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**REFLECTIONS ON CORRUPTION: AN ECONOMIST'S PERSPECTIVE**

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## **REFLECTIONS ON CORRUPTION: AN ECONOMIST'S PERSPECTIVE**

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Let me state at the outset that I do not make these remarks as a long-time student of or expert on the phenomenon of corruption. Rather, I want to bring to the table, as it were, the types of considerations that economists tend to pursue, on those occasions when they face problems of a similar nature. In what follows, I will focus most of my attention on the area of tax evasion, where the label of “corruption” fits most comfortably. Later, I will make reference to black market activity, where the fit may be a bit looser.

The economic aspect of corruption was previewed in a sense, in Daniel Kaufmann’s keynote presentation. He referred there to the “supply side” and the “demand side” of corruption. The existence of these two, traditional economic aspects is quite clear in any case where direct bribery is involved. They are therefore clearly present when bribes are paid to customs or internal revenue agents. But tax evasion also often takes other forms, in which the corrupt parties are the taxpayers themselves, as they conceal or misstate their tax liability. This type of evasion takes place just about everywhere, and I would classify it as “demand side only” corruption. The supply side would enter in, in such cases, only if at some point the responsible

officials end up conniving with the taxpayers in order to conceal their guilt.

Where to begin? I believe the best starting point is to recognize that tax evasion and avoidance are what I would call “social science phenomena”. They represent behavior whose extent and intensity can be estimated with some degree of confidence. Moreover it is behavior which clearly responds to economic stimuli. The higher is the applicable marginal tax rate, the greater will be the incentive for the taxpayers to evade; the more rigorous and serious is official inspection and enforcement, the smaller will be the degree of evasion.

In their behavior responses to changes in tax rates, taxpayers resort to both legal and illegal courses of action. When their evasive maneuvers are within the law, we classify them as tax avoidance; when they are outside the law, we call them tax evasion. In terms of behavior, both serve as avenues of response when tax rates get raised.

Economic concepts are well suited to the analysis of both evasion and avoidance. The “benefit” to taxpayers is, of course, the money they save as a consequence of these actions. But what about the costs? In the case of tax avoidance, the cost may be straight-out financial, for example, in a rate of return that is much lower on tax-exempt bonds than on taxable bonds. Or that cost may take the form of greater expenditure of time and effort, as is the case when taxpayers invest in forestry operations, which not only entail significant risks, but also require significant amounts of hands-on management (the benefit being the treatment of forestry gains at a favored long-term capital gains rate).

With respect to evasion, the cost can take even more forms. The places where a taxpayer can conceal income may have lower rates of return; they may involve more time and effort on the part of taxpayers, and (depending on the taxpayer) they may entail a sense of shame or guilt that by itself acts as a deterrent. But, of course, there is also the potentially very powerful

deterrent provided by the probability of the evasion being detected and the severity of the penalties that are likely to ensue when this is the case.

Now back to the social science aspect. Of one thing we can be quite sure: the higher is the relevant marginal tax rate, the greater will be not only the incentive to evade and avoid taxes, but also the actual amount of such activity (for given levels of penalties and enforcement, and for given sets of alternative strategies by taxpayers).

Most younger people in the United States do not realize that not too many years ago (during and immediately after World War II) our top federal income tax rate was 91%, and that it remained as high as 70% all the way up to the Revenue Act of 1986. Needless to say, such rates gave very strong incentives to evade and to avoid taxes -- much stronger than we see today, with a top marginal rate of 35%. Yet, even today, the incentives are not negligible. The Internal Revenue Service estimates that overall, the U.S. tax gap in 2001 was between 15.0 and 16.6 percent of taxes due. Yet the gap was estimated to be less than 1.5 percent for wage and salary income, which accounts for more than half of the tax base. It follows that the gap from non-wage-and-salary income is over 30% of the amount due, probably reaching as high as 50% in some categories.

All this is occurring in the United States, renowned for its levels of tax enforcement and compliance. Small wonder, then, that tax evasion is a problem of prime importance in the fiscal affairs of most developing countries.

I received my own shock treatment concerning the extent of evasion in developing countries, in the course of a study that I was asked to do as part of a major project on fiscal policy in Argentina, done under the tripartite auspices of the Organization of American States, the Inter-American Development Bank and the United Nations Economic Commission for Latin

America and the Caribbean. In my part of that work, I took as my baseline the actual income tax declarations of Argentine taxpayers in 1954. I then made the assumption that the percentage of total income accruing to each bracket in the income distribution remained the same between 1954 and 1955. (This assumption is reasonably safe, as, barring severe crises, national disasters or similar emergencies, relative income distributions tend to change only very slowly through time.)

On the above basis, it was possible to compare actual 1959 tax declarations with the amounts that would have been declared, had compliance levels remained the same as they had been in 1955. The result of this experiment was that tax collections in 1959 were only about two thirds of what we estimated them to have been, if compliance levels had remained constant. This experiment was then repeated for a subsequent leap forward in time, and it resulted in a further decline of about a third in tax receipts, compared with what we estimated would be collected on the basis of 1959 compliance levels. The end result was that over a span of about a decade, Argentine tax compliance appeared to have been cut by more than half!!!

All this could have happened just by itself, with no help from the authorities. But it is rendered more plausible when placed in context. In point of fact, there appears to have been a sort of tug-of-war between Argentina's taxpaying public and that country's tax administrators. This more plausible scenario runs as follows. The authorities perceive a shortfall in revenue (partly, at least, as a consequence of evasion). To recover the "lost" revenues they raise tax rates, which in turn induces yet more evasion, etc., etc.

This is an example of tax evasion and avoidance as endogenous variables, responding to changes in tax rates (and of course, to other forces such as the intensity of enforcement). In some countries, this endogeneity is so openly recognized that one is almost tempted to label the

income tax as a voluntary tax. More than once, I have heard Central American entrepreneurs state openly that “of course we are willing to pay more taxes, but only when the government shows itself capable of spending the extra money wisely.” That, of course, is no blueprint for bringing about greater compliance; if wealthy taxpayers are given the combined role of prosecutor, jury and judge of how well the government spends its money, one can safely predict that they will always have the ingenuity to find reasons not to pay more.<sup>1</sup>

### **The Culture of Evasion, Avoidance and Other Forms of Corruption**

This brings me back to my original theme of looking at corruption as a “social science phenomenon”. Dealing with corruption is one thing when it is relatively rare and isolated. It is quite another thing when virtually everybody engages in it.

Different experiences come to mind here. First, I recall a time in the 1970s when my family and I landed in Rio de Janeiro just prior to the opening of a course I was giving at the Getulio Vargas Foundation. We were going to be in Brazil for a couple of months, so we had sent a couple of large suitcases as airfreight (to avoid excess baggage charges). Arriving at the airport to pick them up, we were told that we would have to wait until they cleared customs. And how long will that take?, we asked. Imagine our consternation as we heard the answer -- “O, maybe 3 or 4 months, maybe 6 months”!! Our dismay did not last too long, however. Needless to say, my frustration was very much on my mind as I arrived at the Foundation for my first class, so it was the very first topic I brought up at a lunch with the other professors. I was surprised at the calm with which they listened to my tale of woe. “No problem,” they said, “all you have to do is hire a despachante (an expediter) to get your stuff out of customs.” Expeditors

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<sup>1</sup>One American former student of mine served as a consultant to the tax authorities of several Central American countries. In one of them he had access to the individual tax declarations of the nation’s top income-tax payers. Imagine his surprise to find his own name among the top dozen income-tax declarers in the country!!!

represented a perfectly legal and respectable profession, advertising their services in newspapers, in the yellow pages, etc. So I dutifully hired one who was recommended to me and for a price of \$100 or so (far lower than the excess baggage charges I would have had to pay), our bags were delivered to the door of our Ipanema apartment the following day.

It is notable that in this story, neither my colleagues nor the despachante himself even mentioned the possibility that bribes to the customs officials might be involved. He was simply helping to solve a problem that we faced, in much the same way as old fashioned mayors and aldermen in Boston, New York, Chicago and other big cities typically found ways of “helping out” when their constituents found themselves in difficult situations. (I would add that in these U.S. cases money was rarely involved, what the politicians were “buying” was the political loyalty and future votes of their constituents.)

What had happened here was that “society” had found a way to adapt to what might otherwise to a terribly constraining “disturbance”. It was not in the interest of the customs inspectors to hold up everybody’s shipment for month after month. That would almost surely lead to a great political hue and cry, and most likely to a crackdown by the authorities. But neither was it in the interest of the customs inspectors to have to deal with each and every recipient of each and every shipment that arrived. Not only would this involve a lot of time and trouble, but it too could easily lead to a big enough protest (to the political authorities) to in the end result in a crackdown on the customs inspectors themselves. How convenient, then, was the appearance on the scene, as if by magic, of this profession of despachantes!! They could serve as intermediaries, keeping their clients at a distance from the inspectors. But to do this they had to know (more or less) how much to ask of the clients. So for the system to work smoothly, a kind of informal price schedule would have to emerge, so that most of the time the despachantes

could give their clients a reasonable estimate of what their services would cost (or, as it was, in our case, an exact price.)

I have no doubt that the government received some complaints from irate importers, but nothing like the volume of complaints they would have got if the despachantes' fees were outrageously high or totally capricious. So the system went on, providing an "equilibrium" solution that was reasonably acceptable to most of the parties concerned. Readers should note that in this equilibrium, the government did indeed receive revenue from its customs operations. Some of the \$100 that I paid almost certainly went to the government; some went to the customs official, and some obviously went to pay for the services of the despachante.<sup>2</sup>

It is hard to predict in what cases such an equilibrium solution, involving some degree of corruption and some degree of market mechanism, will in fact emerge. But we can certainly describe situations in which elements favorable to such an outcome are present. The case of starting up new businesses comes immediately to mind as one in which the services of expeditors might be quite helpful, and in which therefore their emergence has some degree of likelihood.<sup>3</sup>

### **The Special Case of Black Markets**

In circumstances in which official controls attempt to keep prices below their equilibrium level (where supply equals demand), "black" or "gray" markets emerge with such frequency that

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<sup>2</sup>This suggests the likely flexibility and adaptability of the system. If a new minister presses forcefully for more rigorous customs administration, the despachantes' fees will go up, and the government's share may increase in response to the minister's pressure. Later, perhaps, the pressure may subside, with the old "equilibrium" be restored. But if the pressure keeps up, the likely result is a new equilibrium, representing higher despachantes fees with a higher share being actually paid to the government.

<sup>3</sup>An interesting experiment would be to canvass newly established enterprises within the so-called formal sector of a developing country, trying to explore the process by which they reached that status. Did they go through all the specific steps that were formally required, or were shortcuts available, enabling them to reach the same goal more "efficiently?"

many economists outright “predict” their presence. (Note that the mere fact that prices are held below the level that equates supply and demand by itself guarantees that some of that demand would be unsatisfied if all transactions took place at the control price.<sup>4</sup>

When a black or gray market is fully functioning, it establishes a market clearing price. If all supplies and all demands are transacted at this price, it is as if the (lower) control price simply did not exist. This is not the typical case however. Normally some demanders will be lucky (or specially favored) enough to be able to actually buy the item at the control price, so only a fraction of the supply is available to the black market. In such a case the black market price will be above what would have been the market-clearing price.<sup>5</sup>

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<sup>4</sup>The only exception to this rule occurs when the authorities buy the affected commodity in the world market, reselling it (at a loss) at the control prices so as to satisfy all demanders. This is what the Chilean Popular Unity government (1970-1973) did, importing wheat and reselling it so as to satisfy the market demand for bread at its (very low) control price. The budgetary loss stemming from the implicit subsidy on imported wheat reportedly cost the government hundreds of millions of dollar. Even this might have been regarded as a bargain by the authorities, for the loss would have been much greater had the government also paid the world price to the domestic suppliers of wheat.

<sup>5</sup>The limiting case occurs when suppliers are functioning “on” their original (normal) supply curves and are thus producing (at  $P_B$ , the black market prices, which is above  $P_N$ , the normal price, a quantity  $Q_T$  which is greater than the normal quantity  $Q_N$ . This total quantity produced goes to two groups of consumers -- the lucky ones, who make their purchases at the control price  $P_C$ , and presumably buy more than what they would purchase at the normal price  $P_N$ , and the unlucky ones, who have to pay  $P_B$  and therefore demand less than they would have done at  $P_N$ . It is evident that the market-clearing black market price  $P_B$  must be greater than the normal market price  $P_N$ , because if it were equal to  $P_N$ , total supply would be the normal quantity  $Q_N$ , and the unlucky demanders would demand their normal amount also. But the lucky demanders (buying at the lower price  $P_C$ ), will demand more than their normal amount, leading to total demand > total supply at  $P_N$ . This excess supply is relieved by  $P_B > P_N$ , because as  $P_B$  rises, the unlucky demanders end up demanding less than at  $P_N$ , while suppliers end up producing more than at  $P_N$ .

The above case is rare, however, for we can expect that suppliers will recognize that some degree of risk is involved when they sell at a price greater than the control price. For this

In spite of its complications, a typical black or gray market mimics a free market situation in the sense that the going price tends to be widely known among regular suppliers and demanders, and of course, in the sense that this price in fact tends to equilibrate supply and demand in the black market segment of the total market.

Sometimes, indeed, market participants may consider themselves to be substantially unaffected by the existence of a black market premium. Such was the case, for example, in India in 1961-62. India at that time was literally plastered with controls of all kinds -- on imports, exports, investments, interest rates, etc. Under the circumstances, many people, but especially businessmen, had a good motive to keep a significant part of their wealth in places where they could use it freely, independent of the Indian government's controls and restrictions. Thus during my stay in India in this period, I was prone to take advantage of any chance meeting with an Indian businessman, to probe into what he considered to be the cost involved in using the black market (for foreign exchange) to convert his rupees into British pounds in order to invest them in the London financial market. Thus I would ask, what sort of rate of return they expected in their London investments. Somewhat to my initial surprise, nearly all of them answered that they would get the same rates of return as native Londoners were getting. "And what about the black-market premium?" I asked. To which they answered "It really doesn't matter -- we pay, say, 20 percent more for our pounds on the outbound operation, but we typically get 20 percent more when we convert the proceeds back to rupees using the same black market. The only risk is that the black market premium may change between the outbound and the inbound operations,

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risk they will need some compensation, which will be reflected in a modified supply curve, with supply prices exceeding, for each quantity, those that would prevail in a straight, uncomplicated market setting. This set of reactions modifies the above result for the limiting case. In a more "typical" black market situation, the total quantity transacted will very likely be less than the corresponding normal equilibrium quantity, and the black market price will even more surely be higher than the normal equilibrium price that would prevail in the absence of controls.

but even then it can equally well change in our favor, as against us.”

### **Little Sense of Transgression**

One thing that is characteristic of most black markets is that their participants seem to have little or no sense that they are really doing something wrong. They are more likely to fume at the government for creating a situation where they have to pay a black market price than they are to feel guilty about doing so. With rare exceptions, this absence of a sense of guilt is a characteristic of black market situations.

Nowhere has this been more evident than in Chile. First, and as an important piece of background information, let me inform readers that Chile as a nation is world-famous for its lack of corruption. When people develop indicators of corruption, Chile ranks with Singapore, the United States and the Scandinavian countries rather than with the rest of Latin America. Chile's police (the carabineros) are absolutely renowned for their honesty. Indeed, in over 50 years of visiting Chile, I have heard not a single one of my hundreds of Chilean friends and acquaintances speak of paying a bribe, or even of hearing about somebody else paying a bribe, to a Chilean carabinero. Another Chilean anecdote. Recently a Chilean Central Bank President discovered that his own secretary was clandestinely selling secret financial information to an outside group. He immediately fired, and instituted judicial proceedings against the culprit. Nonetheless, and in spite of the president himself being the one who discovered the crime, he was in the end asked to resign, because he had been the central bank president under whose responsibility the crime had occurred. That seems to many to represent an excess of zeal on the part of the Chilean government.

But I am here recounting this incident, along with the fame of the carabineros, in order simply to underline Chile's general and well-deserved reputation as a place where acts of

corruption are rare events. This reputation is not of recent vintage. It was there in the 1950s and the 1960s, pretty much as it is today. But now turn the clock back to 1970-73, when the popular unity coalition led by Salvador Allende ruled Chile. That was a government that seemed to specialize in economic policy mistakes. There were literally thousands of items subject to price controls. At one point there were a dozen official exchange rates for the U.S. dollar, ranging from a low of 25 escudos to a high of something like 1325 escudas per dollar. And above all this there was a black market in foreign exchange at about twice the highest official exchange rate. So distorted was the pricing situation that one could pay for a night's lodging in a suite at Santiago's best hotel (the Sheraton San Cristobal)) with the proceeds of two dollars sold in the black market. With the proceeds of a single dollar one could buy some 500 maraquetas (small loaves of bread about the size of a Kaiser roll), or some 1200 tokens to use for a pay telephone call.

I describe the situation in some detail so as to help convince readers of how wild, how crazy Chile's economic situation was at that time. Official prices were huge bargains, but one had to be lucky to be able to buy anything at official prices. The mere availability of an item at official prices led to queues that stretched for blocks -- people joined these queues instinctively, not even knowing what was the item being sold at the head of the line, simply because they knew it would be a great bargain. How much of a bargain can be gauged by the fact that the black market prices of most items were quoted as multiples of the official price -- e.g., chicken at 5 times the official price, beef at 7 times, butter at 8 times, etc.

Probably there were a few households in Chile whose access to the official markets and prices was sufficiently good that they could avoid the black market altogether. But the great majority of households ended up participating in black market activity on a regular basis, simply

to meet the family's most basic needs.

Now, finally, to the punch line -- at that time, in Chile, Latin America's champion of probity, nearly everybody participated regularly in black market activity, without evidencing the slightest sense of guilt. Somehow, black market activity was in a different category from trying to bribe a policeman or engaging in other corrupt acts.

To give U.S. readers some sense of how many black market participants feel, in many other parts of the world, I like to use the analogy with U.S. attitudes toward "speeding" on a contemporary U.S. limited-access highway. On most such roads, the posted speed limit is 65 miles per hour, but most of the day one sees the entire flow of traffic going at 68, 70, 75 and even higher speeds, with no sense of guilt, no sense that they are doing something wrong.

The purpose of all of this is to help readers to sense some of the problems in modifying people's behavior in such cases. If the police randomly stopped an occasional car for going 68 mph, when everybody else was going at the same speed, and the unlucky recipient of the ticket has to pay a huge penalty, most people would regard that as capricious, unjust and in the final analysis unacceptable behavior on the part of the police. Gentler approaches are what is called for -- a widespread publicity campaign, highly visible police patrols, going on the highways at or below the posted speed limit, automatically leading the great majority of drivers to slow down, etc., etc. If prosecutions and heavy penalties are involved, much better if they start out by catching the occasional truly reckless driver going, say, 85 or 90, and only gradually tightening the net by citing drivers going at 80, then somewhat later at 75, etc.

I think most U.S. drivers would see merit in such a gentler, perhaps more gradual approach to speed limit enforcement. I believe also that this is a good recipe for dealing with tax evasion in those cases where it starts out being rampant, with the perpetrators having no sense of

guilt.

### **How to Deal With Widespread Tax Evasion**

The speed limit example just presented suggests the appropriate strategy for dealing with widespread tax evasion (such as prevails in a great many developing countries).

The idea is to start, not with a random attack on ordinary, average citizens, but with a campaign focused on “outliers”. For example, the authorities might first arrest the owners of a nightclub that simultaneously serves as a center for illegal gambling and perhaps for prostitution. The publicity surrounding their arrest and prosecution, and, presumably their sentencing to prison terms will send a message to taxpayers generally. Compliance will automatically improve. Perhaps at the next step the prosecution would turn to some more “legitimate” business people, but ones whose understatements of income were very large in absolute terms. The longer-term strategy involves moving the “active margin” at which prosecutions and serious penalties take place, by gradual but very firm and deliberate steps, from the “outlier” point at which it started, closer and closer toward the region where most taxpayers are located. Experience suggests that this strategy can bring about excellent results. A further useful step could be the periodic publication of lists of those taxpayers who have declared incomes higher than a certain level.

An example is the case of Mexico during 1988-94 (the Salinas presidency). Francisco Gil Diaz (who later became finance minister under President Fox) was then collector of internal revenue. He instituted a compliance campaign following the above-described strategy, and ended up sending something less than a hundred violators to jail. But the jump in compliance was notable -- such that real tax revenues went up, in spite of substantial reductions in the tax rate.

### **Dealing With Corruption at the Customs House**

Perhaps because customs duties are one of the oldest and most traditional sources of finance for national governments, their administration has a very long and rich history of corruption.

As an economist, I want to open this topic with what I feel is the most important lesson -- the wisdom of the uniform tariff rate as the cornerstone policy. With a uniform tariff rate, there are only two ways in which a customs official can engage in corruption -- by simply letting an item pass without paying anything, or by understating its true value. By contrast, with highly differentiated tariff rates, a customs official can simply note that "this item might be classified in category 3521, carrying a tariff of 150%, or in category 2260, with one of 110%, or in category 1556, with a rate of 70%, etc." Corruption then becomes very hard to detect, particularly when the different categories all carry some degree of plausibility with respect to the item in question (a condition that is not very hard to meet with traditional tariff schedules typically covering 5000 or more categories).

While a uniform tariff rate solves some problems, it leaves open the vexing issue of getting an accurate value on each imported item. The incentives to falsify can be substantial, but are not so great when the tariff rate is itself low (e.g., in the 0% to 10% range, or even that between 10% and 20%). Special note should be taken of the cases of systems of severe import restrictions via licensing or other schemes, or of rigorous exchange controls. In such cases importers have incentives to overstate the value of the goods they are importing, simply to get a bigger foreign currency allocation. (The excess value to later be sold on the black market or simply freely used, without the need for official authorization, by the importing entity in question.)

One way in which an increasing number of countries have attempted to improve their customs valuation is through contracts of preshipment inspection. International firms specializing in such inspections are contracted to do the inspection in the foreign port -- before shipment to the country in question. This gives a pretty ironclad insurance against undervaluation due to the corrupt practices of the country's own customs officials. But that guarantee holds only to the degree that the preshipment valuation is allowed to stand. In some actual cases the preshipment valuations are either advisory (rather than definitive), or subject to appeal and later revision in the receiving country. In these cases, of course, corruption by the local inspectors can again come into play.

I should add that the scheme of preshipment inspection was sanctified by a World Trade Organization agreement (in 1993), that a considerable number of countries, many in Africa and several in Latin America have adopted the system, and that a considerable number of international firms now offer preshipment inspection services.

### **The Final Goal: How Successful Countries Defeat Corruption**

The economics of tax evasion can easily lead one to fatalistically accept the idea that, like death and taxes themselves, this form of corruption will always be with us. To an extent that is bound to be true, but certainly not for the typical taxpayer.

The pessimistic vision stems from the economic notion that economic agents gravitate towards an equilibrium in which, at the margin for each type of action, the incremental benefits associated with the last spurt of effort will tend to be equal to its incremental costs. Since escaping some dollop of tax (via a little extra evasion effort) will always entail the financial benefit of not paying it, the economics of the story seems to boil down to each taxpayer just finding the right degree of evasion effort -- being ready to engage in such efforts up to, and just

up to, the point where the next bit of effort would carry a cost greater than the benefit. At this point it almost seems as if economics predicts that just about everybody would be a tax evader, even if only for a small amount.

Countries like the U.S. and the UK seem to suggest that this dire “prediction” need not be reflected in reality. And the reason turns out to be quite simple and straightforward. It relies on what we economists call a “corner solution”. The analogy is with those foods we do not eat at all. This may be because even our first serving of caviar is too expensive to warrant its very high cost. Or it may be that our dislike for anchovies causes us not to eat them, even when they appear as items on free breakfast or luncheon buffet. In the caviar case, there is a positive benefit to the first serving, but the cost is too high. In the anchovy case, even the first serving fails to have a benefit -- and indeed has a cost in terms of what we call “disutility”, so that we would have to be actually paid to do so before we would take even our first bite of anchovies.

All this can quite simply be linked to tax evasion. The caviar case is the one where taxpayers really would engage in evasion if they clearly knew that they wouldn’t be caught. This determines that they perceive the results as beneficial. But they fail to engage in the evasion activity because its likely cost, as they perceive it, exceeds the benefit by a clear and probably substantial margin.

The anchovy case has its parallel in those taxpayers whose internal ethical scale already imposes a sufficient burden of opprobrium on any act of “cheating the government”, that they would not do so even if they were sure of not being penalized by the authorities.

This gives us a good way of looking at the problem. For any level of penalty, and any level of the probability that it will be imposed -- there will be first those taxpayers who wouldn’t cheat even if there were no penalty at all (call these group A -- the anchovy people). Then there

are those who probably would engage in acts of evasion if the penalty were smaller, or if the probability of detection and penalty were lower, but who for the given penalty and probability levels find it prudent to comply fully with their tax obligations (call this group C -- the caviar people). But finally there are quite likely to be those who sense a benefit from at least some degree of evasion, which is greater than the perceived cost (for given penalty level and probability of detection). Call these group E, the evaders.

What, then, is the recommended strategy? It is to set the penalty levels and/or the probability of detection sufficiently high so that nearly everybody who might otherwise be in class E chooses, logically and rationally, to be in class C (those in class A will presumably be there, independent of the actions of the authorities). This is the approach followed by the United States Internal Revenue Service, the UK's Inland Revenue and similar authorities in other high-compliance countries. It is an approach that works well, at least by comparison with the systems of most developing countries. But, as I have been at pains to explain, it is not an approach that lends itself to being implemented overnight. It is critical that typical taxpayers be left with a high degree of confidence that the system will treat them fairly, and in a nondiscriminatory fashion, and that the penalties are not outrageous, when viewed in relation to the delinquencies that call them into play. One reaches this sort of tax administrator's nirvana, I am afraid, only at the end of a long and arduous road. But for any country, in my opinion, it is a road well worth traveling.