The man who says to one, go, and he goeth and to another come, and he cometh, has, in most cases, more sense of restraint and difficulty than the man who obeys him.
John Ruskin, *The Stones of Venice*

What Is the Problem?

According to the experts, nearly 40 percent of all garden sheds in the Soviet Union were built in the black economy. This official revelation might raise no more than a bemused eyebrow, until one realizes who revealed it and why.

The information comes from a statement\(^1\) by no less a personage than the Procurator General—the most senior official responsible for law enforcement in the Union of Soviet Socialist Republics. Thrusting aside more fanciful thoughts (Who were these “experts”? Did they carry out an economic census of Soviet back gardens?), it is not hard to see why such an eminent figure should comment upon apparently homespun trivia: The black economy is a fact of life in the USSR, and the authorities there, as in other countries, are concerned lest it undermine the effectiveness of the mechanisms of government control. Elsewhere it would be the Treasury Minister expressing anxiety at the erosion of the tax base through evasion. The form of the
problem may be different from one type of economic system to another; the economic issues to which it gives rise are, in substance, intriguingly similar.

Indeed, Soviet garden sheds, shares in Newmarket stallions,² and the Universal Life Hidden Valley Church³ have a serious side to them. In an area of study where many conventional methods of observation and measurement are plainly out of the question, casual evidence should not be casually dismissed. Odd anecdotes and bizarre examples of officialdom’s ignorance or lack of control may actually be symptoms of a significant economic problem. The “shadow economy”—tax evasion, illegal employment, welfare fraud—is widely claimed to be a growing phenomenon. Whatever the substance of this claim, it is certainly true that scholarly and journalistic writing about the shadow economy is a growing phenomenon.⁴ It is evidently a topic that grips the popular imagination.

An economics monograph on the subject ought perhaps to start by identifying the economic issues. To a harassed Finance Ministry these might be summarized in a single question of brutal practicality: How does the government get its cash? This concern for simple fiscal housekeeping leads into a set of more complex and analytically challenging questions relevant to any government that attempts to influence the running of the economy: To what extent will it be constrained by the private recalcitrance of the members of the public in whose interests it purports to act? This book is principally concerned with the economic aspects of this sort of question: what the underlying economic problem is, why it arises, and how the government or its agents can usefully react to it.

Before I launch into this, though, two questions about the general line of approach need to be dealt with: Is economic analysis an appropriate tool to apply to the study of what is simply unlawful behavior? On what basis should this particular form of unlawful behavior be singled out for special treatment?
Playing by the rules becomes a habit of thought among economists; the orderly market, the respect for property rights, the calm acceptance of legal regulation are all part of run-of-the-mill model building. Of course the phenomenon of crime upsets a lot of these rules, and to the tidy-minded this might appear quite disturbing: If we throw aside so many of the standard tenets of microeconomics, are we to be left in a wilderness of analytical chaos?

Evidently not; the substantial and thought-provoking literature on the topic testifies to that. Actually, many elements of the phenomenon of crime are recognizably economic in nature and can usefully be analyzed with standard economic apparatus. Hijackers, whores, and hit men all weigh the prospective costs and benefits of their labors. The public perception that “crime pays” prompts populist demands for stiffer sentences. The entrepreneurial spirit displays itself in bootlegging and drug trafficking. “Crime is a logical extension of the sort of behavior that is often considered to be perfectly respectable in legitimate business.”

Yet there remains a nagging feeling that the economic approach to lawbreaking and law enforcement neglects some important issues that are bound to have a bearing upon criminal activity and therefore upon the way in which it might be prevented or counteracted.

Take, for example, the issue of motivation. Standard economic models take the position that people are criminals simply because it pays them to be criminals, but at best this can be only a part of the story. Some people just will not engage in certain types of crime; for them there is no well-defined tradeoff between the proceeds of crime and the rewards of a blameless, upright life. To say this is not to subscribe to the notion that criminals are genetically predisposed to their criminality. But some motivation other than pure rate of return must surely...
influence the potential lawbreaker. I am fairly sure that I would never engage in a bank robbery, no matter how big the prospective haul and how small the chance of being caught; still less would I ever be tempted to murder my granny for her money. Are these additional influences just a matter of taste? Or is there a deeper analytical point to be developed—and, if so, what implications does this have for the enforcement of social rules?

Or take the issue of social control. The economist’s approach to law enforcement is akin to the regulation of a public nuisance, such as pollution: Offer the right scheme of incentives and you can reshape the behavior of uncooperative citizens to an appropriate—law-abiding—pattern. However, this presupposes that the state’s carrots and sticks are more effective than changing the environment that induces the noncooperation, and that individual cooperation is bound to fail. It also presupposes some accepted standard of what constitutes acceptable behavior; from where does this standard come? These issues deserve consideration but are normally outside the scope of economic models.

Such reservations about the simplistic versions of the economics of crime apply similarly (although perhaps with less force) to the study of tax evasion and the black economy. One of the tasks of this book is to deal with them in a systematic fashion—to examine how certain types of economic analysis can be brought to bear on private behavior that is intended to frustrate the instruments of government economic policy, and what counteracting measures might be appropriate.

**What Is Special about Tax Evasion?**

It is tempting to lump tax evasion with business fraud, shoplifting, and burglary as just another form of theft. By treating it as one special case in the economics of crime, we might hope to infer all the necessary analytical results concerning tax evaders
from general propositions about the rational economic behavior of criminals. However, to do so would be to miss some of the most important economic aspects of tax evasion. The theoretical and practical problems to which these special economic aspects of tax evasion give rise will form the subject matter of later chapters. I will mention three of them briefly here.

First, tax evasion is a fraud that is committed against a very special economic agent: the government. The government is special in that it has, presumably, the power to set and to enforce some of the “rules of the game” by which economic relationships are supposed to abide. It sets the structure and the level of taxes. It also has ultimate control over the mechanism used to enforce the payment of taxes and over the structure of penalties for offenders. It combines the roles of rulemaker, victim, and umpire. Contrast this centralized, unitary authority with the victims of burglary and business fraud: Companies and individuals do not normally have anything like the resources, the power, or the organization available to the government with which to combat those crimes.7 In fact, rather than stress the apparent analogy between tax evasion and common theft, it is more useful to consider evasion as one of a special class of “economic crimes.”

The second reason for singling out this subject for special treatment is the delicate interplay of information among those involved in the black economy (evaders, investigators, the government). This gives rise to some particularly interesting economic problems. In some cases the decision between tax compliance and tax evasion explicitly involves the contents of a report to the authorities, a feature that is absent from crimes such as theft8; in others the behavior of an individual evader (his consumption or his occupation, for example) can be interpreted by investigators as a useful signal of what may be going on unseen. This feature of the problem can afford some insight into the design of public policy, since information—in the form of known characteristics of people and organizations, or of
observable behavior—is essential to an operational tax system. The government’s awareness of the scope for evasion, and its (imperfect) knowledge of how the tax-evading sector operates, can play a crucial role in determining the structure of taxation.

Third, there is a special relationship between tax evasion and certain other topics central to the study of public economics. Evasion is a particular “economic crime”—one that involves a breach of the laws designed to ensure that people act in the economic interests of the community and not just in their own economic interests. The need for such laws arises from an ambivalent relationship between the individual citizens and the state that is supposed to act on their behalf. There may be genuine public support underlying government programs for providing collective goods, for redistributing income, for managing the economy; yet, even if that support were universal, individuals might still try to act contrary to the program they publicly support. The precise form that such economic crimes take—tax evasion, fiddling government controls, smuggling, trading on “black” markets—will differ according to the type of society, the economic structure, and the legal system. Because of this ambivalent relationship and the associated incentives to economic crime, a government usually recognizes the restraints on its choices of economic policy. It is not as simple as saying to one, go, and he goeth and to another come, and he cometh.

In short, the issue of evasion is, unlike other illegal activities, inseparably bound up with the instruments of fiscal control that the government attempts to use in carrying out its economic policy. The quest for effective policies of taxation and public expenditure makes the topic of evasion interesting in its own right.

An Outline of the Approach

The idiosyncratic and sometimes faintly comic snippets that emerge about the black economy are often symptoms of an
important problem: dissent and defection from government control. To understand this problem, and to evaluate its significance, we need to set up a coherent theoretical framework within which we can incorporate the “economics of dissent” as a natural phenomenon. We can then use this to examine the design and the implementation of policies that take this phenomenon into account.

I shall try to adhere to two guidelines: facts before theory and analysis before prescription. Unfortunately, it is not always possible to maintain this order of precedence. The problem is a subtle one, and it is sometimes necessary to spend some time sorting out what might be supposed to be going on in principle before one knows where one might try looking for the facts. Nevertheless, it is with the facts—such as they are—that we shall begin.