sum taxation as a standard of reference, the minimization of total excess burdens (related to the theory of optimal taxation), tax neutrality (which arguably would be more efficient than a badly implemented optimal taxation), and harmonization (neutrality in an international or interregional context; fiscal coordination) (Hettich & Winer, 2005: pp. 112-117).

From a process-oriented point of view, the authors consider the importance as the approaches of a comprehensive tax base (which depends on the concept of horizontal equity), limiting the government's power to tax, applying the generality principle, and time consistency (neutrality over time) (Hettich & Winer, 2005: pp. 117-121).

The optimal tax and the Laffer curve

Finally, a key concept for analysing taxation from an economic perspective is the optimal tax, which is connected to the Laffer curve. The model proposed by Arthur Laffer implies that raising the tax rates will only generate an increase in tax revenue to a certain point; past this *optimal taxation point*, the revenue decreases by lack of realization of the taxable events (Carvalho, 2021: p. 271).

Indeed, the Laffer curve is a concept of great interest for policy making, leaving room for rich empirical research on the matter of a maximum tax burden. A recent study has structured a model through a statistic approach for the prediction of a top tax rate in the Laffer curve with quantitative guidance (Badel & Huggett, 2017).

Another illustrative example of the potential of empirical research on the Laffer curve is a study on optimal taxation in 41 developing economies, including Brazil, which assessed linear and nonlinear relationships between total taxation and economic growth rates (Menescal & Alves, 2004).

Perhaps one of the most prominent functions of Law and Economics in the scope of taxation is to verify if taxes, as economic incentives/transaction costs (according to the Coase theorem), work to increase efficiency, i.e. through reducing tax evasion (Caliendo, 2009: p. 268). In other words, it is a powerful tool for studying the effectiveness of taxes, being highly appropriate for studying ancillary obligations (such as tax returns), the correlation between prices and taxes, and tax incentives, for example (Folloni & Simm, 2016: pp. 15-17).

4. The Economics of Tax Evasion

Prima facie, from the economic basis summarized throughout the previous topic, it is intuitive to observe that taxpayers, using their limited rationality, act to maximize their well-being, which often leads them to avoid costs, of which taxes are a prime example (Carvalho, 2021: p. 264). In that sense, it is rational *not* to con-

tribute by paying taxes; avoiding or evading is individually the best-maximizing choice, albeit the worse collectively.

However, that is a rather limited model that would imply much higher levels of tax evasion than effectively observed; that is why it is important to go deeper than a surface-level take on economic factors for such a phenomenon. The most relevant aspects will be addressed as follows: first, considering a positive perspective; then, from a normative perspective.

4.1. Positive Analysis

Tax avoidance is a complex and dynamic phenomenon influenced by a wide range of factors. For instance, complexity and loopholes in tax law can create opportunities for tax avoidance via exploitation of ambiguities or gaps. Economic factors such as recession, inflation, or changes in market conditions can also affect tax planning decisions, leading taxpayers to adjust their strategies in response to economic pressures or opportunities.

Moreover, in an increasingly globalized economy, businesses and individuals may engage in cross-border transactions to take advantage of differences in tax rates and jurisdictions, leading to opportunities for tax avoidance. Advancements in technology might also be a factor, as they provide new tools and methods for tax planning and evasion.

With that nuance in mind, however, we will concentrate on the most important economic theories of tax evasion in the literature.

When addressing an economic analysis of general criminal activity, Cooter and Ulen (Cooter & Ulen, 2021: p. 463) draw a predictive model of criminal behaviour based on the notion of rational crime, derived from the rational choice theory.

In such model, which considers as a premise a “rational, amoral person”⁴, the authors relate two axes of variables, “**seriousness of a crime**” and “(expected) **punishment**”, producing the curve “(expected) **payoff**”, which slopes up as the punishment more severe the more serious the crime (Cooter & Ulen, 2021: pp. 463-465).

The theory points out that, in conditions of strict rationality, the agent assesses their net gain from a hypothetical criminal activity by pondering the expected punishment legally provided, and administratively enforced, according to the seriousness of the misconduct.

That same rationale can be used, to certain measure, to establish a predictive model of rational tax evasion, where the taxpayer considers expected tracing and punishment to a hypothetical evasion (depending on the degree of the illicit according to legislation) to assess the expected (financial) payoff obtained by omit-

⁴Perhaps the most common criticism to the Law and Economics movement is the usage of rational choice theory, especially in its early stages (which were closely related to Classical Economics). Such concept ignores both psychological and social factors that may conduct an individual to a determined choice, such as guilt, morality, social norms, or poverty. Cooter and Ulen state the importance of considering hypotheses of diminished rationality in criminal behaviour.

ting the taxable events and consequently failing to pay the due taxes.

In a similar sense, in their very prolific works on the economics of tax evasion, Allingham and Sandmo adopt the deterrence model, which estimates that tax evasion is a rational choice under risk, like gambling (Allingham & Sandmo, 1972: pp. 323-338). In that sense, the optimal tax evasion rationale considers the “*chance of getting caught and penalized, the size of the penalty for evasion, and the individual’s degree of risk aversion*” (Slemrod, 2007: p. 36). It should also be noted that since compliance costs are transaction costs⁵, the decision not to report might consider the resources spent on reporting, auditing, and such, other than only the direct tax costs.

The Allingham-Sandmo model is complemented by Yitzhaki’s contribution concerning the differences between income understatement and tax understatement, the latter being, according to the author, usually more accurate, meaning that tax rates do not impact the tax evasion gamble (Yitzhaki, 1974: pp. 201-202). However, as pioneering as Yitzhaki’s work on behaviour patterns of the tax evader has been, empirical research has resulted in contradictory findings, showing that reported income decreases with the tax rates. That difference is known as the “Yitzhaki paradox” and might be related to psychological factors, i.e. guilt (Morita, 2014). It is saying, therefore, that the correlation between tax rates and tax evasion is still inconclusive.

Further approaches have perfected theoretical studies on tax evasion using game theory models, like the Graetz et al. games, which considered both the taxpayer’s choice of whether to evade or not taxes (evasion probability) and the tax authority’s choice either to audit or not (audit probability) (Graetz et al., 1986: pp. 1-32). Lipatov games have also considered the correlation between transaction costs and evaded amounts (Lipatov, 2017: pp. 92-102), and the variable of the price paid by firms to tax specialists hired to help them structure evading strategies (Lipatov, 2017: pp. 92-102).

Complementarily to those models, in a foundational work, Slemrod addresses other relevant variables such as personal risk exposure, tax rates, audit chances, and the possibility to underreport as relevant for the decision to evade, compiling a series of empirical data (Slemrod, 2007: p. 36).

Concerning personal risks, the author states that several studies have noticed that individual decisions on whether to take the risk of noncompliance relating to one’s taxes often show higher degrees of risk-aversion, in comparison to decisions taken by corporate agents of corporations (notably large ones) regarding the firms’ tax reports (Slemrod, 2007: p. 36).

Nevertheless, subsequent studies have resulted in scarce empirical evidence towards the separation of tax declarations by firms from the personal tax evasion choices of their decision makers (Goerke, 2006: pp. 281-292).

An interesting finding reports that increasing audit chances has varying ef-

⁵As noted by CARVALHO (op. cit., p. 273), such compliance costs are not only perceived by taxpayers but also by the tax authority, who expends higher administrative resources to enforce taxation (by hiring more trained tax auditors and buying better computers, i.e.).

fects on noncomplying taxpayers. While low-income taxpayers are more prone to show increased risk aversion when receiving audit notices (which results in more detailed reporting), high-income taxpayers tend to view audits as opportunities to negotiate with tax authorities, therefore reporting less information and leaving it for the audit to scrutinize, which may or not result in punishment. It is also important to note that higher-income taxpayers often find means to control the probability of evasion detection by measuring the “*traceability, deniability, and ambiguity*” of information provided in tax reports (Slemrod, 2007: p. 37).

Behavioral models have noticed, however, that an individual’s level of risk aversion and simple cost-benefit calculations are not sufficient to explain non-compliance; in fact, some studies point out a series of both intrinsic and extrinsic motivations that lead taxpayers to comply or not to tax liabilities, such as “civic virtue”, patriotism, fear of punishment (official penalties, or social ones, i.e. loss of social reputation), and the perception of fairness of the system are influential in the decision to comply (Slemrod, 2007: p. 37). In that sense, perhaps the most important contribution of the fascinating studies of NIE is the *free rider problem*, a concept built to explain opportunistic behaviour that earns individual gains from others’ actions (Caliendo, 2009: p. 56). According to Douglass North, this concept explains that conducts are not only based on cold, rational cost-benefit calculations, but also on social values (North, 1990: p. 24).

Those behavioral theories also cite that the will to cooperate, the context in which the taxpayer is inserted, their perceptions of the fairness of the tax system, and even bad conscience are important aspects. Taxpayers that agree with the usage of tax income through government policies, for example, are shown to be more prone to voluntarily comply, whilst corruption undermines that civic initiative; contexts that appeal to the citizens’ patriotism such as war times are also relevant (Slemrod, 2007: p. 39).

More recently, Clemente and Lírío proposed a theoretical framework to analyse the Brazilian taxpayer behavior and tax actions towards reducing tax evasion (Clemente & Lírío, 2018: pp. 405-407). The authors conclude that intense punishment, such as penalizing taxpayers through high fines or deprivation of liberty penalties, is less effective as a tax evasion reducing policy than investing in tax inspectors to increase evasion detection (Clemente & Lírío, 2018: p. 409).

4.2. Normative Analysis

Optimal enforcement

Considering the last topic, it may seem like enforcing tax compliance to reduce evasion requires all the resources needed, however, economically, it is not optimal to eliminate tax evasion; beyond a certain point, the cost of enforcing tax laws surpasses the revenue thus generated (Slemrod, 2007: p. 43).

Once again, Law and Economics of crime provides useful introductory information for that matter, for it establishes an optimal amount of crime deterrence,

“based upon the goal of minimizing the sum of the harm caused by crime and the cost of deterring it” (Cooter & Ulen, 2021: p. 484).

Analogically, concerning tax evasion, Kaplow points out that even though normative work on the matter is relatively recent in comparison to positive studies, complex assessments have been traced relating an “optimal government expenditure” to the social costs of enforcement (Kaplow, 2007).

Slemrod states that to reach an optimal tax enforcement policy concerning resource allocation (Slemrod, 2007: p. 39), instead of increasing the probability of detection (which implies greater cost, not only of pecuniary nature but also nonpecuniary, such as invasion of privacy), the *social benefit* of the reduced evasion, which is not adequately measured by the increased revenue, should be balanced to the marginal resource cost (Slemrod, 2007: p. 43). In that sense, third-party reporting of information (such as the employers’ tax reports on employee income) might be useful.

The author understands, however, that there is not yet a reliable model on those issues, partly because of the lack of sufficient empirical knowledge on its effects.

Economic tools for tax compliance enforcement

If it is economically rational for taxpayers not to contribute, could it be possible to use economic tools to enforce tax compliance?

Literature has listed several policies and methods to make tax systems more efficient, such as enlarging the taxpayer base; making simple, objective tax rules; prioritizing the tax incidence over goods and services of inelastic demand; achieving fairness; and aiming for low administrative costs (Carvalho, 2021: p. 270).

Regarding deterrents to tax evasion, they can represent both higher enforcement/punishment policies and positive incentives. While it is easy to think of punishing deterrents, Brazil has a strong case for a positive enforcement measure that configures a notable anti-evasion policy involving cooperation and tax citizenship.

Several Brazilian States and Municipalities have adopted programs to stimulate the emission of invoices (and consequent reporting of the taxable event of ICMS⁶ and ISS⁷ to the competent authorities). Such programs grant pecuniary rewards to citizens who ask vendors to emit the respective invoice when selling goods or services. Each invoice has the buyer’s CPF (individual taxpayer registration), and the due reward is calculated using the value of the tax paid by the seller (Folloni & Bubniak, 2017: p. 72); it also grants an additional chance of winning special prizes in relevant amounts.

Therefore, it not only delegates to citizens the shared responsibility of enforcing the sellers’ tax obligations; it also tracks potential buyers’ evasion by comparing their acquisitions (checking the invoices that have their CPF on them)

⁶ICMS is a state tax that applies to the movement of goods, transportation, communication services, and other general supplying of goods.

⁷ISS is a municipal tax that applies to most services.

and the reported income in their tax returns.

It is ingenious as an enforcement measure: firstly, it appeals to taxpayers' voluntary sense of maximization; and second, it is a situational prevention technique, that is, not only connected to formal social control (i.e. the tax administration) but most importantly, to informal control (family, moral, and so on) (Folloni & Bubniak, 2017: p. 82).

Still from a behavioral perspective, it has been noted that when it comes to prevent re-occurrence, enforcement measures that fuel resentment towards compliance and tax authorities are less effective than reintegrative ones (Murphy, 2008). Also interesting is the delegated tax responsibility. A classic example from tax law textbooks consists of how indescribably easier it is to tax and police ten Coca-Cola factories than ten thousand bars; for that reason, in specific segments, the law determines that big, relevant taxpayers are responsible for effectively paying the taxes for the whole chain, making the enforcement easier and less costly.

However, the policies cited above currently apply to consumption taxes. In the case of income taxes, the most relevant means of better enforcement is the third-party reporting, especially the obligation of employers to report their employees' wages and to withhold the corresponding tax.

That efficient system of delegated reporting is also adopted in other countries, like the United States of America (Internal Revenue Service, 2024). Nonetheless, it leaves a gap for self-employed taxpayers, whose "*business income is not subject to information reports, and its estimated noncompliance rate is sharply higher*" (Slemrod, 2007: p. 29).

Presently, it should also be noted that tax reform proposals around the globe aim for adaptation to structural conditions and political institutions, and their interactions, which leads to a "*trend toward revenue-neutral taxation oriented toward internalizing externalities*" (Kiser & Karceski, 2017: pp. 75-92).

It must be noted that Brazilian tax authorities have been investing significantly for the last twenty years in an integrated system of information concerning market operations, corporate finance and accounting, capital gains, and any other relevant information for taxation, to provide impressive close scrutiny of taxpayers⁸. While it is far from perfect, especially considering the increased compliance costs that come from a multitude of different tax reports, such an intricate system is an undeniable ally in the fight against tax evasion.

More broadly, in the scope of anti-evasion norms and programs, the Organization for Economic Co-operation and Development (OECD) has been developing a global action plan to address base erosion and profit shifting, BEPS, which include tax policy analyses and statistics, the promotion of tax treaties, and transfer pricing rules (OECD, 2013).

Such movement against tax evasion can also be observed in domestic norms. In Brazil, an important (albeit somewhat controversial) legal measure is the sole

⁸It builds the popularly known "fine mesh".

paragraph of the Article 116 of the National Tax Code (CTN), which allows the tax authority to disregard acts carried out with the purpose of concealing the occurrence of the taxable event or the nature of the constituent elements of the tax obligation (Brazil, 1966)⁹.

The forementioned provision has recently been discussed by the Plenary of the Supreme Federal Court (STF), which, by majority vote, upheld its constitutionality in the judgment of Direct Action of Unconstitutionality (ADI) 2446. The action was filed by the National Confederation of Commerce of Goods, Services and Tourism (CNC) against Article 1 of Complementary Law 104/2001, which added the sole paragraph to Article 116 of the CTN, under the argument that the provision allows the tax authority to tax a non-occurred taxable event as provided by law.

In the leading vote of the judgment, the rapporteur, Justice Cármen Lúcia, noted that the disregard authorized by the provision is limited to acts or legal transactions carried out with the intention of concealing or hiding taxable events. The rapporteur also argued against the confederation's claim that the provision removes incentives or establishes prohibitions on tax planning for individuals or legal entities. In other words, according to the decision, the norm does not prohibit taxpayers from seeking tax savings through legitimate means, conducting their activities in a less burdensome manner, and thus avoiding paying taxes when the taxable event whose occurrence has been lawfully avoided is not configured (Supreme Federal Court, 2022).

5. Conclusive Notes

Taxes are the price of freedom (Torres, 1991: p. 3). For that reason, the study emphasizes the paramount importance of utilizing methodologies rooted in Law and Economics to delve into the intricate economic motivations underpinning tax avoidance, with a particular focus on the phenomenon of tax evasion. By dissecting these economic drivers, researchers can not only comprehend the underlying mechanisms but also forecast potential evasion patterns, thus enabling the crafting of effective public policies aimed at enforcement and deterrence. This multifaceted approach underscores the necessity of comprehensive strategies that go beyond mere punitive measures to tackle tax evasion at its core, addressing both the incentives for non-compliance and the systemic flaws that facilitate it.

Turning attention to Brazil, the analysis underscores recent strides in the country's adoption of diverse enforcement policies within its tax framework. However, it also highlights a pressing imperative for the nation to reassess the

⁹Article 116. Unless otherwise provided by law, the taxable event is considered to have occurred and its effects to exist: I, in the case of a factual situation, from the moment the necessary material circumstances occur to produce the effects that are normally inherent to it; II, in the case of a legal situation, from the moment it is definitively established, according to the applicable law. Sole Paragraph. The tax authority may disregard acts or legal transactions carried out with the purpose of concealing the occurrence of the taxable event or the nature of the constituent elements of the tax obligation, subject to the procedures to be established by ordinary law”.

structure of its tax system. Recognizing the risks posed by an overly complex and burdensome tax regime, the study advocates for reforms aimed at streamlining procedures and reducing compliance costs. By doing so, Brazil can navigate away from the pitfalls associated with the Laffer curve, safeguarding against potential declines in investment and tax revenues that may arise from excessive taxation and administrative burdens.

This recalibration holds promise for fostering a more conducive environment for economic growth and fiscal sustainability in Brazil.

Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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