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Working Paper Corruption in Tax and Taxing the Corruption

*Suggested Citation:* Pazhanisamy, R. (2019) : Corruption in Tax and Taxing the Corruption, ZBW – Leibniz Information Centre for Economics, Kiel, Hamburg

This Version is available at: https://hdl.handle.net/10419/193967

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## **Corruption in Tax and Taxing the Corruption**

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#### ABSTRACT

Most of the countries in the world face corruption and struggling against to it in many aspects. Due to various loopholes and institutional inefficiencies it continues to be pressing issues which affects public in various dimensions. The long existence of corruption around the world made an illusion to the policy makers and public as it is unavoidable and adjustable. This creates an intuition to enquire into what makes the corruption market successful all over the world for many centuries and what Economic theory is operate behind it. In this paper an enquiry is made into how the corruption market works effectively without any intervention. It also explore the possibility of the Ronald Coase theory's to control the corruption and justifies what intervention is needed to achieve optimal amount of corruption. It concludes that to achieve the optimal amount of corruption in the society all farms of corruptions has to be internalized by introducing a permit and tax for corruption.

Key words: Corruption in Tax, taxing the Corruption, Coase theorem and tax, tax evasion, breaking the tax evasion using Coase theorem, internalizing the externality of corruption

JEL Codes: B21, B41, D03, D47, G02, G18, G28, H26, I38

## **1. PREMISES AND RATIONALE**

Most of the countries in the world have been in war with many form of corruption for many centuries. But the economic wars against the corruption are not yet finalized. Corruption is also considered as one of the major unavoidable problem with considerable externalities in the economy as equivalent to the pollution in the economy. The prime motivation behind this title is raised from the intuition that why don't the Coase idea can be applied to achieve the socially optimum amount of corruption through assigning rights to corrupt for someone and legal right to control the corruption by some others. When the corruption becomes inevitable like pollution, how for the institutions are adjustable to permit to corrupt and what kind of control over it can be imposed through tax in what quantity becomes question of debate. The question of how to match the cost benefit for different types of distribution of rights with its respective tax rate is also becomes the challenging task ahead.

According to Ronald Coase the private economic actors can solve externalities among themselves, assuming they can bargain without cost so that they can always reach an efficient outcome irrespective of the initial distribution of rights either right to pollute or to control it. The Coase Theorem states "that when there are conflicting property right, bargaining between the parties involved will lead to an efficient outcome regardless of which party is ultimately awarded the property rights, as long as the transaction costs associated with bargaining are negligible".

The available literature on corruption reveals that there are very limited attempt are made by the researchers to through lights on the theoretical implication and solution to the problem of corruption which warrant an attempt to connect and discover the economic theories and its application to resolve the corruption. With this backdrop an attempt is made in this paper to fill this gap in research.

## 2. REVIEW OF LITERATURE AND RESEARCH GAP

Acemoglu, D. (2003) discusses various approaches to political economy and develops the argument that there are strong empirical and theoretical grounds for believing that inefficient policies and institutions are prevalent. They reached a conclusion that inefficient institutions and policies are chosen by the politicians or social groups that hold political power at the expense of the rest. The theoretical case depends on commitment problems inherent in political parties who are holding power.

Becker, G. S. (1983) researched the economic approach to political behavior by assuming that actual political choices are determined by the efforts of individuals and groups to further their own interests and concluded that the Political equilibrium depends on the efficiency of each group in producing pressure, the effect of additional pressure on their influence, the number of persons in different groups, and the deadweight cost of taxes and subsidies. This analysis unifies the view that governments correct market failures with the view that they favor the politically powerful who are produced by the com- petition for political favors.

Chowdhury, S. M., & Sheremeta, R. M. (2011) studied about the structure of existing corruption contests in the literature and how it can be used to analyze new types of contests by characterizing the unique symmetric equilibrium and showcasing about the small parameter

modifications which may lead to substantially different types of contests and hence create different equilibrium levels. Coase, R. H. (1960) in an attempt to explain the actions of business firms which harmful effects on others have recommended a few change of approaches like opportunity cost approach, laissez fair policy and various farm of government regulations required to solve the social cost problem of welfare.

Coate, S., & Morris, S. (1999) highlights in their paper about how the government policies are framed and how they are maintained with the help of policy persistent approaches by which kind of mechanism to introduce such a new policy that alter the incentives in the political process towards favoring to a new status qua.

DeLeon, P. (2015) de classifies various models and cases of corruptions and suggested that what should be done by the people and systems to remove such cases in the economy. Dungan, J., Waytz, A., & Young, L. (2014) has given a new dimensional psychological aspect of corruption as it is the violation of moral values in the system and it is the decision to engage in corrupt behavior may not always reflect a choice between right and wrong rather, the decision may represent a trade-off between competing moral concerns.

Dwyer, J. (2016) traces the corruption in New York city and highlighted the mindset of the people who are involving in corruption by quoting one of his respondents answer that "think of it as an offering to the gods of official paperwork" Easterly, W. (2001) explains the interlink between the corruption and growth by superimposing about the all world corruption tour and how the government can kill growth itself by allowing the corruption.

Jonathan Haidt (2007) in his paper new synthesis's on moral psychology portrays how the moral values plays important role in the determination of corruption and explain how human behavior of self-interested, care about how they treat people, and how they participate in groups. These moral motives are implemented in large part by a variety of affect-laden intuitions that arise quickly and automatically and then influence controlled processes such as corruption.

Hayek, F. A. (1945) also quoted the idea that what are the problems will arise when we try to construct a new economics orders like corruption free economy and concluded that the unavoidable imperfection of man's knowledge and the consequent need for a process by which knowledge is constantly communicated against corruption. As pointed out by the leading thinker in economics Hicks, J. (1939) the foundation of economic welfare is lies in the social welfare which is determined by the welfare of all section of the society.

Holcombe, R. (2018) has made an attempt to highlight the relationship between the markets and the government. He tried to apply the Coase theorem to the various markets and to the various forms of government and proved that the theory would be effective in the case where there is no transaction cost. Johnson (2005) argued that how the syndromes of corruptions such political instability, social and economic insecurity, wrong religious belief such as dowry system etc determines the magnitude and the degree of corruption while Lambsdorff, J. G. (2002) argued about the rent seeking behavior , public choice among various solution for the problems and its role in corruptions.

Le, V. H, de Haan, J. & Dietzenbacher, E. (2013) has made an in-depth enquiry into how far increasing the wage can help to reduce the corruption and at what time it became worthless effort under what circumstances. But the ideas given by Leff, N. (1964) along with Méon, P.-G., & Sekkat, K. (2005), helps to understand how the bureaucratic corruption itself can be fine-tuned towards the economic growth. Mises, L. (1998) also gives various reasons for the human actions of corruptions and support the ideas of the how the same can be reversed towards the growth.

There are various causes of exploitations are documented in the literature of Mitchell, W., & Munger, M. C. (1993) which has Exploitation should that be defined as the result of rent-seeking activity that results in social outcomes that are not Pareto optimal. Government, or the organization with a constitutional monopoly on the legitimate use of force, is ideally charged with balancing two competing kinds of exploitation. The first is the *private* exploitation of agents acting in unregulated markets where property rights are undefined and unenforced. The second is *political* exploitation using the powers of government itself. The ideal task of government is to minimize the total exploitative activity in the polity.

Munger, Michael (2018) has developed an approach to understanding dynamic processes of political change and policy outcomes. The key insight is the notion that political insiders have a comparative advantage—because they face lower transaction costs—in manipulating rules. The result is that political actors can collect revenues from threatening to restrict, or offering to loosen, access to valuable permissions, permits, or services. To the extent that the ability to pay for such favorable treatment is a consequence of private activities that produce greater social value, there is a "political Coase theorem": corruption makes bad systems more efficient. But the dynamic consequences are extremely negative.

Munger, M. C, Murphy, K., Shleifer, A., & Vishny, R. (1991) have studied the implications for the growth by the distribution of talents and knowledge and concluded that the individual knowledge about the impact of corruptions on society plays an important role in the determination of corruption behavior in the society. By supporting the same view Douglass North (1990) developed an analytical framework to explain the ways in which the behaviors, institutions and their changes create impacts on the performances of the economy. He further argued that how the institutions practiced by human becomes one among constrain for the growth while the same in some other economies produce growth and development while in some other countries it develops the status of stagnations.

Shleifer, A., & Vishny, R. W. (1993) have studied about the corruption by assuming some products as homogeneous good produced by the government and incorporating it corresponding to the private demand curve and found a similarity between the bribe and commodity taxes and suggest how the political and economic competitions can the level of corruption and its effects. To sum up the review of literature it is found that there are very limited attempts have made by the research community highlighting the interconnections of economic theories and the corruption. It also lack to discover the economics theories operating behind the corruption and to control it. In this context this paper is attempted to fill this gap in research.

#### **3. THE PARADOX OF PROSPECT THEORY IN THE CORRUPTION MARKET**

The basic intuition for this attempt is raised from the understanding of theory called prospect theory. According to the theory of prosperity an individual's value function would be (whether for money or otherwise) concave for gains but convex for losses. In other words, people are more sensitive to losses than that of gains of similar magnitude. This can be is illustrated by using the diagram as follows



#### **Graph 1: Comparison of Gain and Loss of Corruption**

In this above double dimensional diagrams gain is measures on the OX –OY axis and loss are interpreted in the respective axis OX' and OY' assuming A amount of corruption taken place in the economy. "A" is the loss for the people who give it in the form of bribe or any other form of sacrifice when the government increases tax to compensate the tax revenue which is evaded by others which is measured in the left bottom of the figure with horizontal red arrows indicating the quantity of money or material sacrificed by giving it and the respective loss is indicated by dotted blue line from up to down. Similarly the quantity of money or materials received by practicing corruption is measured on the right side of the figure with "A" (covered by red color arrows) and the respective gain is measured by the vertical dotted blue line with "A" representing the amount of gain of practicing red "A" amount of corruption. It is easy to understand from the figure that quantity of gain is less than that of the loss that "A "amount of loss is higher than that of the amount of social gain for the "A" amount of corruption which rise a question of how the transaction of corruption takes place successfully even though the social loss is greater than the social gain.

In the presence of perfect institution in the society this paradox will never occur. The economy which fueled with institutional inefficiencies and in efficiencies of institutions will certainly cause to this paradox. It means, if the corruptors get punishment and the publicity of this corruption reduce their reputation in the society than gain the market will work properly. Suppose the corruptor get small amount of punishment with least probably and the get popular in the society due to his corruption and increase his value among wrong institutions the market will never work properly and the paradox will continue to exit in the economy.

So the market for corruptions also failed as the market of environmental goods like pollution. With this theoretical framework in mind this attempt is made to understand the possibility of the application of Coase theorem to achieve the socially optimal corruption in the economy.

## 4. ASSUMPTIONS OF THE COASE THEOREM

1. Producers and consumers subjected to externalities generated by other producers and consumers

- 2. Everyone is rational
- 3. Price taking behavior of Consumers and Producers (Perfectly competitive market)
- 4. Free court system for enforcing agreements in the Economy
- 5. Utility maximizing consumers and profit maximizing behavior of producers
- 6. Neutrality of incomes or wealth effects in the Economy
- 7. No transaction costs. In addition to the above assumption to the Coase theorem some Additional assumptions are felt required to prepare a correct framework. These are...

8. Corruption provides benefit to the people who practice it and create loss to the rest of the economy even to the people who are not practice it. Example if anyone entertains tax evasion it would be beneficial and desirable to him due to illegal economizing of private expenditure and increase his saving. But the amount of money evaded has to be indirectly and unknowingly shared by the rest of the individual taxpayers by additional tax in the next period to so that the social cost of providing all the services by the government would not e disrupted. In the same way any form of corruption like bribe would be desirable to the individual who practice it while the same is not desirable to the rest of the population. So corruption has both externalities and the impact of it on the economy is purely depends upon the degree in which they are internalized. 8. Corruption is accepted by all since it is understood as unavoidable.

9. Existence of perfect information about the tax evasion, bribe and the elite laws in operation.

10. Tax evasion is unavoidable in the country.

11. Tax is the only source of revenue to the government to meet the public expenditure.

12. Welfare state of the government

13. Zero transaction cost for the enforcement.

14. Property rights are acceptable by the public. With these additional assumptions the application of Coase theorem to resolve the corruption can be explained using the graph as under.



# 5. ACHIEVING OPTIMAL CORRUPTION FOR THE SOCIETY

To understand the optimal amount of corruption in the economy the above graph is used by measuring the level of corruption activities on the x axis and associated social benefit to the people who practice it and the respective loss of the people who are affected by it is measured in the Y axis. The AI downward sloping line shows marginal social benefit MSB which represent the inverse relationship between the activities of corruption and that of the marginal social benefit of the corruption. The MSC upward sloping line reveals the positive relationships between the corruption activities and marginal social cost of the people who are sacrificed their welfare.

If there is no legal rights are assigned to corrupt the MSB would be at OA with zero corruption and the same would reduce to LCB when the corruption is allowed upto OL. At this point of OL amount of corruption the social benefit would be OABCL and after meeting the social cost of corruption OCL which would be consider as the feasible to both group while it gives OABC amount of social benefit after compensating the Social loss of corruption. Now the corruption can be permitted upto the point where its benefit become equals to its social cost. It is noted by the level of corruption activity at D and the corresponding equilibrium of E.

On the contrary to this if the legal right to corrupt is granted without the controlling right the maximum corruption will take place in the economy upto the point of I where the marginal social cost will be IJ with the corresponding benefit zero. This would result a warrant to reduce the corruption to move from I to F at which the marginal social cost would be FGH with the benefit of FG which intern further push the corruption to be reach the socially optimal amount at point D through various stages like K.

Suppose consider a case if the property right to corrupt is not issued, in such situation people will all form of corruption invisibly as a result the magnitude of corruption in the economy would be equal to the amount from O to I which is the highest since there is also no right to control it. In the same way if the right to corrupt only assigned will also produce the same amount of corruption. On the contrary to this if the rights are assigned to control the corruption without assigning the rights to corrupt also will fix the economy at the point "L" where the marginal social cost is less than that of the marginal social benefit which ultimately increase the propensity to corrupt up reaching the point "D". So it is understandable from the figure that the socially optimum amount of corruption can be achieved at the point "D" where the MSC=MSB.

It is evident from the figure that irrespective of the right to corrupt and to control it, the socially optimal mount of corruption can be achieved when the rights are assigned properly as what is proposed by Ronald Coase. But only the condition required to achieve such optimal solution is that we have to provide a platform of to work the theory by issuing the legal rights to corrupt and legal tight to control it through the financial mechanism called tax.

Now the question is if the idea works well in practice why most countries should are still locked with the inability of controlling corruption. This is just due to the fact that the corruption market is not permitted legally but the enforcement only exit to control it.

#### 6. CONCLUSION AND SCOPE

Now, what would be the solution to the problem and hoe it has to be handled? As Ronald Coase wrote that we have to provide framework to the theory to work by issuing the legal rights to (pollute) corrupt by one group of the people and assigning the legal rights to control it by other group would be the feasible solution to the corruption. So irrespective of who is to be assigned and what kind of right, either to corrupt or to control the corruption the solution is to provide the framework of institutions would be the first and foremost solution. By providing right to corrupt and control it would be the socially desirable solution. This can be done by introducing a new tax called the corruption tax which can control and resist the corruption within the socially optimal level.

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