

Chapter - III : Efficiency of Market in Corruption

Models of bureaucracy are mostly built upon the normal assumptions of neo-classical economics. In such models, the bureaucrats are portrayed as rational individuals who maximize self-interest. In Niskanen's model, the top bureaucrat maximizes the bureau-budget. Then how do the public employees behave in the rent-seeking model postulated above? Do they try to maximize rent? In a corrupt tax bureaucracy, do the tax-officials maximize corruption? Is tax evasion maximized thereby?

The answer depends on the perspective of analysis. Modelling a public official from the economics of crime perspective *a la* Gary Becker would prompt one to say 'yes' to the questions [Becker, 1968]. The economics-of-crime approach assumes an individual to be a rational entity who tries to *maximize* personal utility through deviance from prescribed norms. This means that so long marginal expected gains from deviance net of expected costs would be positive, deviation will continue to rise. A tax-official modelled this way would maximize evasion through corruption subject to the certainty (risk) of detection and severity of associated penalty. If his gain from corruption were a fixed proportion of the evaded amount, then this would lead to a maximization thereof. That is: all opportunities of corruption would be exhausted until marginal expected bribe from evasion and marginal expected penalty on

detection are equalized. Such a modelling would also be consistent with most models of tax evasion, starting with the seminal work of Allingham and Sandmo [1972], in which evasion is maximized by the rational non-compliant taxpayer.

A decision-theoretic approach such as that of Becker[1968] has been considered inappropriate because the probability of detection is not independent of crime since the offender and the law enforcer are involved in game-theoretic interaction [Tsebelis, 1991]. Moreover, notwithstanding copious literature, the conclusion that certainty and severity of punishment would have positive effects of deterrence remain largely unproved [Cameron, 1988]¹³. However, models of deviance, either economic or game-theoretic, have identified level of enforcement as a critical determinant of the actual level of deviance. Accordingly, effective enforcement has been emphasized for controlling corruption. But it may be observed that, in reality, even when enforcement is slack, deviance does not reach its height. In the real world, enforcement may not be that a critical determinant of the level of deviance as usually assumed. This is particularly true in relation to public sector corruption.

In tax administration, the relevant parties maximize neither corruption nor evasion involved therein. However, the reason is not a lack of rationality on behalf of the tax-officials or slackness in enforcement. Rather, non-maximization occurs due to of a number of non-enforcement constraints that operate in the corruption-market¹⁴.

These constraints do not allow all the 'possible' transactions to take place despite demand for evasion, and for that matter, supply

¹³ For an exception *vide* Souryal, S. S.: "The Religionization of a Society: The Continuing Application of Shariah Law in Saudi Arabia", *Journal for the Scientific Study of Religion*, Vol. 26, No. 4, 1987, p.429-449.

¹⁴ For elaborate discussion of the operation of the market in corruption refer to Chowdhury [1991].

of corruption by the taxpayers. In effect, many of the opportunities of corruption go unutilized and consequently, neither corruption nor evasion is actually maximized. Apparently, the market in corruption operates inefficiently. At least five categories of constraints may be identified that operate in the market in corruption around tax administration. These are :

- a. the problem of accountability management
- b. the problem of uncertainty
- c. social costs
- d. costs of negotiation, and finally
- e. discount rate for future.

These constraints affect the concerned parties and various types of transactions differently. So the impact is different with different forms of taxes and different tax regimes. The most important impact is, however, on the consideration of an opportunity of evasion, and the operation of the market in corruption is affected thereby. In the end, the outcomes of the market are different with respect to different types of opportunities.

The point is borne out by the fact that in Bangladesh, the severity of customs evasion varies depending on the sources of imports. In an estimate carried out in relation to Bangladesh's import from seven Asian countries¹⁵, the average rate of underinvoicing was found to be about 29 percent. However wide variation was observed in inter-country rates. The rate of underinvoicing was as low as 9.31 percent for imports from China and as high as 61.47 percent for Korea [Chowdhury, 1992]. The dispersion shows that market in corruption performs differently with imports from different countries, in the same scenario of

¹⁵ These are major sources of imports to Bangladesh, namely, Japan, India, China, Singapore, Korea, Hong Kong and Malaysia. These are also notorious for underinvoiced imports [Chowdhury, 1992].

enforcement, indicating that the factors affecting the attractiveness of the opportunities of corruption do not operate with similar influence in all situations.

In another study, in relation to tax evasion and corruption in local government in Tanzania, Fjeldstad observed that practice of corruption and evasion varies between the individual types of taxes with different bases and modes of administration [Fjeldstad, 1996, p.7]. Consequently, the level of corruption, and, for that matter, the level of evasion that is eventually perpetrated vary depending on the nature of the prevailing environment. These examples discount the relevance of the punishment and enforcement structure, and indicate that the factors affecting the attractiveness of the opportunities of corruption do not operate with similar impact in all situations.

In sum, different constraints operate and determine the nature of the market in corruption for evasion. Their impact differs depending on the nature of the institutional arrangement, regardless of the enforcement mechanism, its structure and effectiveness. Below, we discuss these constraints and their mechanism of affecting the market in corruption in tax administration.

Problem of accountability management

As documented in economics of crime, one of the main concerns of tax-officials in conniving in evasion is the probability of detection. Perception of this probability is based on individual experience of the intensity and the effectiveness of enforcement. In reality, tax-officials are critically concerned about the prospective level of enforcement *in future* which may be high enough to overcome the current level of information asymmetry that allows to perpetrate corruption. Since their activities are recorded in official documents, an intensive investigation at a subsequent stage

may implicate connivance. Accordingly, their overriding concern is the scope of defence in case of detection. If there is a suitable cover, the tax-official may escape personal liability despite connivance. In other words, in deciding whether to connive or not, a tax-official is more concerned about a 'satisfactory explanation' than the chance of detection in course of investigation. Unless there is such a reliable scope of *accountability management*¹⁶, a tax-official will in most cases forgo an offer of gainful connivance. So the need for accountability management constitutes a critical 'decision making cost', to use the term coined by Horn [1995].

How the need for accountability management constrains a tax-official in engaging in corruption may be illustrated. Let us consider a hypothetical but representative case of a customs official who is going to assess a consignment of timber imported into Bangladesh from Myanmar. It is a voluminous consignment of 2,000 metric tonnes of timber and the declared price is £70 per metric tonne. The highest recorded price is £100, which relates to a previous consignment of only 100 metric tonnes of timber imported from Malaysia nearly 14 months ago. Because of the price differential, the present consignment looks like a case 30 per cent underinvoicing. Can the customs officials in this case afford to connive with the importer and assess on the basis of the declared price?

Yes, he can; because there is ample scope for accountability management in this case. The customs official can reject the highest recorded price (£100) and uphold the declared price (£70) of the present consignment saying that (a) Malaysian timber is better in quality than Burmese timber, (b) the cost of transportation from Malaysia is higher than that from Myanmar, (c) the present

¹⁶ 'Accountability management' is different from 'accountability conspiracy' mentioned earlier. The latter implies collusion between officials along the hierarchy to ignore a case of malfeasance after detection.

consignment is relatively large in volume and so, it may have enjoyed a genuine discount, and last but not the least (d) there is a substantial time gap between the two consignments why they are not fairly comparable. Given such enabling reasons a customs official can afford to settle in favour of the declared price and allow evasion thereby.

What if the present consignment was similar to the consignment of the highest recorded price: same origin, same exporter, same quality, and same volume? Then the customs official would decline to connive because, *if ever* there was an audit or investigation, he could not justify his action of accepting the declared price for assessment.

In the same vein, customs officials are very reluctant to connive in cases of misdeclaration of commodity description¹⁷. If detected, there is little scope of defending one's action in such a case.

Problem of uncertainty

The problem of uncertainty arises because it can not be predicted in advance whether a plot of evasion will see through success. In customs, an attempt at evasion involves misdeclaration of commodity description or value of the consignment in the trade documents. It would also require fake documents to make out a persuasive case. So an importer is required to invest in a plot of evasion before he can approach the customs officials for connivance. But all efforts will fail if the attempt is detected by a customs official who can not be bribed into accountability conspiracy.

On detection, not only that the taxpayer will have to meet a higher tax liability than planned, he may also have to face the charge

¹⁷ Misdeclaration of commodity description is attempted by the importers so that, if undetected, a lower rate of duty will be applied and/or a lower assessment value will be used, resulting in lower duty liability.

of malpractice leading to fines and penalty. In customs, the adjudicating officer may even order confiscation of the goods to the state without the option for redemption in lieu of fines. In a severe case of fraud, a competent officer can even refer the matter to the court of law for prosecution as a criminal offence.

This uncertainty could be avoided if the taxpayer could involve the tax-official in 'collusion', that is, if he could discuss his plans of evasion with the concerned tax-official and secure his commitment before effecting shipment. However, the tax-officials are also unwilling to collude. They prefer to avoid any pre-commitment not only because the nature and extent of risk involved cannot be ascertained in advance, that is, unless the importation has been effected and trade documents are available for scrutiny, but also because they regard collusion a lower form of deviance than connivance. In collusion, the tax-official is *encouraging* an *attempt* at evasion not yet made whereas in connivance, he is *just helping* a taxpayer to *get away* with his attempt at reducing tax liability. Moreover, a number of officials are involved in the evasion process and approaching all of them and obtaining pre-commitment is an impracticable job.

In such a situation, taxpayers attempt at evasion only of a type and level for which connivance of the tax-officials may not be too difficult to secure. Thus opportunities like high rate of underinvoicing or blatant misdeclaration, which may appear to be unacceptable to the tax-officials, remain largely unattempted, and the effective demand for evasion is reduced thereby.

Social costs

In engaging in corruption, tax-officials face a dilemma because of their innate need for maintaining a good social image *vis-à-vis* the temptation of large sum of illicit money. Indiscriminate corruption damages one's social image much more severely than that of a thoughtful officer. Despite involvement, they try to retain

reputation as honest officer. This requires them to trade off between social stigma and illegal income albeit without knowing where the equilibrium is. Presumably, tax-officials stop short of the level at which he intuitively perceives public branding as 'dishonest'. Concern for social prestige, therefore, operates against *systematic* involvement in corruption and reduces the demand for corruption.

Careful about their social prestige, officers are found to be *selectively corrupt* in practice. Corruption compensates for low salary and so, for many, the right time to stop is when there is *enough* earning for a decent livelihood and a dependable saving for the future.

Senior officers are more careful of the social costs of engaging in corruption. Many prefer to be known as 'reasonably honest' officer to most of the subordinates and clients. Some of them refrain from corruption for a long time after assuming charge in a new office. Some officials are *usually* incorruptible and only in exceptional cases, when the stake is very high but apparently safe, they agree to connive for an exorbitant bribe. Low stake petty corruption is normally avoided by them.

While some may be promiscuous, most senior officials are very choosy particularly about partners in corruption. They are *selectively permeable* and do not *open* to anybody proposing connivance. They prefer to wait until there is a reliable mediator. Moreover, they avoid all such proposals that may attract suspicion and lead to wide exposure. Wide exposure quickly and irreversibly entails branding as an 'approachable' and 'corruptible' officer.

In sum, corrupt tax-officials behave in a way so as to minimize the social costs of engaging in corruption despite temptation and venality. The result is self-restraint and lower effective demand for corruption by the bureaucracy.

Costs of negotiation

Any transaction involves expression and exchange of symmetric interests through negotiation between the prospective parties. However, the market in corruption is virtual rather than physical, and so, it does not facilitate negotiation between the taxpayer as the supplier and the tax-official as the consumer of corruption. How can then the taxpayer be aware of the tax-official's demand and readiness for accepting bribe? On the other hand, how can the tax-official come to know whether the taxpayer is willing to offer money and may be taken into confidence? Indeed, the problem of negotiation is a stumbling block in the process of corruption.

In the arena of tax evasion, negotiation is a bilateral problem in that both the taxpayer and the tax-official are unsure of whether the other party is amenable to a proposal of corruption. For a taxpayer the main problem would be the unpredictability of the response of the officials. In the process of involving a tax-official in evasion, a taxpayer requires negotiation for a number of reasons. First, to ascertain the legally due tax-liability; second, to agree upon the safe and feasible amount of evasion; and third, to decide upon the share of the officer in the amount evaded [Chowdhury, 1992].

Negotiation in a stigmatized affair like corruption that constitutes a moral-psychological problem for individuals. Men are born with shame and inhibition. Moreover a proposal of corruption is not only an indecent one, it also constitutes a criminal offence and therefore has a risk element ingrained in it. Owing to the sense of self-esteem, taxpayers are ashamed to propose a corrupt deal and the tax-officials are ashamed in exposing their readiness to accept such an offer.

However, it is observed that the problem is substantially reduced when professional people work at the taxpayer-official interface. In Taipei, it has been found that the certified public accountants (CPA) play a major role in negotiating corrupt deal

between income tax-officials and the taxpayers [Chu, 1990]. In Bangladesh, it is the income tax consultants that play a similar role. In respect of customs duty, it is the licensed customs agents, officially known as the 'clearing and forwarding agents' that play an effective role in negotiating corruption deals. In sum : the market in corruption for tax evasion is not self-efficient and works effectively with mediation.

The problem of negotiating a successful deal also has an environmental factor to it. A deal of corruption requires private and secret discussion, the scope of which is limited in a public office. Though in the context of today's Bangladesh, tolerance of corruption is quite high, it remains exclusively at the individual and private level. At the social or official level, corruption is wholly a taboo issue, ineligible for open tolerance. Despite pervasive corruption, this divergence between official and private morality is an important determinant of people's demand for privacy and secrecy. Lack of privacy is a physical impediment to efficiency of the market in corruption. Notably, apart from verbal negotiation, the transfer of the 'brown envelop' containing bribe money is also a problem.

Discounting future

One of the crucial constraints on the corrupt behaviour of the tax-official is his concern for future. Not only that he does not want at any cost to lose his job but he does not also want to risk his future 'postings'. His intention is to complete the tenure in the current position and then, in course of routine job-rotation, secure a similarly rewarding position with certain scope of corruption. In other words, tax-officials apply a high rate in discounting future income as they, in effect, try to maximize lifetime income out of corruption. This leads them to exercise self-restraint when faced with opportunities of evasion. In the end, they are not ready to connive in all proposals of evasion offered to them.

Even thoroughly corrupt customs officials take care in utilizing opportunities of evasion. They avoid such opportunities, which if detected, would not only render them liable for disciplinary action but also establish them as 'an unreliable officer lacking sense of proportion' and disqualify themselves for lucrative positions in future.

In Bangladesh, two categories of officials perform customs functions. By tradition, sea customs stations, called 'custom house', are managed by career customs officials. On the other hand, it is the excise and VAT officers who manage the land and air customs stations. They are posted to land or air customs stations for a limited period on a temporary basis. This is so since land customs stations are under the jurisdiction of the Excises and VAT commissionerates. In terms of illegal earning, customs stations are by far more attractive than the excise and VAT offices in Bangladesh. When assigned to customs positions, the excise and VAT officers regard it as a golden opportunity to make a fortune. Destined to be reverted to non-customs positions within a year or two, they tend to maximize *current* income and are often found to engage in relatively reckless behaviour to that end. Benapole Customs, the largest land customs station in Bangladesh, is infamous for this syndrome as it is manned by the excise and VAT officers assigned customs job in course of job rotation.

However, the opposite is true for sea-customs officials who apply a high rate in discounting future income and exercise self-restraint when it comes to maximization of current income through corruption. Within sea customs, all positions are not equally rewarding. First of all there are appraisers and cargo examiners. Appraisal is considered more rewarding. However, within the appraisal wing, there are positions which are not very lucrative. Sea customs officials make it a point that, in course of job rotation, they are not relegated to a very unattractive position because of

notoriety; or they do not have to suffer a pre-mature transfer out of a lucrative position for reckless conduct. Clearly, officials value future career at a high rate and exercise self-restraint in demanding corruption.

Impact of the Constraints

Different types of constraints discussed above are important determinants of the level of corruption in tax administration. They have been combined to develop a unified model that is useful in comparing different institutional arrangements in terms of their behaviour in the market for corruption. Notably, in a bureaucratic regime, the decision to engage in corruption is taken at the individual level, while in a private regime, it is decided at the organizational level.

It should also be noted that the constraints have been analyzed mainly from the perspective of the tax-officials that are the consumers of corruption (supplier of evasion). In fact the model is comprehensive, and on reflection, it will transpire that the constraints also restrict the behaviour of the taxpayers as the supplier of corruption (consumer of evasion).

In a market of corruption around tax administration, higher efficiency would also mean higher demand for evasion, and for that matter higher effective supply of corruption, by the taxpayers. As has already been indicated, due to uncertainty in the market, the taxpayers are constrained to attempt at all sorts of evasion. Contrarily, if the cost of negotiation is lower, the taxpayers will want more evasion than when the cost of negotiation is high.

Similarly, factors like social cost and high discount rate for future will reduce the efficiency of the market in corruption. Officials will find it rational to exercise self-restraint and be selective in demanding corruption. Again, the result will be 'sub-optimal' level

of corruption and evasion meaning that despite opportunity, the effective supply of corruption will be less.¹⁸

Most importantly, in such a scenario, the importers will also exercise self-restraint and refrain from planning massive evasion and avoidance through gross underinvoicing and high-risk misdeclaration. That is, the effective demand for evasion will also be lower.

In the following chapter [Chapter-IV], we present a case of privatization of tax system to which this model can be usefully applied. The ultimate purpose is to analyze how the market in corruption would behave under a private regime relative to a bureaucratic mode of tax administration¹⁹.

¹⁸ In this connection, it should be clearly mentioned that all cases of tax evasion do not necessarily imply complicity of customs officials. Indeed, numerous instances of evasion go undetected for various reasons.

¹⁹ It should be clarified here that in this book, by 'corrupt tax officials' reference is made only to a section of tax-officials who are engaged in corruption. A good number of tax-officials remain thoroughly honest and never participate in corruption.