



USAID
FROM THE AMERICAN PEOPLE

EG Technical Briefings
Volume IV No. 1, Jan. 2007

Corruption and How to Limit it by Use of Common Sense Economic Policy: Briefing on Corrupt Behavior in Tax Evasion, Customs Clearance Operations, and Black Market Dealings

Summary: This technical brief is largely based on a presentation given by Prof. Arnold C. Harberger at a USAID Roundtable on "Lessons Learned in Designing Anti-Corruption Interventions in Economic Growth" on June 12, 2006 in Washington, DC. Prof. Harberger's presentation, now available as a paper prepared for USAID, identified corruption as a "social science phenomenon" that can be observed, whose intensity and extent can, to some degree, be measured or estimated, and like many other kinds of behavior, responds to economic incentives. In addressing the economic aspects of corruption, Prof. Harberger focuses on specific varieties, including: tax evasion, and black markets, and argues that since behavior that leads to corruption is influenced by economic considerations, economic policy can be an important tool in a country's effort to reduce corruption.

Tax Evasion:

In contrast to most other forms of corruption, such as bribery, with classic "supply and demand" sides, tax evasion is dominated by demand-side behavior. Taxpayers behave corruptly by evading taxes in misstating their tax liabilities and sometimes, when challenged, by bribing public officials to condone the evasion. Both legal avoidance of taxes and their illegal evasion can be explained with the help of economic analysis. However, tax evasion is generally considered to be corrupt behavior, while mere avoidance of tax liabilities by legal means is not. In both case, expected costs and benefits to the individual can be identified that help explain people's behavior under different tax policies. The benefits and costs of tax avoidance to the taxpayer who engages in it are fairly clear. The costs of legal avoidance of tax liabilities might include a lower before-tax rate of return for the taxpayer's investments for example, tax-exempt bonds, and hours spent in planning and executing legal tax avoidance strategies. Tax evasion costs are potentially much higher. Their deterrent value includes the probability of being caught, severity of the punishment, and, in some cases, moral anguish about cheating.

In the United States, top federal income tax rates have dropped significantly since World War II, and dropped even more with the Tax Reform Act of 1986. But, even so, incentive to cheat remains. Despite the reduction in rates, a significant gap persists between taxes due and paid, especially for non-wage and non-salary income. Recent estimates suggest that in 2001 the gap between total tax due and tax paid in these categories was about 30 percent, and up to 50 percent for some activities, such as profits of business enterprise reported on individual tax returns. The estimated gap for wage and salary incomes, in contrast, was less than 1.5 percent.

Developing countries are challenged in achieving broader tax compliance. The need for revenues can create a vicious cycle, in which tax rate increases - intended to improve public finances -- provide instead more incentives for tax evasion. In some countries low compliance is widespread, and taxpayers have lost confidence in the fairness and functioning of the tax code. For example, from the mid-1950s over a period of 10 years, the estimated tax compliance rate in one South American country fell by almost 50 percent, while tax rates continued to rise.

Culture of Evasion and Other Forms of Corruption

It is important to differentiate between situations in which corrupt behavior is rare and unusual, and situations in which certain kinds of corruption are wide spread and "generally accepted" as part of doing business. Corrupt systems often continue to function through the creation of facilitators; these middlemen provide – for a fee – the public with the service "to work the system," which may include bribery. The intermediaries create a system of price discrimination between those willing and able to pay for services, such as the release of items in customs at the border, and the rest of the public. The fees are often low enough that a large part of the public can afford the services and therefore ensure that the system does not come to a screeching halt. These fees might be considered an "equilibrium" solution that is acceptable for most parties involved in the transaction.

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Black Markets

A black market develops if the government sets a fixed price for a good or service or rations it at a price that is lower than the price that would be achieved in an open market. In a fully developed black market – where almost the total supply of a good is traded in the unofficial market – the market clears at a price that is unaffected by the official (lower) price. But in most cases, some consumers are able to buy the product at the fixed price. This reduces black market supply so the effect is a black market price that is higher than the price that would prevail in a free market.

Often Little Sense of Transgression in Trading on the Unofficial Market

Participation in black markets often generally is considered a lesser form of corruption than tax evasion or bribery, and, under certain circumstances, black market participants may lack any guilty feelings about their actions. If citizens are unable to meet their daily needs through regular market transactions, large parts of the populations often turn to unofficial markets. The analysis of how black markets work to evade the obligation to sell or buy a good or service only at or below an officially prescribed ceiling price is similar to that of how unduly high tax rates coupled with lax enforcement and low penalties tend to produce tax evading behavior.

Economic policies may encourage black market behavior. For example, the government's fixing prices for certain products below market clearing levels encourages consumers to buy whatever amounts may be available at the fixed, low prices since these products – to the extent they are available at the official prices – they are being offered at a bargain price and can be resold with a black market premium. (If the products are offered in quantities sufficient to satisfy demand at the artificially low prices in full, they are being subsidized, often at heavy cost to the government budget). This explains the phenomenon in countries with widespread price controls of pedestrians' common habit, when walking by a buying queue, of joining the queue without even knowing what products are being offered for sale

How to Deal with and Reduce Widespread Tax Evasion

Prof. Harberger suggests several strategies to achieve higher tax compliance. Instead of initially challenging non-compliance among average citizens, he proposes targeting less popular businesses, such as, say, nightclubs that also engage in illegal gambling and prostitution operations. In his view, targeting such illegitimate or borderline enterprises automatically encourages higher compliance by other, more reputable businesses and citizens. The next step is to start to enforce the tax law among legitimate businesses with suspected underreported income. A slow graduation of enforcement from the "outliers" to the majority of ordinary taxpayers can improve compliance rates. In addition, Prof. Harberger suggests the periodic publication of names of taxpayers with declared incomes above a certain level. This strategy has been used successfully in some countries where the prosecution of a relatively small number of tax payers evading part of their taxes led to a dramatic overall improvement in the compliance rate.

Dealing with Corruption at the Customs House

Tariffs are historically an important source of state revenues, and remain so for many developing countries. Customs operations are therefore often the target of corruptors. An effective way to reduce corruption is to introduce a uniform or near uniform ad valorem tariff rate. This eliminates the need for classifying products and the incentive to improperly influence tariff officials' decisions on which rate applies. However, even a uniform rate allows scope for adjusting the declared value of imports and thus to corrupt the duties levying process. Licensing schemes and similar systems pose the greatest problems, especially if the licenses distribution is not transparent. Some countries have introduced pre-shipment inspections, executed by international companies in the exporting countries. This approach reduces to low levels corruption at their borders.

The Final Goal: How Successful Countries Defeat Corruption

The complete eradication of corruption is a lofty goal, but countries can reduce corruption significantly. Applying economic analysis to the problem of tax evasion might suggest that most people will try to avoid paying taxes as long as the costs are slightly less than the potential benefits. However, high compliance countries, such as the United States, experience a so-called "corner solution." When penalties are sufficiently high, and prosecution sufficiently sure, many taxpayers who might otherwise engage in evasion choose not to do so. They go into a "zero evasion" mode (a corner solution) judging that the likely costs of evasion far outweigh its potential benefits to them.

(Source: Arnold C. Harberger, "Reflection on Corruption: An Economist's Perspective, available at http://pdf.usaid.gov/pdf_docs/PNADG654.pdf)