1. Introduction

Shell Brasil, the Brazilian subsidiary of the Anglo-Dutch oil group, is to sell 285 service stations and six fuel deposits to Agip do Brasil, the local subsidiary of Eni, the Italian group. Shell said the move was part of efforts to concentrate on the most profitable parts of its business in Brazil, but it is understood to have sold the stations, in remote central and western regions of the country, after failing to compete with smaller distributors undercutting bigger companies by evading taxes. (Financial Times of London, 25 February 2000, page 18)

In 1997 I visited the Czech Republic and got to know one of the main wholesalers of cut flowers. He made his living by importing flowers from Holland and selling them to hotels and flower stands across the Czech Republic. I learned from him how a Dutch auction works, how purchasers rate the quality of flowers, and the how wholesalers and retailers guess at demand and race against the clock to sell flowers before they wilt. My discussion with the wholesaler filled a chasm in my practical education about markets left by the theoretical excesses of graduate school. These discussions also showed me that there can be distance between what producers on the front line of markets find to be a market failure, and what professors of economics believe hinder markets. The wholesaler’s hair was greying because the government did not apply taxes evenly to him and his competitors. Rogue merchants would travel to Holland in small unrefrigerated vans in which it was easy to smuggle flowers across the Czech border. The cost of flowers that withered in the vans was more than balanced by the border tariffs the rogues managed to avoid. Major wholesalers who delivered their flowers intact and paid their full customs duties saw small, inefficient suppliers slowly pushing them out of the market. The competitive edge of the small suppliers was not a zest for efficiency that brought flowers to the market intact, nor a keen eye that spotted the flowers Czechs wanted. The small suppliers were thriving because they were good at evading taxes. Between 1994 and 1997, the value of smuggled flowers had risen from 16.4 per cent of sales to 29.4 per cent of sales, according to official Czech and Dutch customs statistics compiled by Tulipa Praha SRO (1998). This competition from the underground economy harmed my friend’s welfare, but it also seemed that a larger harm came from the damage to efficient flower sellers.

The example of the Czech flower sellers and of the Brazilian gas stations suggests there exists a form of social loss that arises from government’s inability to make all firms pay their full tax. A tax system that rewards tax evasion will
advance the fortunes of producers who are good at evading taxes. When an inefficient producer who is good at tax evasion displaces an efficient producer who is a poor tax evader, there is a social loss. The loss is the difference between the costs of the two producers. This loss is not reflected in higher prices, but rather in lower profits. Consumers do not care whether a producer with low production costs and poor evasive abilities supplies them or whether a producer with high production costs and excellent evasive abilities supplies them. All consumers care about is price. Whether that price is the sum of low production costs and high taxes or high production costs and low taxes is a matter of indifference to consumers. Displacement losses are social losses because they strike at an economy’s revenue. Low profit firms are not able to pay generous wages or dispense fat dividends.

What seems to be at work in the example of the flower producers is a failure of markets brought on by a failure of governments. The mix of free markets with unequal enforcement corrodes economic efficiency. This corrosion comes in a variety of forms. What is true of taxes is also true of price controls, regulation of pollution, fishing quotas and other attempts by government to impose laws for the common good. Firms that pay the full minimum wage to their workers may stumble behind firms that violate the minimum wage. Fishermen and fisherwomen with nets that damage their catch, but in possession of fast boats that evade the quota police, may steal the market from competitors who do not damage their catch but who respect the allowable catch. In these examples regulations make nonsense of the market’s purpose of matching eager buyers to efficient producers. Welfare economists are aware that taxes and regulations may discourage consumers and producers from making trades that in the absence of taxes and regulations would bring benefits to all. Textbooks say little about how taxes and regulations encourage exchanges between high cost producers and eager purchasers. In the pages that follow I refer to ‘displacement deadweight loss’ as the amount by which the cost of the inefficient producers exceeds the cost of the efficient producers they have ousted.

Like vultures circling above injured prey, deadweight losses signal to the researcher a crippled market. Adding the ability to evade taxes to the ability to produce efficiently creates markets that may not encourage survival of the most efficient firms. Governments that cannot enforce rules evenly are not just unfair governments, they are brake-pads pressing against an economy’s progress. Governments seem aware of the deadweight loss from encouraging survival of firms that evade rules. A 1996 publication of the Quebec Ministry of Finance explains that:

Businesses that pay their taxes in full are also seriously affected by unreported work and tax evasion. They face unfair competition on the part of businesses that offer goods and services at lower prices because these businesses did not pay or collect
income tax or other taxes or they do not comply with the regulations in force (Quebec Ministry of Finance p. 24).

The International Monetary Fund has warned that corruption is a manifestation of poor enforcement of rules that may weaken the labour market. Vito Tanzi (1994), a senior economist at the IMF, explains that corruption can restrict the right jobs to the wrong people. Corruption leads to an arbitrary hiring and promotion of individuals who would not have been selected or promoted on the basis of fair and objective criteria and "the selection of these individuals will damage the economy not only by lowering the quality of decisions made by them and by increasing the frequency of mistakes but also by discouraging more able but less well-connected individuals from pursuing particular careers if they feel that the decks are stacked against them" (Tanzi, 1994, p. 12).

Governments try to minimize the loss from unfair competition in two ways. The first way of avoiding displacement loss is the obvious one of trying to enforce rules evenly among producers. 'Evenly' means that similar producers pay similar taxes or are subject to the same regulations. This prescription for efficiency is simple, but, as with those prescriptions for a good life laid down in the ten commandments, talking the talk is easier than walking the walk. A government may not be able to apply taxes evenly if tax evaders smuggle their wares in boats too fast for excise officers to catch, and if evaders befuddle tax officials with offshore accounts. Bribe and threats from tax evaders may also keep a government from enforcing taxes evenly. After the fall of communism, the Russian government gave special tax breaks to firms who were friends of high Russian officials. A large part of being a friend in the world of Russian tax collection consisted of unmarked envelopes bulging with cash. Part of Russia's problem in developing its economy may come from the rise of producers who are good at bribing and threatening, but poor at producing and distributing a product efficiently. A government without political institutions that resist corruption will have trouble keeping down the displacement deadweight losses from evasion of taxes and regulations.

The second way governments keep down displacement losses is to encourage a split between evasive and productive abilities. Evasion deadweight loss comes from the jointness of production and evasion. If governments could somehow encourage inefficient producers to give up their rights of production to efficient producers, deadweight losses could be contained.

This is the principle that seems to be at work with tradable quotas. Fishermen get quotas limiting their catch. Inefficient fishermen sell their quotas to efficient fishermen. Provided government has set the quota at a level that solves the common property problem, there will be no deadweight losses of any sort. The most efficient producers will pay the most for the rights to production and will come to dominate the market, just as a land-developer with the ability to build
a profitable shopping mall will buy out dozens of smallholders whose best use of the land is to grow potatoes. A well-developed political system that allows lobbyists to thrive may also be a device for containing the deadweight losses from evasion. Political lobbying is a legal form of exchange between evaders and producers. Lobbyists market their talents at getting special government favours, such as investment grants, to firms who can make the most of these favours. Two supermarkets may seek an exception to a commercial zoning law that would allow one of them to build in a residential area. The efficient supermarket with weak political connections might lose out to the inefficient supermarket with strong political connections. By hiring a lobbyist, the efficient supermarket may prevail. A political system with open lobbying and a leadership open to persuasion may help to minimize the adverse selection of talents that leads to a displacement loss. Perhaps this is why the tax systems of developed economies are complicated. Complication allows producers and evaders to specialize and trade with each other through the political market. The costs of organizing these political markets, often referred to as rent-seeking costs, may be seen as an echo of the deadweight losses that would have resulted from adverse selection.

I am not the first economist to have discovered the notion that there is a gain from trade when individuals specialize in their comparative advantage, and that markets develop in part to encourage non-jointness in production. But most discussions of specialization show the benefits of putting one’s energies in one of several productive activities. This approach to specialization has created the field of international trade economics and is at the basis of many other branches of economics. In the present book I want to draw attention to how equilibrium arises in markets where each participant has a productive talent and an unproductive talent. Using very simple and general assumptions I will build a case that many private and government institutions have evolved to avoid the deadweight losses that could arise when inefficient producers with some illicit talent for survival bump efficient producers out of the market. Government institutions have sought to allow individuals to peel away productive from unproductive talents, to specialize in one or the other and to trade production for evasion.

The chapters that follow have several goals. The first goal, which is technical, is to model tax evasion in a general equilibrium context. Modelling is interesting to economists, and I devote some space to explaining the new analytical tools I have developed. But modelling should have some payoff. I show that surprising insights come from the models I build and the techniques I use; insights which might not follow directly from intuition, but which arose from the modelling. For example, I discovered that tax evasion can raise government revenues, that the evasion of minimum wages forces some changes on the standard view of labour market equilibrium, and that subsidies given to
maximize a positive externality from production impose on society the same sorts of displacement deadweight losses as tax evasion imposes.

My second goal is to show that tax evasion is part of a larger problem of the uneven enforcement of government rules. This uneven enforcement carries a trademark social loss which can be measured using a specialized calculus I present in the chapters that follow. I show that the displacement losses from tax evasion have a counterpart in the world of price controls, quota regulations, subsidies to business, and the granting of monopoly licences. The present book responds to the alarm sounded by Vito Tanzi (1994) in his work for the International Monetary Fund. Tanzi warned that economic efficiency would suffer from the arbitrary application of rules and regulations which gave preference to some individuals over others. He cited the allocation of import permits, subsidized credit, zoning permits, permits related to various economic activities, and government officials turning a blind eye to tax evasion by favoured companies as examples of government-granted advantages that furthered the fortunes of politically savvy producers over the fortunes of efficient producers.

Finally, the chapters that follow emphasize that tax and regulation evasion are threats to economic development. I believe I am not alone in thinking this way and that a large part of the justification for ‘fairness’ as an ideal of government policy is to ensure that efficient producers are not discouraged and pushed to the margins of markets. Fairness is efficient. I show that even under the most benign of assumptions about how evasive talents are distributed in society, the deadweight losses from evasion of regulations and taxes can rival the traditional deadweight losses associated with these government interventions. Any deadweight loss so important will provoke a reaction among government leaders. I suggest that much of government policy is devoted to cleansing society of the deadweight losses from evasion I have discussed here. These losses are non-antagonistic. Getting rid of them would not lead to a fall in government revenue. No interest groups would suffer from seeing these deadweight losses go. We can then expect to see government bending to ensure that these losses do not get out of hand. Governments that succeed in taming these losses may be the ones that have shepherded their economies to sustained economic growth.

It is customary at this stage in an introduction to give a blow-by-blow description of the chapters that follow. Instead of sitting the reader down to this ritual of tedium I will summarize the book in one sentence: when inseparable productive and unproductive talents determine the survival of a producer, the most efficient producers may not survive and government will do its best to organize markets so that productive talents predominate. How all of this happens and what this means for economic modelling is the topic of the present book.