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Effect of Tax Evasion and Earnings Management on Tax Revenue in an Emerging Economy: The Nigerian Trajectory

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Abstract

Tax evasion and earnings management have become alarming situations in most developing countries. The recent worldwide economic downturn caused by the Russian-Ukraine war, which led to instability in the price of crude oil and sales quantity in the global market, and the theft of crude oil by economic saboteurs in Nigeria, has contributed to difficulties in the implementation of the annual budget, leading to consistent borrowing by the Nigerian government. This necessitated the shift to more tax revenue collection, but the biggest problem is the high rate of tax evasion and earnings management by taxpayers. It is against this background that this study explored the effect of tax evasion and earnings management on tax revenue of developing economy: The Nigerian trajectory. The study adopted an exploratory research design using literature from the fields of accounting, taxation, and government tax revenue. Intentional tax evasion and real earnings management by taxpayers in the manipulation of accounting records during a tax assessment year, according to the study's findings, have a detrimental effect on the tax revenue of the Nigerian government. The study makes several recommendations, including that the Nigerian government should reassess some of its fiscal policies that provide citizens with opportunities for tax evasion and real earnings management.

Keywords: *Tax Revenue, Tax Evasion, Earnings Management, Nigeria Taxes*

Introduction

The Provision of social-economic amenities that contribute to making life easier for citizens, such as drinkable water, electric generation, roads, health care facilities, education, and sports centers, amongst others, is one of the fundamental responsibilities of government. Tax revenue is one of the major sources of government revenue used to finance and maintain these amenities. Taxation is the most dependable and significant fiscal tool used by government to raise the funds required to provide public amenities for citizens. According to Bahadur (2018), taxes are the main tool utilized by government to generate the funds needed to pay for its public expenditures and obligations. Governments in majority of developing nations, including Nigeria, encounter the difficulty of not having sufficient revenue to fulfil their social obligations because of the poor tax-to-gross domestic product ratio brought about by the high prevalence of earnings management and tax evasion. According to Mohsen & Yazdan (2016), numerous nations' taxes make up a larger portion of the government's overall revenue than other types of income, and taxes are the primary source of revenue used by governments to pay their debts.

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Ogbueghu (2016) opined that most of the nation's taxable individuals and companies evade and avoid paying taxes, which reduces the tax revenue realized by the federal, state, and local governments. As a result, governments are unable to provide the socio-economic amenities that make life easier for citizens. With the current circumstances of tax evasion, individuals and companies conducting legitimate business also engage in tax evasion with impunity by hiding behind the shadow economy. Tax evasion is when a taxpayer intentionally fails to report all or part of the source of his or her income to the appropriate tax authorities for accurate assessment (Omodero, 2019). According to Bahadur (2018), tax evasion is fraudulent and unethical since it reduces government tax revenue and impedes the overall economic growth of a nation. It is also a criminal and unjustifiable act. It is the act of distorting taxes by submitting fabricated paperwork, misleading information, or exaggerated claims.

Furthermore, another act of dubiously and intentionally diverting tax revenue on the part of individuals and businesses is the use of earnings management. The act of earnings management is another form of management decision that could impact tax revenue. Earnings management may infringe or not infringe on generally accepted accounting principles (Frank et al., 2009) and improve or reduce accounting earnings for personal gain (Goel, 2016). Real earnings management and accrual earnings management are the two categories under which earnings are managed by individuals and businesses. Real earnings management is an action aimed at converting reported earnings in certain directions and is achieved by changing the timing or structure of operations, investments, or funding that have unfavourable business effects (Zang, 2011). Accrual earning management is accomplished by altering the accounting method or prediction used when presenting transactions in the financial statements (Febriyanto & Companyansyah, 2018).

According to Graham et al. (2005), managers are more likely to use real earnings management than accrual earnings management. During the accounting period, management can alter the timing and scope of real activities such as sales, investments, and financing in order to achieve the desired profit (Kim & Sohn, 2013). Investors find it challenging to understand the effects of real earnings management on present and future corporate cash flows, and as such, board members, auditors, regulatory agencies, and other stakeholders generally pay less attention to and monitor these issues (Kim & Sohn, 2013). Actions taken to control real earnings management may be meant to hide actual business growth or earnings in order to reduce the actual earnings, which will invariably affect the tax revenue of the government.

Tax evasion is universally regarded as a crime, making it an illegal act on a global scale. However, a number of factors have been put forward for justifying tax evasion in recent times, including but not limited to: high tax rates, poverty, lack of proper awareness, lack of sufficient education for tax officials, theft of tax revenues, inability to interpret multifaceted tax laws, a weak legal system, and failure on the part of the judicial system in enforcing relevant statutes against tax defaulters (Obafemi, 2014; Onyeka & Nwankwo, 2016; Folayan & Adeniyi, 2018). In any case, tax evasion hurts an economy, especially one that is developing like Nigeria's, because the lack of tax revenue keeps development from advancing. In order to accomplish certain business results, Dhaliwal et al. (2003) investigation reveals that companies' managers will manipulate income tax expense when manipulating earnings. Therefore, it could be stated that tax evasion and earnings management have an adverse impact on the Nigerian government's tax revenue.

More importantly, the current state of affairs in the nation requires self-sufficiency, reliance, and restraint when it comes to borrowing from abroad in order to spare the country from needless embarrassment. As a result, it is imperative for the government to increase its own revenue generation in order to provide its citizens with adequate social and economic amenities without turning to loans from abroad. Unfortunately, Nigeria only has a pay-as-you-earn (PAYE) method of taxation, which is less ambiguous and more certain and gives taxpaying citizens fewer opportunities for evasion and earnings management maneuverings. The correlation between PAYE and direct assessment tax yields is important because it reveals the relative effectiveness of the methods of collection (Onah, 2006). Government tax revenue collection authorities and policymakers are concerned about the problem of combating tax evasion, earnings manipulation to reduce tax expenses, and any other shady practices in tax returns. It is on this backdrop of tax evasion and earnings management that this study decided to use an exploratory research method to review existing literature and explore the menace of tax evasion and earnings management, and their effect on tax revenue of the Nigeria government. According to Abdulaziz et al. (2023), the public sector refers to the area of a country's economy that is devoted to providing fundamental services to its citizens within the framework of a governmental organisation.

Review on Tax as a Means of Revenue Generation

Taxation which is one of the major fiscal instruments used in regulating the economy, boosting investment, regulating inflation, and generating revenue to finance government expenditures, has been overlooked since the inception of oil revenue in the 1970s in Nigeria. According to Samuel and Simon (2011) and Yunusa

(2003), taxation is the process by which the government imposes a mandatory levy on all income, goods, services, and properties of individuals, partnerships, trustees, executorships, and companies. The fundamental elements of generating revenue for the government of most nations are taxes and systems of taxation by the tax authorities. According to Brautigam (2008), taxes determine the balance between accumulation and redistribution of wealth that gives states their social character and underwrites their ability to carry out their primary responsibilities to their citizens. Taxation also serve as one of the main venues for conducting relations between the state and society. Therefore, taxes increase the ability of government to provide security, health facilities, basic education, and economic growth (Onyeka & Nwankwo, 2016). Taxation of individuals and businesses is how a government generates revenue to pay for its expenditures. Without the money raised through taxes, governments cannot create the necessary infrastructure, put necessary laws into place, or create vital programmes. Due to its impact on the government's fiscal policy and developmental goals, taxation promotes an environment that is favourable to business and wealth creation (Ackom, 2023).

A country's tax structure frequently reflects both its societal values and the values of the ruling class (Ross, 2007). In order to establish a taxation system, a country must decide how the tax burden will be distributed and how the money raised from taxes will be expended (Onyeka & Nwankwo, 2016). These decisions represent the kind of community that the public or government wishes to create in democratic countries like Nigeria, where the people elect those responsible for designing the tax system. As a result of the stability and certainty of the tax system, taxation is viewed as a sustainable means of government revenue generation (Aguolu, 1999). Taxes, in contrast to other revenue streams, are always available as long as economic activity is occurring in society (Cobham, 2005). However, recent changes in the national and global economies that have had a substantial impact on government revenue have shifted attention to taxation as a reliable source of funding (FIRS, 2009).

Taxation has been recognized as a substitute for oil revenue and as a more dependable source of revenue for government (McKerchar, 2003). Therefore, the national tax policy of the Nigerian government is to encourage and promote a change in government priorities from non-tax revenue to tax revenue at all levels of the Nigerian economy (FGN, 2009). In order to assist the quick development of the Nigerian ecosystem, the national tax policy tends to foster and encourage healthy competition amongst tax and revenue authorities in Nigeria at the federal, state, and local levels. The competition will be centered on maximizing

tax income within the purview of each level of government in accordance with statutory and constitutional requirements.

Government implements growth and development plans that have a favourable influence on the lives of its citizens through efficient taxes. Taxation is thought to serve the primary and most significant purpose of generating revenue. Taxation, however, is not merely a way for government to generate income; it can also be used to nurture other sources of government revenue and expand other sectors of the economy where the government can generate income (Onyeka & Nwankwo, 2016). However, no sustainable development can occur in a country when there are leakages in tax collection administration due to tax evasion and earnings management. As a result, large rates of tax evasion and real earnings management are typically accompanied by high unemployment, inability of government to provide necessary amenities, and a poor pace of national development.

Tax Evasion and Tax Revenue Generation

Government negligence, tax evasion and avoidance, financial record manipulation, apparent inefficiency, and leakages in the tax collection administration are responsible for the persistent low tax revenue generation (Adegbite & Fasina, 2019). These have, over the years, limited the amount of tax revenue generated by the government. Taxpayers frequently evade and avoid paying their fair share of taxes, which lowers government revenue and, in turn, decreases the government's ability to take up its socio-economic responsibilities, which in turn, results in lower income savings and spending by households and businesses, which lowers economic activity and growth (Cornelius et al., 2016).

The most prevalent type of tax evasion in Nigeria takes the form of willful failure to file tax returns with the appropriate tax authorities in the nation (Modugu & Omoye, 2014). Companies and individuals may intentionally refuse to pay taxes by hiding the true state of their business operations; these could be tailored towards the consistent high tax rates that are now associated with the Nigerian tax system and perhaps government's failure to employ the tax revenue to provide the necessary infrastructure. The impact of tax evasion and avoidance on the administration of personal income tax in Nigeria was examined by Adebisi and Gbegi (2013) and the result from the study revealed that effective use of revenues from taxes to fund public goods and services might increase revenue collection and deter tax evasion and avoidance in Nigeria.

This is an indication of giving back to the society the expected socio-economic responsibility of the taxpayers by the government.

Bahadur (2018) examined the impact of tax evasion on total tax revenue and economic growth in Nepal. The study discovered that tax evasion has a negative effect on Nepal's GDP and overall tax revenue. In examining the relationship between tax evasion and economic development, Carlos and Lars (2018) discovered that a higher tax rate increases both total tax evasion and the number of tax evaders. When a nation consistently increases it tax rate without putting in place proper economic policy that will protect and safe guide the interest of the tax payers the chances of tax evasion becomes very obvious.

Earnings Management and Tax Revenue Generation

Roychowdhury (2006) and Budi (2016) described earnings management as an intentional intervention in the financial reporting process with the aim of attaining certain objectives established by the company's management. According to Holland and Jackson (2004) and Healy and Wahlen (1999), earnings management is the alteration of financial statements through the use of self-opinion in transaction structuring, either to achieve some contractual benefits based on available accounting figures or to deceive the firm's stakeholders about the true economic position of the business. Also, earnings management entails the use of accounting information and processes to falsely represent financial reports in order to achieve certain goals that are at odds with the firm's underlying economic realities (Sun et al., 2010; Badertscher, 2011).

Opportunity-seeking individuals and companies use tax avoidance strategies to manipulate earnings by modifying and fiddling with their organization’s financial records to maximize their benefits. Managers with opportunistic tendencies tend to change earnings to expropriate wealth from shareholders to themselves, affecting the equity value negatively (Hunt et al., 2000). This is also extended to the relevant tax authorities at the federal, state, and local levels.

The most obvious cause of earnings management, according to Scott (2003), is income taxes. Large companies find it difficult to forecast tax expenses due to the complicated financial information that managers must gather between the end of the fiscal year and the release date of the earnings report (Amidu & Yorke, 2017). On the other hand, Scott (2003) argues that tax authorities typically apply their accounting

procedures for the determination of taxable income, limiting the firm's ability to manipulate their financial reports. Therefore, he maintains that taxes should not have a significant impact on earnings management.

According to Desai et al. (2007) and Desai and Dharmapala (2007), the amount of tax liabilities owing to the relevant tax authorities depends on the financial reports presented during the period under review. Individuals and company management prepare financial reports using accounting standards, which allow management to use their discretion in preparing the financial report which encourage financial information manipulation. The value of accounting reports as a form of communication can potentially be increased or decrease by management by using their understanding of the business and available opportunities to choose reporting techniques, estimations, and policies that align with the business economics of the organisation (Healy and Wahlen, 1999). However, Scott (2003) argued to the contrary and stated that tax authorities apply their own tax laws in determining taxable incomes of individuals and companies. The possibility for management to apply their own discretion to financial reporting creates the opportunity for management to be involved in real earnings management which will cause tax liability to be reduced and directly also reduce tax revenue.

Causes and Effects of Tax Evasion on Tax Revenue of Government

According to Uadialeet al. (2010), tax evasion is a deliberately dishonest act by taxpayers to avoid paying their tax liability by using unlawful strategies. According to Fatoki (2014), Tax evasion is caused by a number of factors, which include, amongst others, governance corruption, a lack of tax education and awareness, misappropriation of revenue taxes collected, ignorance of the tax authority, inadequate enforcement for default, proliferation of taxes, legal loopholes, unequal income distribution, the absence of a "Quid Pro Quo," or something of value provided in return by the government, a high level of illiteracy on the part of the taxpayers, and high tax rates. Tax evasion certainly had a negative effect on the economy as a whole and on the government's capacity to generate targeted revenue from taxes. However, despite government initiatives to curb tax evasion in Nigeria, the issue still exists. The three tiers of government in Nigeria still undoubtedly get less tax revenue than they expect due to lack of good governance and the unpatriotic behavior of tax evaders.

Causes and Effects of Earnings Management on Tax Revenue of Government

According to Wang and Chen (2012), discretionary accrual as an earnings management instrument is the intentional manipulation of accounting records during a certain accounting period that results in discrepancies between cash flows and income. Tax expenses may be inflexible; therefore, when profit is established and tax expenses are computed based on profit, there will be a cash outflow. This shows that earnings management will be driven by tax evasion in businesses with high tax burdens. When tax liabilities are evaded as a result of earning management, this will have a negative effect on the tax revenue of the government.

According to Hoai and Hoa (2015), a company will alter its income to enhance the company income tax payable during the incentive period if it is eligible for favourable corporate income tax policy, while the same company will adjust its income to reduce the company income tax when it recognizes deferred revenue, revenue under the schedule of a construction contract, numerous provisions, or deferred income tax expenses. This type of action will, at the end of the day, affect the amount of tax revenue that will accrue to the government. Furthermore, a study by Ngoc (2019) has shown that companies reduce earnings in order to minimize taxes when income tax rates are high, whereas companies often manipulate their financial records in order to boost income when income tax rates are low.

Classification of Nigeria Taxes

The classification of taxes is a factor of the tax burden based on the taxpayer payment. Therefore, tax can be classified as either direct or indirect tax. A tax is considered direct if it is imposed or charged on an individual income or company's profit; in other words, the burden is borne by the taxpayer and cannot be shirted to another person. It is imposed on an individual's personal income or a company's income from its operations. However, it is known as an indirect tax if it is levied on the sales price of goods or services (Benjamin et al., 2009). Indirect taxes burden can be shifted wholly or partly from the taxpayer to another person i.e. consumer depending on the elasticity point. The direct and indirect taxes are only allowed to be imposed by law on individuals and companies; otherwise, they are termed illegal taxes (Okafor, 2012). Through established and authorized legislation, as defined by the Institute of Chartered Accountants of Nigeria (2006) and the Chartered Institute of Taxation of Nigeria (2002), taxation is a mandated financial contribution to assist government in achieving its desired goals. When businesses are unable to pay taxes, it is a reflection of a nation's economy that is poorly performing (Soludo, 2009). The direct taxes include;

Personal Income Tax (PIT), Company Income Tax (CIT), Petroleum Profit Tax (PPT), Capital Gain Tax (CGT) and Education Tax (ET). While the indirect tax includes; Value Added Tax (VAT), Excise Duty, Export Duties, Stamp Duty. The tax laws that permitted the Nigerian government through its relevant tax authority like the federal inland revenue services, state internal revenue service and local government revenue authority to tax its citizens and businesses includes; The Petroleum Profit Tax Amendment Act of 2004, the Capital Gains Tax Amendment Act of 2004, the Value Added Tax Amendment Act of 2007, and the Education Tax Amendment Act of 2004 (Ojo, 2009).

Nigeria Major Taxes

According to Samuel and Tyokoso (2014), The Joint Tax Board (JTB) in Nigeria has specifically specified the taxes of every tier of government as follows in order to theoretically prevent double taxation from the same taxpayer:

Federal taxes: The federal taxes include education tax, value-added tax, customs and excise duties, police fund levy, information technology levy, national agency for science and engineering infrastructure levy, withholding tax, sabotage levy, capital gain tax, stamp duty, company income tax and personal income tax in respect of: armed forces, police, non-resident persons and companies, members of the Nigerian foreign mission, and residents of the federal capital territory.

(State taxes: the state taxes include personal income tax, road taxes, pool betting and lotteries, business premises registration, development levy, naming of street registration in state capitals, right of occupancy on state owned land, and market taxes on state financed taxes.

Local government taxes: the local government taxes include those on shops and kiosks, tenements rates, liquor licences, slaughter slab fees, marriage, birth, and death fees in rural areas, right to land occupancy in rural areas, motor park levies, domestic annual licence fees, market taxes and levies, wheelbarrow and cart fees, truck, canoe, and bicycle fees, cattle tax is exclusive to cattle farmers only, road closure and merriment levy, fees for radio and television licences (other than those for radio and television transmitters), vehicle radio licences (required for local government registration of vehicles), wrong parking fines, public convenience and refuse disposal, customary fees for burial ground permits, fees for religious establishment permits, signboards, and advertisements.

Empirical studies

In 2016, Cornelius et al. examined the impact of tax revenue on the Nigerian economy. Data were retrieved using the desk survey approach from the Central Bank Statistical Bulletin. The relationship between the dependent and independent variables was established using multiple regression models with ordinary least squares. The results showed a strong correlation between the petroleum profit tax, non-oil revenue, and the growth of the Nigerian economy. It was suggested that government should make effort to provide social amenities to citizens of the nation. Additionally, government should completely reorganize the systems in place for administering taxes in order to decrease the intolerable issues of tax evasion and avoidance.

Ibadin and Eiya (2013) investigated tax avoidance and evasion behaviors on self-employed Nigerians. To determine how each element affected the choice of the self-employed Nigerian to evade and avoid paying taxes, the study sampled the opinions of Nigerians in specific geopolitical zones and states. These variables included ethical views, educational attainment, tax administration methods, religion, and cultural practices. Regression analysis results showed that the respondents believed tax evasion to be moral, particularly in the context of the circumstance in which they found themselves. The lack of effective government in Nigeria should be held responsible for the problem of considering tax evasion to be ethical.

Folayan and Adeniyi (2018) used primary and secondary data covering 2011 to 2016 to examine the consequences of tax evasion on government revenue in Oyo State. Descriptive and inferential statistical tools were used in the study's analysis, and the results showed that the predicted revenue between 2011 and 2016 was not achieved. The results showed that tax evasion resulted in revenue loss, which meant that tax evasion had a negative impact on the Oyo state ability to generate revenue internally.

In order to accomplish specific business goals, Dhaliwal, et al. (2003) investigate whether businesses will manipulate income tax expenses when manipulating earnings. The study result reveals that businesses first manipulate non-taxable elements to accomplish certain business outcomes. However, if the management of non-taxable goods' earnings is unable to generate enough profit to meet that objective, the business will use specific strategies to lower the company's income tax liability. This study offers theoretical justification for implementing tax-based income management.

Kapoutsou et al. (2015) examined earnings management and income tax evidence from Greece. Discretionary accruals were used as the portion of profits that can be affected by management accounting decisions on tax income. Based on this study's results, there is a statistically significant correlation between the values of discretionary accruals and the overall tax of the business. The study further demonstrates that businesses have the opportunity to engage in earnings management practices because of the provisions of international financial reporting standards regarding taxation. This implies that taxation may generally be used as a tool to aid the management of earnings.

Theoretical Review

Tax morale principle is the anchoring principle of this study. According to Torgler (2003), tax morale is an innate motivation to comply with fiscal obligations by citizens and is further acknowledged as playing a significant role in the high rate of tax compliance witnessed in many nations (Molero and Pujol, 2005; Güth et al., 2005). According to Torgler and Schneider (2005), the concept of tax morale is the inner motivation to adhere to tax law, pay taxes, and thereby willingly contribute to the welfare of society. According to the tax morale principle, taxpayers have a moral obligation to fulfil their civic duty to the government by paying their taxes.

Ukaj (2014) asserted that effective governance boosts citizens' confidence in government agencies and strengthens their resistance against tax evasion. Taxpayers are expected to uphold the tax morale principle, which requires businesses and individuals to pay taxes as their contribution to society and to keep good ties with the government (Omodero, 2019). Citizens who adhered to tax morality understand that paying taxes is a moral obligation and do not need to be coerced into compliance by the government before performing their moral responsibility to a constituted authority. When citizens of a nation realize their government is corrupt based on governance system, the loyalty and commitment of citizens to such a government begin to erode. The assumption is that by virtue of the illegal and dishonest actions perpetuated by public servants or tax authority staff, the same taxpayers would consciously decide to avoid paying taxes and manipulate their earnings in such a way that it would reduce tax expenses or invent other ways to do so.

Methodology

The study used an exploratory research design in which pertinent books, journals, and other literature in the fields of tax revenue for government, tax evasion, and real earnings management were examined,

conclusions were drawn, and suitable recommendations were made with the intention of expanding the frontiers of knowledge.

Conclusion and Recommendation

The study reviewed the effect of tax evasion and earnings management on tax revenue in an emerging economy: The Nigerian trajectory, from the perspective of existing literature. In the course of the review of existing literature, it was discovered that the intentional application of discretionary accrual as a real earnings management instrument and tax evasion by taxpayers in the manipulation of accounting records during a tax assessment year have a negative impact on the tax revenue of the government at the three tiers of government in Nigeria.

It was discovered that tax evasion and earnings management may not be completely eradicated for reasons like continued increases in tax rates, poor business performance, poor power supply, deplorable road conditions, aiding and abating by tax authority staff, insecurity of life, property, and business activities, amongst others, but rather could be reduced. Based on the findings in this study, the following recommendations are essential to improving tax revenue generation by the government in Nigeria and discouraging or eliminating tax evasion and earnings management by taxpayers: (a) Government should review some of the fiscal policies that create loopholes for tax evasion; (b) Government should enact severe penalties that would be meted out on individuals and businesses found guilty of tax evasion and real earnings management; (c) Government should continue to build good road networks and a healthy business environment because of the deplorable roads and distressed economic situation, which reduce income and increase the responsibilities of the taxpayers; (d) The federal, state, and local governments should constantly interact with taxpayers to inform them of the purpose of the taxes by pointing out visible and concrete projects and services provided with the tax revenue; (e) A tactical and undercover monitoring team should be established by the government that will be charged with the responsibility of overseeing the activities of the tax authority officials.

The outcome of this study will undoubtedly aid government in the development of tax policy and reforms, beneficiaries of the tax revenue, academic researchers, and practitioners in attempting to better understand the effect of tax evasion and earnings management on tax revenue in an emerging economy like Nigeria.

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