

## **The Menace of Tariff Evasion**

**By Syed Abul Basher**

In the fiscal year 1997-98, the Government of Bangladesh targeted the total receipts of Tk. 8217.40m from import bill. But the actual figure fell short by Tk. 825.20m (FE, 1998). Such shortfall has become a repeated occurrence over the years. However, the government has demurred from taking any practical measure to rectify this condition.

Few people would deny that the existing system is praetorian. Import bill may fall short of the target if the reported amount of imports is lower than the actual figure. The practice of under-invoicing is prevalent among profit-seeking importers who seek to maximize their own gains, while powerful yet underpaid government officials are lured by importers' offers and collaborate in such activities.

The evasion of tariff is not limited to the collection of import bills; it is equally an equivalent problem in collecting the general taxes, such as those of income taxes, usually known as tax evasion. Whatever the area of tax and/or tariff be the central problem remains the same: corruption exists and it encourages to escape from paying due tax.

Corruption arises because the law enforcer's (agent) salary is often below his opportunity cost. That is, it is less than the amount he would be paid had he been employed elsewhere. If a person is given a lot of power coupled with insufficient monitoring, corruption can proceed.

In LDCs civil officials are mostly underpaid. Lower wage leaves them little room to refuse bribes. One common recommendation often made for poor countries is to increase the pay of civil servants. There are at least two reasons why higher wages could improve performance in the collection of taxes. The first concerns the incentive of tax inspector to shirk or in other words taking bribes. A wage premium may be used to increase the value of remaining in a job relative to outside opportunities and hence reduces shirking. The second argument concerns the quality or the honesty in this case, of the agents. Higher quality workers are assumed to have higher reservation wages.

While public sector wages may be low in LDCs, it is widely recognized that there are rents to those who behave dishonestly. These accrue in the form of bribes paid to corrupt inspectors by taxpayers who wish to avoid paying their due taxes. Paying higher wages constitutes one means of enforcing honest behavior from those, who if paid only what they could receive in their next best occupation (i.e., their reservation wage), would not be dishonest.

The above discussion leads to one popular phenomenon, 'efficiency wage,' – a wage that solves the moral hazard problem. Theoretically it is such a wage regime where the incumbent has zero incentive to accept bribes. Although for efficiency wage to make sense certain conditions require to be fulfilled. However, experimentation on it is not quite uncommon. During the mid-nineteenth century, Chinese Customs House was run and staffed by the extremely corrupt officials. The final effect on tax revenue was resounding when the wages were raised to improve the quality of the workforce. There is no good reason to suppose that there was a change in the honesty in the pool of available labor, but the monitoring of custom officials was greatly increased, with random audits and immediate dismissal for any proven impropriety.

In fact there exists asymmetric information – a situation where one agent knows more than the other. For example, both the briber and the bribee know very well the amount of bribe to be exchanged, but the authority, as a third party is in vacuum. These asymmetries give rise to two classic phenomenon of information economics namely moral hazard and adverse selection. Moral hazard arises because taking bribes cannot be observed without costly monitoring; and so does adverse selection, since not all potential tax inspectors (in our case, it is the custom officer) can be selected confirming whether they would be honest or dishonest.

The above asymmetries result in a two-fold problem. On the one hand, it provides incentive to agents to accept bribe, shirk duties, consequently depriving the country of due revenues. On the other hand, it undermines the image of the honest officers. We hardly trust our police force nor we have faith on our civil officials. However, these do not mean that we lack honest officers.

One mechanism to protect the acquittal is *signaling*. One sensible signaling in this regard would be to offer *capitulation wage*, a wage below the reservation wage, at which only the dishonest would become tax inspector. Intuitively, the honest officer would not apply for such position since it is below his opportunity cost. The authority (usually a government agent) only obtains tax revenues from successful monitoring. However, penalty seems to be an inefficient mechanism here since there is little to be gained by dismissing someone who is caught taking a bribe since it is already known that his replacement will also be dishonest. Nevertheless, it provides an important answer to a popular query: *why do workers continue to seek employment in and remain in the public sector?* The answer that goes is that civil servants can moonlight. It seems weak indeed considering the fact that private sector workers can also moonlight if they wish to. The theory of capitulation wages, however, provides an alternative plausible and coherent answer to this puzzle.

It came out in a survey result in Indonesia that 96.8% of job-hunting university graduates preferred government work to all other forms. In addition, no one ever seems to leave a job in the tax office once it has been attained (Besley and McLaren, 1993).

Like the honest officials there are also truthful importers. Khan (1997) categorized importers into two broad classifications, one is 'entrepreneur importers' – importers who reveal the actual prices of imports. Other is 'rent-seeking importers' – who are in contrast conceal the true price. In 1995, the government of Bangladesh delegated the mandatory PSI (Pre-shipment inspections companies) to deter bribery and improve tariff collection. The final outcome was quite striking. At the end 'rent-seeking importers,' 'corrupt bureaucrats' and 'PSI companies' formed a collusion to evade tariff revenue (Khan 1997).

Corruption occurs throughout the world but it is of particular concern for developing countries. Widespread corruption is a symptom of a poorly functioning state, and a poorly functioning state seldom experiences economic growth. The type of corruption that damages economic growth most is not petty bribe but rather the massive theft of state funds by venal politicians and their senior henchmen. It is hard to believe that corruption at this level is much influenced by official pay scales. Pettier forms of corruption become much harder to control when junior officials see their supervisors filching vast quantities of other people's money.

### **The theory of second best**

One common solution to state inefficiency is to disavow it. Privatization in this regard plays a crucial role and it's being increasingly practiced. Recently, the GOB has listed a total of 54 losses ridden SOEs (State Owned Enterprises) to be considered for privatization. Side by side the government can also privatize the tariff revenue collection. It can lease out the custom office to an agent who would maximize the tariff revenue and in return give a negotiated amount to the government. This would not only solve the problem of adverse selection and moral hazard but it will also allow the government to secure a certain amount of revenue. The profit-maximizing agent, in contrast, would endogenize his monitoring to reap his return.