Inequality, Good Governance and Endemic Corruption

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Introduction

- Endemic Corruption
  - So ubiquitous becomes unremarkable
  - Bribe normal course of events
  - Pay-for-play not thought of as criminal
  - Use particular accountant - avoid evasion accusations
- Inequality
  - At least two groups, one better off; initial conditions matter
- Good Governance
  - promoting social welfare vs. rents

Our Goal

- Understand something about the determination of Tax Administration policy in the context just outlined, & who wins and loses in the struggle over it. & whether and when this is consistent with good governance.
- Within theoretical model, discuss & compare choices of tax administration & behavioral instruments/efforts influencing compliance facing the government which is confronting large scale endemic corruption & wants to achieve the highest aggregate level of good governance
- Issue of focus. Recent paper develops a TA index - a crude single variable measure summing up a lot of information,. They figured out a way to TAME all of the TA factors into one.

- Some Tax Administration Tools [Das-Gupta (var)]
  - Tax Authority's (TA) ability to audit, inspect, penalize
  - Number/quality of tax inspectors, information
  - taxpayer identification/registration, processing of returns, audits, post-audit appeals, sanctions, tax collection, taxpayer assistance, internal audits, TA budget
  - output per inspector; duration, arrears, revenue loss duration of assessments completion/appeals

- Tax Administration Measure of Effectiveness (TAME, Das-Gupta, Estrada and Park (2016))
  - index that captures the tax administration environment including its effectiveness and enforcement
  - conceptualization the key policy element in this paper, the enforcement level E

Two main parts in our modeling

Part I: The effect of lobbying on the tax enforcement policy

The approval of a tax enforcement policy by the **TA** is a function of the lobbying efforts of the **rich** and **poor** who compete for the approval and rejection of the proposed policy.

Explicitly accounts for lobbying costs, probability of winning, utility of winning vs. losing.

❶ The poor prefer some enforcement as the recognize they benefit from the revenues raised; however, they don't want too much enforcement

❷ The rich prefer very little enforcement, for simplicity say zero

Two main parts in our modeling

Part II: social welfare and rent seeking by government/TA

The effect of lobbying on the tax enforcement policy when there exists a tax administrator (politician/bureaucrat) maximizing expected social welfare and lobbying efforts.

Consider social welfare, explicitly accounting for the actions of the tax administrator (TA), their consequences, and the responses of the rich and the poor.

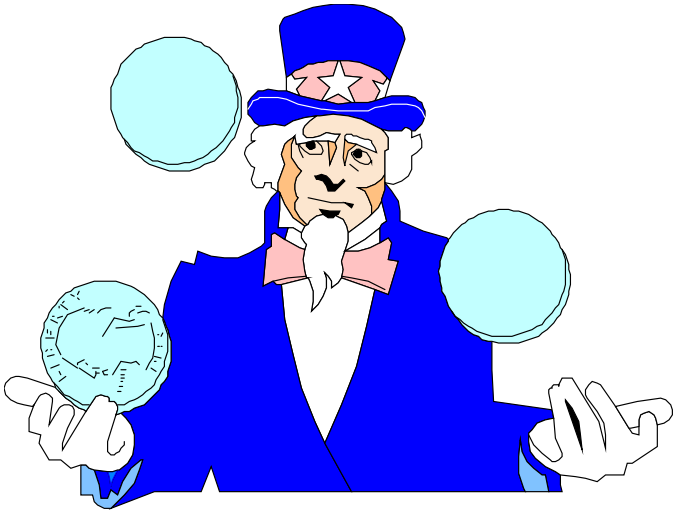
❶ The TA takes the rent-seeking/avoidance contest as a political constraint

❷ The TA is motivated by commitment to the populace and self-interest

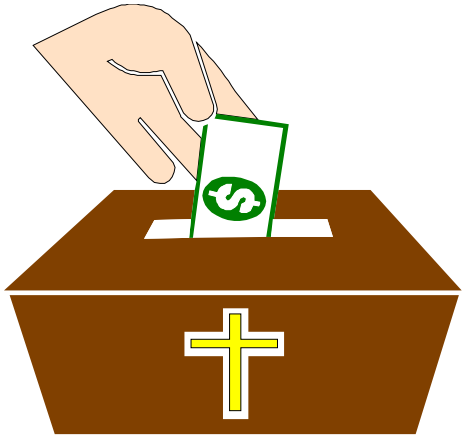
Illustration

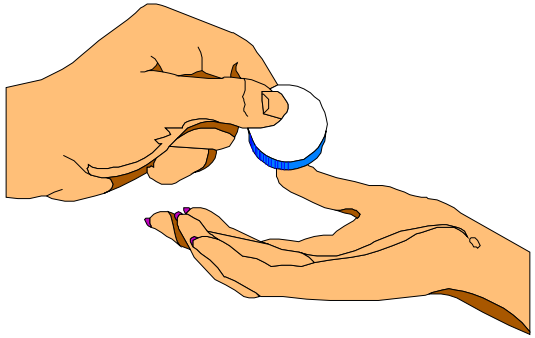
Rich

Poor

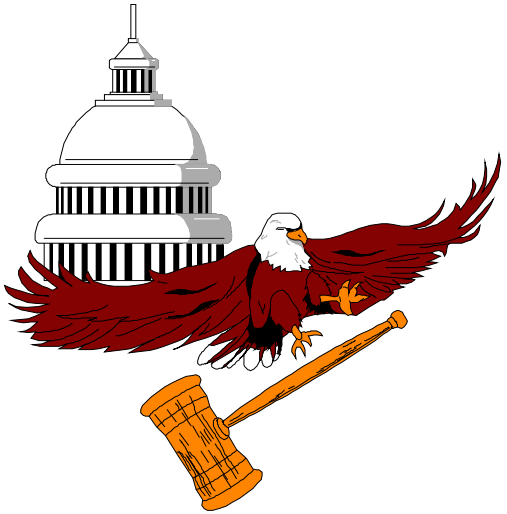


Tax Administrator





Government



Tax Administrators

Contest

One Winner

Part I:

Implementation and the contest

Policies endogenously determined: E_c^{**} and E_w^{**}.

The rich want minimum or close to zero

❶ The outcome of the political/lobbying contest:

- probabilities Pr_c and Pr_w.

❷ The outcome of the contest depends on

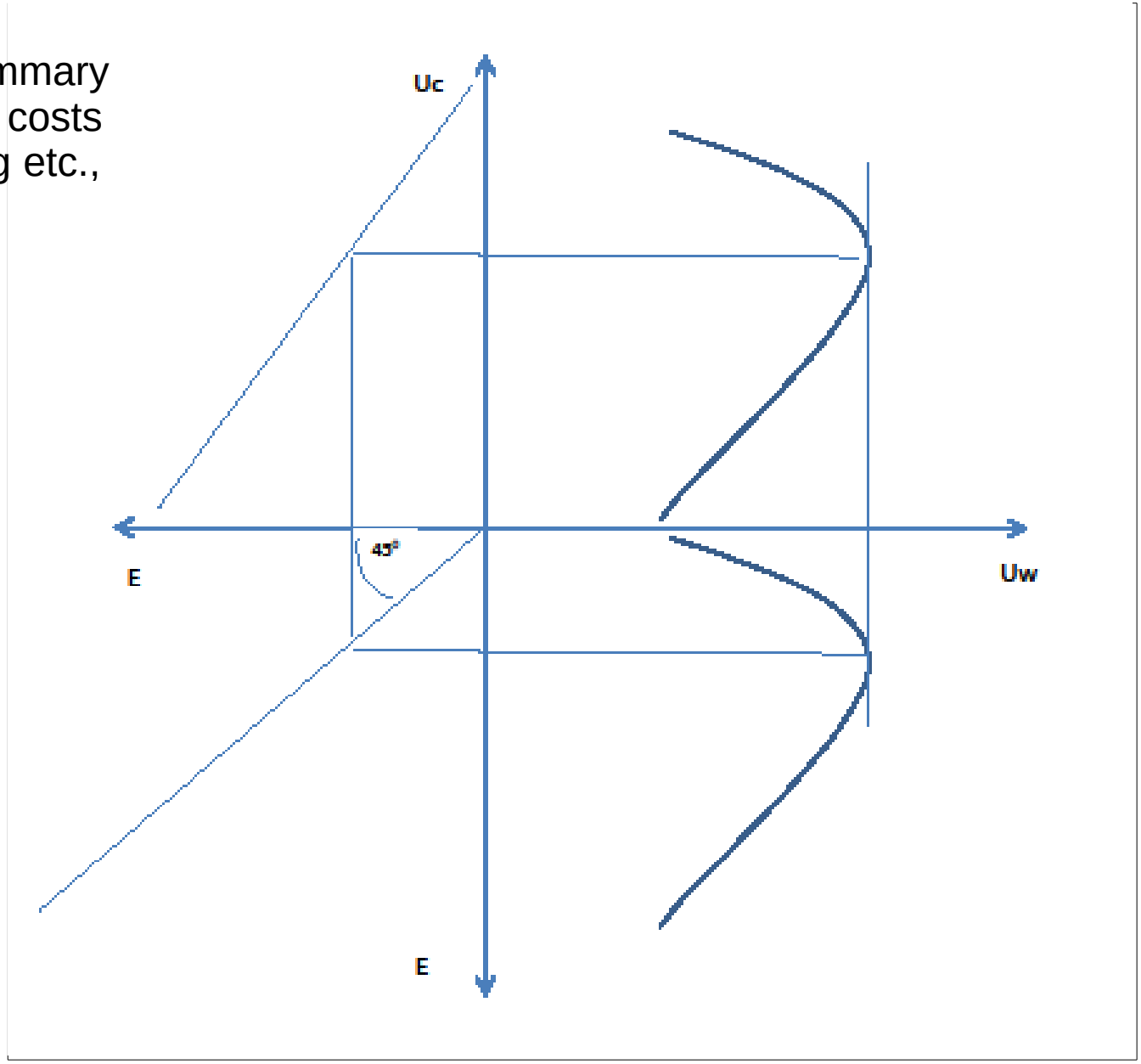
- the stakes of the contestants
  - proposed policies
  - exerted lobbying or rent-seeking efforts

E_w is the optimal policy proposal of the poor provided that their supported policy gains *certain approval* OR when the Tax Administrator chooses randomly.

E_w^* is the level that maximizes the expected payoff taking into account the probability of winning and the investments of the rich.

$$0 < E_w^* < E_w$$

Part I: Summary simplified, costs of lobbying etc., omitted



Part II: α captures
"good governance"

The weights assigned to social welfare and rents

$$G(.) = \alpha\left(\overline{E}\left(w_c^*\right) + \overline{E}\left(w_w^*\right)\right) + (1-2\alpha)\left(x_c^* + x_w^*\right)$$

- TA establishes enforcement level E taking into account its the contest between rich and the poor, its desire to acquire rents and its commitment to enhancing social welfare.

- The TA's specific objective function represents these commitments.

- The TA gains from expenditures made to lobby with regard to the proposed enforcement level and from the four possible payoffs to the rich and the poor, because part or all of their expenditures are a resource transfer to the TA.

Part II: α captures
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- Increasing α implies reduction in the weight assigned to the lobbying outlays.
- Decrease in α interpreted as indication that government becomes more politicized or the TA more selfish, caring more about its narrow interest and less about the public well being.

α=1 Fully committed TA to public interest & society; views expenditures on rent-seeking/avoidance as completely wasteful.

α=1/2 Fully committed TA, rich/poor expenditures are a transfer from rich/poor to government that reallocates it back to them.

α=0 TA maximizes rich/poor contest expenditures; ignoring public's welfare. TA cares only about getting contest rent.

Flavor of our Results

- We can characterize the chances each player has of winning the contest when there is a change in the proposed enforcement level, where winning the contest means obtaining its' desired enforcement level from the TA.
  - If rich's benefit wrt changing E more elastic, poor have better chance of winning and their relative rent-seeking efforts increase.
  - However, poor's benefit can decrease while that of the rich increase with proposed enforcement level increases. Therefore, the poor are more likely to lose and they decrease their relative effort.
- The enforcement level determines the level of investment in trying to affect the outcome

✓Increasing degree of politicization of the government (α), may increase/decrease proposed tax enforcement level. We characterize conditions where a society possesses a sensitivity to corruption that brings about the enforcement level E* that is preferred by the poor.

✓Also characterize conditions ensuring enforcement level exceeds E*. Introduction of enforcement level E* may require positive α, i.e., that the TA assigns a positive weight to the public aggregate expected benefit

✓This implies that the enforcement level maximizing the poor's expected net payoff is smaller than E* .

✓The TA operating where the corruption sensitivity is embodied by $\alpha > 0$ is more committed to enhancing social welfare than a TA whose equilibrium policy equals E*.

Extension One: Herd Effects

- ✓ As enforcement takes hold, very slowly, people stop evading taxes, as they see others not evading. This increases the observed enforcement level, increasing the the poor's benefits.
- ✓ This means the poor will increase their efforts to have increased enforcement, eventually drawing in those with a higher threshold level and slowly further increasing the number not evading.
- ✓ Finally, it will affect the rich.
- ✓ Observing here 'backwards herding'; i.e., instead of evasion leading to increased evasion [Epstein and Gang (2010)], enforcement increases honesty, further increasing honesty, etc

Extension Two: TA's/society's Corruption Sensitivity

- ✓ If there is an increase in the TA's/society's corruption sensitivity we might also observe 'backwards herding'.
- ✓ As corruption sensitivity α increases – the influence of the rich on the chosen level of tax enforcement is reduced.
- ✓ More people would pay taxes, possibly starting a herd affecting others. Like the herd that started not paying taxes, in the same way, a herd can start to pay taxes that will affect the rest of the population.

Extension Three: Poverty Trap

- ✓ Reasonable circumstances exist where there is a positive threshold at which the poor at increase their efforts to have greater enforcement. Eventually they draw in those with an even higher threshold level, slowly increasing the number not evading.
- ✓ However, greater enforcement requires more investment, i.e., greater lobbying costs. If the price of investment is too high or the benefit for the rich is high then the poor will not invest in trying to change the level of payment enforcement. Thus, the enforcement level decreases.
- ✓ In a heterogeneous population, first those with low payoffs stop investing possibly affecting those with higher payoffs, who then cause others to not invest, making the poor poorer and poorer. Thus, we have a trap!

Concluding Remarks (1)

- ✓ We build a story here of how awareness of corruption affects tax enforcement. The story is not always straightforward.

- ✓ We characterize an economy in which there is inequality and tax evasion by both rich and poor, but these two groups have different interests and therefore spend their resources trying to influence the efforts made to enforce tax payments at the level that benefits them the most.

- ✓ The government's multiple objectives are captured here in the character of the tax authority, who we picture a multifaceted individual facing personal conflicts captured in a welfare function.

Concluding Remarks (2)

- ✓ Analysis of endogenous determination of Tax Administration enforcement. Two interest groups: rich and poor. Rich prefer a lower enforcement than the poor.
- ✓ Our results provide some preliminary insights into the economics behind the struggle over setting tax enforcement policy.
- ✓ The enforcement level determines the level of investment in trying to affect the outcome
- ✓ Optimal enforcement level may be higher than what poor want; may also be lower than poor's desires (since they receive benefits from collected taxes) & closer to the rich's wishes (zero enforcement). Depends on sensitivity of the political culture to corruption and reduced tax enforcement.