



## Tax reforms and tax evasion, possible causes

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### Abstract

The development of a country, as well as the sustainability of its fiscal policies, and its impact on social and economic policies, depend mainly on its tax system. Tax revenues allow for financing the expenses of state administration and the provision of public goods and services. The general objective of this research is to determine the relationship between tax reforms and tax evasion in Ecuador. Through a systematic literature review and a survey validated by experts, it is determined that among the most frequent causes for tax evasion are: ignorance or legal complexity at 38%, followed by the existence of mild legislation for non-compliance at 23%, Government Distrust with 18%, Inflation and Tax Pressure with 12%, and determining 9% for the Existence of an informal economy, permanent regularization regimes, and taxpayer behavior. Concluding that there is a direct relationship between tax reforms and tax evasion, being the most frequent cause of tax evasion.

**Keywords.** - Tax evasion, taxation evasion strategies, tax system, tax policy

### CONTEXTUALIZATION

The tax policy of a country considers progressive taxes such as income tax and regressive taxes such as value-added tax (Jiménez, 2010), however, for several reasons, including tax evasion by taxpayers, it does not meet the needs of the country's budget and directly influences the operationalization of the tax system. Cerqueti and Coppier (2011), cited by Sidani, Ghanem and Rawwas (2014).

In Ecuador, the taxes that contributed the most to tax revenues in the period 2013-2020 were the value-added tax -VAT- at 42%, the income tax -IR- at 29%, tariffs at 11%, and the tax on the exit of foreign currency -ISD- with 8% (Flores, 2019; Mazón, 2023). Regressive indirect taxes account for 40% and progressive direct taxes account for 30% of revenue. In summary, (Faro, 2022) more than 40% of the revenue recorded in the budget comes from tax revenues, which means that it is one of the most important sources of public revenue. The analysis of tax policies and taxpayer compliance is essential.



The Latin American reality in terms of public policies, distribution of wealth, and tax structure has often been questioned by the efficiency of the strategies applied to manage these aspects, which limits the impulse to greater equality and economic and social growth (OECD, 2015; Molina-Granja, 2015).

## TAX REFORMS

Tax policy aims to promote an equitable tax burden, that is, to pay more to the one who generates more income and, in this way, encourage a redistribution of public funds and contribute to the stimulation of employment, the provision of goods and services, and motivate favorable environments for responsible and sustainable social, economic and ecological behavior

Until 2017, six major tax reforms were carried out in Ecuador. These are related to the payment of income tax (IR), value-added tax (VAT), and excise tax (ICE). They are also related to the creation of the tax on the exit of foreign currency; deductibility of personal expenses; and the creation of the Law on Environmental Development and Optimization of State Revenues. Solidarity Law. Manabí earthquake, creation of special contributions, (utilities, dependency ratio, contribution on heritage)

Two tax remissions (forgiveness) were applied in 2015 and 2018. According to data from the Internal Revenue Service (SRI), \$ 971 million were managed for this concept in 2015 and \$ 1,268 million in 2018. In periods of remission, tax collection increases. However, in 2020, due to the effects of natural disasters and the pandemic, VAT and IR tax collection decreased by 16% and 14%, respectively (Faro Group, 2021a; Faro Group, 2021; Molina-Granja, 2022).

Ecuador is above average in Latin America and the Caribbean (LAC) in terms of VAT and social security contributions and is below in income taxes, profits, capital gains, and property taxes, likewise, in 2018, the tax burden stood at 23% of GDP.

As of 2017, new tax reforms were carried out with special regimes, inclusions, and special exceptions, which are detailed in the following table.

Table 1.- Tax Reforms 2017-2022

Year	Tax Reform
2017	Increase from 22% to 25% of the IR for companies, except for micro and small enterprises, and exporters. Reduction of 10 percentage points of the IR fee on the amount reinvested in productive assets.
2018	The Organic Law for Productive Development, Investment Attraction, Employment Generation, and Fiscal Stability and Balance was approved (ANE, 2018), which includes: The exemption of the IR from 8 to 15 years in new productive investments in prioritized sectors.



	<p>The remission of 100% of interest, fines, and charges corresponding to fiscal and tax obligations for certain taxpayers of the SRI, the General Customs Service in Ecuador (SENAE), the National Transit Agency (ANT), the Ecuadorian Institute of Social Security (IESS), Basic Services, Educational Credits and Scholarships, and other institutions.</p> <p>The exemption of the ISD for payments made abroad for imports of capital goods and raw materials.</p> <p>The exemption of 50% of the IR payment of profits for reinvestment in the acquisition of new productive assets.</p>
2019	<p>In December 2019, the Organic Law on Tax Simplification and Progressivity was approved (SRI, 2019), which includes:</p> <p>The elimination of the IR advance and the establishment of its voluntariness.</p> <p>The voluntary IR advance now equals 50% of the tax charged from the previous fiscal year.</p> <p>The anticipated value will constitute a tax credit for the payment of the IR. VAT paid on local purchases or imports of goods may be used as a tax credit for up to five years.</p> <p>Natural persons with net income greater than \$ 100 thousand will not be able to deduct personal expenses.</p> <p>A new applicable regime is established for the payment of IR, VAT, and ICE for microenterprises, including entrepreneurs who meet the condition of microenterprises.</p> <p>A one-time, temporary contribution is established for companies that have generated taxable income equal to or greater than \$1 million in the fiscal year 2018.</p> <p>According to ECLAC (2020), the trend in the region shows that tax expenditures averaged around 2015 and 2019. In Ecuador, they reached: Percentage even higher than the investment in health (2.6%) and education (4.5%) of that year. (Faro, 2022)</p>
2020	<p>The Humanitarian Law was passed. Humanitarian Support Act, including:</p> <p>The voluntary advance of the IR, with the recognition of interests in favor.</p> <p>For the 2020 and 2021 IR returns, domestic tourism expenses will be considered deductible personal expenses.</p> <p>Deduction of 50% of the IR and 50% of the value of the interest received for payment of these loans, with certain conditions.</p> <p>The advance collection of the IR for companies was reauthorized.</p> <p>Creation of the Microentrepreneurs Regime, with changes in periodicity and tax obligations.</p>
2021	<p>Economic Development and Fiscal Sustainability Act (effective 2022):</p> <p>Reduction of up to three percentage points of the IR for new investments.</p> <p>New IR payment table for individuals.</p> <p>Replacement of deductions of personal expenses for the tax credit for natural persons.</p> <p>If the annual gross income is up to USD 24,090.30, the reduction will be 20% of the lower value among personal expenses.</p>



	<p>If the gross annual income exceeds USD 24,090.30, the reduction will be 10% of the lower value among personal expenses.</p> <p>New deductible expenses for companies.</p> <p>New goods are taxed at a 0% rate of value-added tax (VAT).</p> <p>The beneficiaries of the first degree of consanguinity of the deceased are exempt from payment of inheritance tax.</p> <p>Elimination of the special consumption tax on electric and hybrid motor vehicles.</p> <p>Reforms to the Income Tax for Inheritance and Gift Taxes concerning the payment of Inheritances of Direct Heirs.</p> <p>Elimination of Regime as Microentrepreneurs and RISE, creation of Rimpe (popular businesses and entrepreneurs)</p> <p><b>SIMPLIFIED REGIME FOR ENTREPRENEURS AND POPULAR BUSINESSES (RIMPE)</b>, They will benefit from this regime: Entrepreneurs: natural and legal persons with a gross annual income of up to USD 300,000 (as of December 31 of the previous year). Popular businesses: individuals with annual gross incomes of up to USD 20,000 (as of December 31 of the previous year).</p> <p>Those who are part of this regime will calculate the Income Tax to be paid on gross income. For this purpose, "gross income" is understood as the result of subtracting from taxed income, discounts, and refunds.</p> <ul style="list-style-type: none"> <li>• The declaration and payment of VAT shall be made every six months.</li> <li>• For popular businesses, the payment of the fee set out in the progressive table includes the payment of VAT.</li> </ul> <p>Exempt from IR if the alienation is carried out by natural persons, provided that it is real estate intended for housing (including its accessories, such as parking lots, warehouses, or similar) and that it is not related to the line of business.</p> <p>Income Tax will not cause the occasional alienation of real estate in the first transfer of ownership that is made from the entry into force of this law until 5 years after its promulgation.</p> <p>Natural persons are entitled to a reduction in their Income Tax. This reduction is applicable before imputing tax credits. (SRI, 2022)</p> <p>Reduction of three percentage points (3%) of the Income Tax for the development of new investments.</p> <p>Special reduction of up to five percentage points (5%) on the Income Tax rate for the subscription of Investment Contracts.</p>
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	<p>The rates of the Income Tax table for inheritances <b>will be reduced by half</b> if the beneficiaries of inheritances and legacies are within the first degree of consanguinity with the deceased.</p> <p>Special contribution to natural taxpayers and companies with assets exceeding 1 million and 5 million dollars respectively.</p> <p>Progressive reduction of the Tax on the Exit of Foreign Currency (ISD) by one point.</p>
2022	<p>The Organic Law for Economic Development and Fiscal Sustainability is repealed, partially by the CAL and later by the National Assembly.</p> <p>Fiscal instability is generated.</p>

Source: (Faro Group, 2021a ; Faro Group, 2021; Molina-Granja,2022;SRI,2019)

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## TAX EXPENDITURE

In Ecuador, tax expenditure "constitutes any indirect transfer that the State makes to certain groups or economic sectors, made through a reduction in the taxpayer's tax liability." Ecuador maintains a higher tax expenditure than the regional average, even though it has a lower tax collection than the regional average (Suárez, 2020a; Molina-Granja,2022). It is known that one of the main objectives is to increase tax revenues in the medium term, correcting some distorting taxes and reviewing certain tax expenditures (Faro, 2022; Luna-Encalada, 2021; Granja, 2016).

### Type of Tax Expenses

Deductions. - They are costs and expenses attributable to the income or income of taxpayers to obtain the value of the tax base on which it is taxed. Deductions can be total or partial.

Exemptions. - It implies the release of the existing tax obligation canceling totally or partially its effects. The tax exemption presupposes the pre-existence of the tax obligation.

Exemptions. - They are the tax rules that affect the quantification of taxes either in the tax base or in the tax rate. They are generally associated with the elimination of the birth of a tax obligation for a certain population.

### Challenges and Perspectives in Ecuador

According to the SRI, the tax collection goal for 2022 is set at an annual increase of almost 6%, and an extra income of USD 1,900 million in 2022 and 2023, as a result of the reforms introduced in the Economic Development and Fiscal Sustainability Law. Among the actions to achieve greater collection, the country must also put efforts into a reduction of tax evasion, a more progressive tax system, building a more progressive tax system, reviewing tax expenditures, and improving the efficiency of public spending; Quality public spending, Quality public spending.

## TAX EVASION



Tax evasion or tax evasion is the various ways that the taxpayer uses to avoid paying taxes or minimize the payment of taxes that corresponds to him according to current regulations. All strategies are based on the concealment of assets or income from the treasury.

Tax evasion is understood as the breach of tax obligations, the correct non-payment of taxes, which can be caused by social, political, and economic aspects, including credibility or distrust and dissatisfaction with the state and its tax system, the idiosyncrasy of the taxpayer, the excessive tax burden, economic cycles, including ignorance or misunderstanding of reforms, corruption, and inequality, among others (Parra and Patiño, 2010; De Simone, 2020).

It is essential to determine the causes of evasion, and the strategies to face and combat evasion, both the causes and the coping and control strategies are diverse since they exist very specific and very general, it depends on the point of view of the authors and the idiosyncrasy of the country where the evasion occurs.

On the other hand, it is key to note that the causes vary from one country to another and even within the same country over time and moments in its history.

Among the main types of tax evasion are the following:

- Sub-declaration of taxes. - Concealment of undeclared profits or securities, improper valuation of intangibles.
- Tax havens. - Establishment of tax domicile of the company, or changes of the country of residence, to a country with low tax burdens, even if you do not reside in that country.
- Testaferrism. - A taxpayer who is visualized as an administrator of the company, business, or contract, covering up the true tax evader.
- Escrow or trust. - The owner transfers an asset or a company so that a third party can manage it in favor of others, so that there may be multiple beneficiaries including foreigners.
- Legal loopholes and special regimes. - It is tax avoidance, taxpayers and their advisors operate on the verge of legality, and seeks to pay fewer taxes, but are framed in the law and its gaps; Additionally, they can operate covertly in special regimes that motivate an investment or economic growth of the country.
- Government distrust. - The treasury has a structure of the tax system that allows evasion or corruption, with an anarchic distribution of powers among the different levels of government. It can also be about the Inefficiency of the Tax Administration.
- Ignorance or legal complexity. - There is a lack of simplicity and precision in tax legislation, there are many changes, inclusions, and exceptions that confuse the taxpayer.
- Inflation and Tax Pressure. - With inflation, a state can surreptitiously raise the tax burden.
- Existence of a significant informal economy. - There is a lack of control in the proliferation of informal, unregistered, or hidden trade. (Cabrillo, 2021;Granda,2022)



- Regularization regimes permanently (moratoriums, laundering, etc.). - The State has a permanent mechanism for the control and regularization of commercial activities.
- Possibility of failing to comply without major risks. - Absence of sanctions and prohibitions, or very light regulations for taxpayers who do not comply with tax obligations.
- Taxpayer behavior. - It has to do with tax evasion caused by the educational, cultural, social, and economic levels of the taxpayer. The behavior of the taxpayer is also affected by legal uncertainty in tax matters, the constant change of regulations or reforms to the Law generates involuntary ignorance, which has a direct impact on compliance with tax obligations.
- Digital economy. - Use and abuse of e-commerce, collaborative platforms, digital currencies, and new ways of marketing goods and services that increase the difficulties of taxing and controlling,
- Undoubtedly, there are thousands of causes, strategies, and mechanisms of evasion, in this document focuses on the most treated by the authors. (CIAT, 2019)

Additionally, it is difficult to estimate or measure evasion (Castillo, 2022), although there are methods that through macroeconomic and microeconomic variables can determine an evasion approximation (Vásquez, 2022; Araujo, 2021), this evasion can be persuaded through detection and sanctions (Díaz, 2021).

### **Measures to control and prevent tax evasion**

A strategy recommended by CELAC is based on 4 pillars and is part of the trend of the use of ICTs in the digital economy.

1. Quantification of tax evasion as a diagnostic tool. With the development of a country methodology, which integrates the best practices of countries with less evasion, and consensus in estimation and management of the tax system.
2. National Focus.- Promote a massification of electronic invoicing, carry out a segmentation of taxpayers, generate simplified special regimes for small taxpayers, automation of registration operations, and inter-institutional information crossing.
3. International focus. - Establish unilateral measures with an analysis of transfer prices, the generation of abuse regulations, and control of assets abroad. And establish cooperation measures with the automatic exchange of information, among others.
4. Coherence of the tax system. - Prioritize equity and simplicity, strengthening the level of resources available to finance a sustainable development agenda.

The phenomenon of evasion is complex and its causes are diverse, for this, an assessment of the most frequent causes is made and thus faces the problem more effectively. It is appropriate to carry out sectoral evasion studies (CIAT, 2019).



## METHODOLOGY

This paper presents a Descriptive, qualitative, inductive-deductive type of research (Hernández, 2021). A survey is generated as a data collection instrument. As a unit of analysis, the companies that appear in the cadastre of the Ecuadorian business structure are determined, according to the Directory of Companies and Establishments (DIEE), there is a population of 846,265 companies in Ecuador by 2020. For the calculation of the statistical sample, a confidence level of 95% is defined, with a margin of error of 5%, obtaining a sample of 384 companies (INEC, 2020).

The survey was applied anonymously to ensure the veracity of the information and the independence of the respondents. It was applied online through the Google Forms tool. The survey was valid pro experts in the statistical and tax area, using the Delphi expert judgment method, and a *Cronbach's alpha* value of 0.87 was obtained, determining an adequate fidelity. After data collection, information analysis is carried out on the most frequent causes of tax evasion and their relationship with the country's tax reforms. Utilizing comparative statistics, the information collected was processed in search of answers to the proposed objective.

## RESULTS

The bibliographic analysis determines the causes and behaviors related to tax evasion worldwide. See Tables 2 and 3.

TABLE 1.- Tax evasion, studies of causes

Author	Contribution
Jorratt, M. 2021	Ineffectiveness of the audit by the tax administration, inadequate systems of sanctions, lack of opportunity in the establishment of tax obligations, lack of simplicity of the tax structure, and finally acceptance of the tax system.
Casparri, M. T. (2013).	The Laffer curve represents the relationship between tax revenues and tax rates, showing how tax revenue varies when rates change. The curve, which was released by economist Arthur Laffer, argues that raising the tax rate does not necessarily increase revenue, because the tax base falls.
Bernasconi, M. 2015, degl'Innocenti, D.2022	Human behavior concerning evasion varies with the time and age of the taxpayer The increase in rates produces an increase in the level of evasion. It recommends tax auditing as a control mechanism.
McGee, Devos, and Benk. 2016	Evasion is the result of ethical analysis, in reproach against an inequitable and inefficient tax system.
Ferrer, C. 2016	The greater the social and business welfare, the lower the evasion





Jacinto, R. 2019	Taxpayer profile and social profile influence evasion. Training, training, patriotism, etc.
Casaburi and Toriano, 2015	Political agents are related to the management of tax agents and their management to prevent evasion
Banerjee and Vaidya (2018) Dularif, Nurkholis and Saraswati (2019),	Auditing and sanctions generate a decrease in evasion, as well as increasing the tax rate motivates tax evasion.
Abdixhiku, Pugh & Hashi (2018)	A higher rate or perception of corruption, a slowness in reforms, and increased tax rates influence the reduction of taxes paid.
(Ionel, 2016) ,	Applying information-crossing techniques reduces evasion,
Porter and Ronit (2018)	Spontaneous action by the government and not generating government control structures.

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TABLE 3.- Tax evasion, behavioral studies

Author	Behavior
McGee, Yoon & Li (2015)	Perception of unfair tax systems Very high rates Inability to pay State corruption Inappropriate destinations of funds raised Dissatisfaction with tax remuneration
Saxunova and Szarkova (2018)	Non-existent tax culture in the taxpayer
Zambrano, N. 2020	Individual compliance is based on the taxpayer's values
CELAC, N. (2018).	Institutional policies, social trends, and economic variations between countries and regions.
Sánchez-Cárcamo, R. A. (2022).	Being a participant in tax policy raises the level of altruism or equity and increases fiscal morale.
Nwabuzor, A. 2005; Gheorghiu, A. 2021	Tendency to evasion by bureaucracy and state corruption
Miceli, T. 2021	Evasion by public policies with little social acceptance
Mendoza, H, 2022	Evasion is motivated by a high tax burden. A financial system increases the opportunity cost of evasion.
Ochoa, J. 2022	Tax expenditures reduce tax revenues and can cause greater inequality by favoring large taxpayers.

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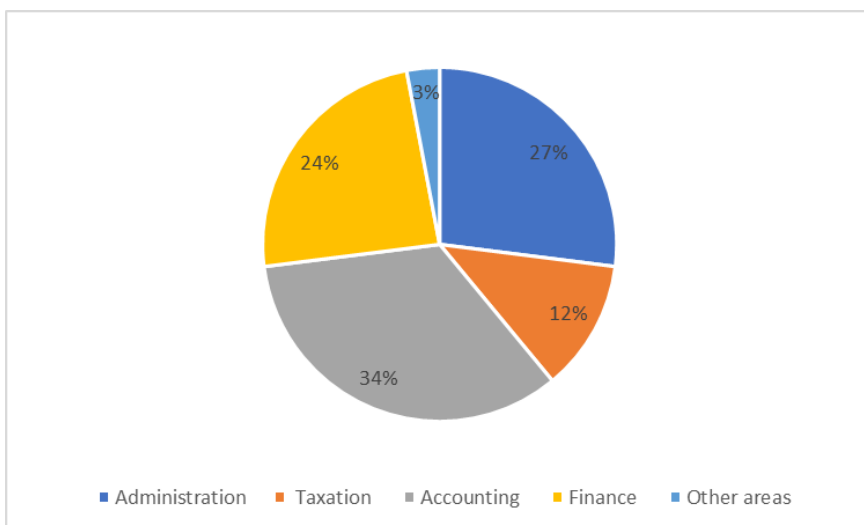
From the application of the survey to companies that during a fiscal period registered economic movements of sales, employed personnel – affiliate measured through employment places



registered in social security and/or made a declaration to RISE, from a sectoral and territorial perspective, the following results are obtained.

72% of the staff surveyed are male, and 97% have academic training related to administration and taxation.

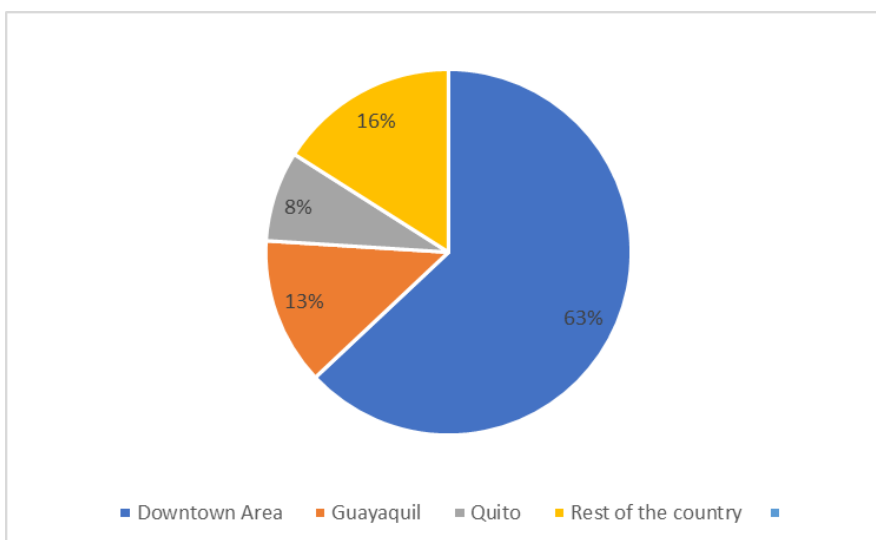
Graph 1.- Professional profile of the personnel surveyed



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63% of companies surveyed were from the central area of the country, 13% have their fiscal domicile in the city of Guayaquil, 8% in the City of Quito, and 16% are located in different cities of the country.

Graph 2.- Location of the companies surveyed

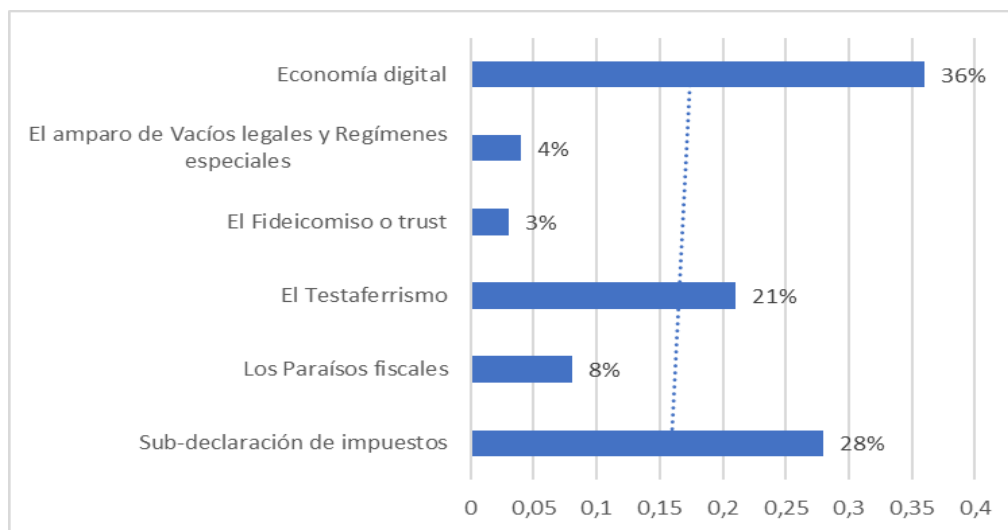




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Among the most used strategies for tax evasion, in the literature analyzed are mentioned the Sub-declaration of taxes, tax havens, Testaferrismo, Escrow or trust, The protection of legal loopholes and special regimes, and the use of mechanisms of the digital economy; and among the most frequent causes for tax evasion, there are Government Distrust, Ignorance or legal complexity, Inflation and Tax Pressure, the Existence of an informal economy, permanent regularization regimes, mild legislation for non-compliance and, the behavior of the taxpayer.

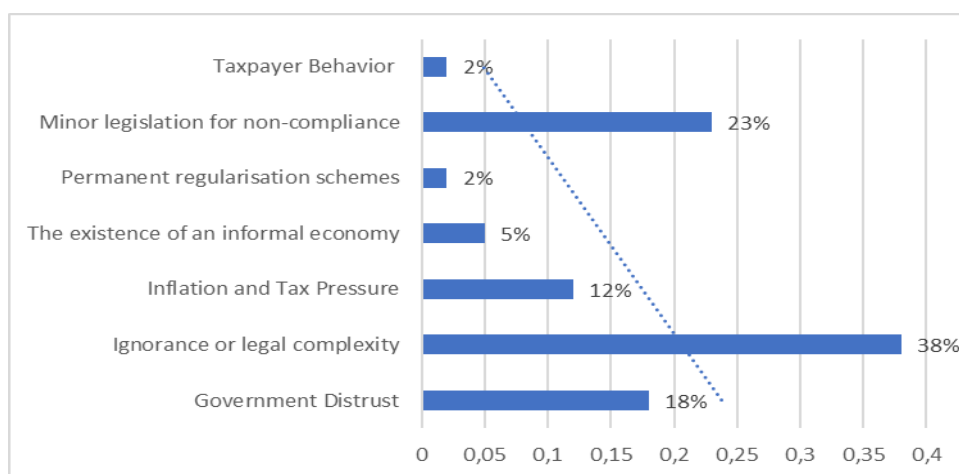
Graph 3.- Most used strategies for tax evasion,



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The data collected show that the most used strategy for tax evasion in Ecuador is the use of digital economy mechanisms, which has a frequency of 36% among respondents, followed by the Sub-declaration of taxes or division of income with 28%, The protection of Legal Loopholes and Special Regimes with 21%, and determining 15% for evasion strategies based on tax havens, the Testaferrismo and the ideological or trust f.

Graph 4.- Most frequent causes for tax evasion



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The most frequent causes are ignorance or legal complexity at 38%, followed by the existence of mild legislation for non-compliance at 23%, Government Distrust at 18%, Inflation and Tax Pressure at 12%, and determining 9% for the Existence of an informal economy, permanent regularization regimes, and taxpayer behavior.

## CONCLUSIONS

In terms of tax evasion strategies, the government should pay special attention to control mechanisms for commercial transactions that use digital means, as well as effective mechanisms to eliminate or reduce tax avoidance practices such as Testaferrismo and possibly targeted audits to reduce the application of Tax Sub-declaration strategies.

On the other hand, as for the possible causes of evasion, ignorance or legal complexity are determined as the most important, which undoubtedly reflects the legal, political, and fiscal instability of the government by having several tax reforms, with special regimes, specific cases of inclusion and exclusion of the reform, which generates confusion in the taxpayer. Additionally, with electronic invoicing, the penalty of blocking or preventing the performance of economic activities if you do not make the tax declaration promptly disappears; Finally, there is distrust in the government, probably in the distribution and destination of collected resources or their management.

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