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Underlying Causes of the Black Economy: A Qualitative Review of the Principal Factors

1. Introduction

MUCH has been wtitten on the causes of black income generation.[1] For the most part we shall draw on the existing literature and our extensive interviews. In one relatively neglected area—the effectiveness of deterrence (of tax evasion) — we have marshalled a considerable body of fresh information to which we devote a separate chapter.

We find it convenient to group the causes of black income generation under the following heads:

i. the level and structure of taxation;
ii. the effectiveness of tax administration;
iii. controls on economic activity;
iv. general laws and regulations;
v. political finance;
vi. government spending: its scale and accountability;
vii. standards of public morality;
viii. inflation.

Before turning to an item-wise discussion of these causes, we begin with a few general observations. First, we should

emphasise that the causes itemised above operate *together*, not as isolated elements. When an economic agent or enterprise undertakes its decisions on product, finance, sale, investment, accounting, etc., which lead to black income generation, it does so in a context where all (or at least some) of those factors are operating *simultaneously*, not in isolation, or seriatim. It is important to emphasise this since, for ease of exposition, our discussion of the causal factors is organised sequentially. Second, and quite obviously, the range of causal factors influences different sets of economic agents to different degrees. Third, given the complexity of the context in which black income is generated, it is quite beyond the scope of this study to *quantitatively* isolate the relative influence of different causal factors, an exercise which would also require much firmer estimates of the extent of black income and over an extended time period, than it has been possible to make. Finally (and this harks back to the first point), the causal factors can and do act to reinforce each other. For example, the need for financing election politics through illegal contribution from (or levies on) trade and industry bolsters a system of economic controls and interventions within which black incames can be readily generated.

2. The Level and Structure of Taxation

a. *Some lessons from theory.* We begin with a brief review of the theoretical literature on tax evasion and its determinants. In a series of papers published in the early 1970s, Allingham and Sandmo (1972), Singh (1973) and Srinivasan (1973)[1] developed a model based on the analysis of choice under uncertainty. In essence the model perceives an individual taxpayer as maximising his *expected income*, which is depicted as a sum, weighted by probabilities, of two possible states of affairs, one in which he conceals a part of legally taxable income and successfully evades tax and another in which such evasion is detected through the administrative efforts of the tax system and a monetary penalty imposed.

While different authors have advanced alternative variants of the model, its spirit can be captured by the following equation:

$$E(Y) = k\,[Y-T(Y)-P(m)mY] + (1-k)\,[Y-T(1-m)Y]$$

where,

Y = the individual's true income,

$T(Y)$ = the tax function,

m = the proportion by which true income is understated,

$P(m)$ = the penalty function,

k = the probability that evasion is detected.

Thus, the first expression on the right hand side depicts the situation when evasion has been detected and the second expression represents successful evasion.

On the assumption that individuals maximise expected income, E(Y), this model has been used to generate a number of qualitative conclusions, including:

i. The "optimal" extent of evasion depends simultaneously on the rate structure of taxation, the probability of detection through administrative efforts and the rate structure of monetary penalties;

ii. Other things equal, and assuming a progressive tax structure, the optimal proportion of income understatement (that is, the degree of evasion) increases with the individual's income;

iii. Other things equal, the optimal degree of evasion decreases as the probability of detection increases;

iv. If the probability of detection increases with income, then, for a constant marginal rate of tax, the optimal degree of evasion declines as income increases;

v. Penalty rates and tax administration efforts (the latter modelled by k) both act to deter evasion and to some degree one can act as a substitute for the other; that is, the same optimal degree of evasion can be secured through higher penalty rates and lower detection efforts — and vice versa.[3]

vi Other things equal, when the overall structure of taxation is raised, the optimum degree of evasion for individuals at any given income level will increase, that is, total evasion will increase.

As with any theoretical model, these qualitative conclusions depend, to some extent, on "reasonable" tax functions, penalty

functions and so forth. Broadly speaking, the qualitative conclusions are also in harmony with common sense; indeed, the underlying model(s) may be characterised as formalisations of common sense. That said, we must recognise that these models suffer from some severe limitations.

First, the models do not provide policymakers with any empirical guidance regarding the responses of tax evasion to alternative instruments such as tax rates, detection efforts and penalty rates Second, by confining the analysis to the paradigm of an individual subject to a single tax (on income), the models do rough justice to the real world where an individual or enterprise may be subject to several taxes as well as a number of other influences that we have indicated above, all of which will jointly determine the extent to which income is underreported to tax authorities. For one thing, each of these other taxes may have a quite separate battery of detection and penalty procedures. For another, the approach abstracts from the larger social environment, which may have a lot to do with evasion and compliance. Surveys conducted in Sweden (Vogel, 1974) and the United States (Spicer and Lundstedt, 1976) emphasise the significance of social norms on tax compliance and people's perceptions about the equity (or inequity) of the prevailing tax system.

Third, by representing tax administration efforts through a single variable, k, the models oversimplify — to the point of misrepresentation — the real world, where the probability of detection is likely to vary enormously across types of economic activity and where detection can, in effect, be nullified through bribery. Corruption apart, the "fact" of detection (of evasion) becomes somewhat nebulous when we take account of the numerous appellate stages in which the *prima facie* finding of income concealment can, and is, challenged. Similarly, the idea that penalty rates are well-specified and automatic must appear extremely naive to anyone familiar with the Indian scene, where numerous appellate and judicial procedures intervene to dilute the relevance of a given structure of penalties. And, in the case of illegal source incomes, the deterrence/incentive effects of tax rates and tax evasion penalties are likely to

be secondary to those implicit in the laws broken in making the illegal source incomes.

b. *Empirical evidence*. Other things equal, a higher effective rate of tax clearly increases the incentive to evade. And, as virtually every official committee of enquiry on tax issues in India has observed, evasion of taxes is rampant with respect to every major tax, a view which is supported by our estimates for tax-evaded income presented in Chapter 5.[4] But studies which quantify the nature of the links between the *level and structure of taxation* and the *extent of evasion* are virtually nonexistent in India. Given the enormous difficulty of arriving at any reliable estimates of evasion and the uncertainty which attaches to these estimates, this is hardly surprising.

In discussing the role of ths level and structure of taxation in encouraging tax evasion, it is important to distinguish between:

i. the aggregate level of taxation in the economy;
ii. the composition of the tax structure;
iii. the rate structure and other relevant characteristics of the important taxes that make up the tax system.

With respect to the aggregate level or rate of taxation, defined as the ratio of total tax revenues to GNP, we have already advanced some indirect evidence in Chapter 4, which suggests that the increase in the economy's tax ratio from 7 per cent in the early 1950s to 15 per cent in 1980-81 has been associated with an increase in incomes, outputs and transactions not reported to the tax authorities.

A priori, we would expect the *composition* of taxes to have a bearing on the extent of evasion. It is generally believed that indirect taxes on commodities are more difficult to evade than direct taxes on income and wealth. That is why countries at earlier stages of development (that is, with low per capita GNP) normally rely much more heavily on indirect taxes than more developed nations, where the more abundant availability of administrative skills and information systems facilitates much greater reliance on direct taxes. Thus, there is some presumption that as a country develops over time the composition of its tax revenue would gradually shift in favour of direct taxes. Over the past three decades the trend in India has been

in the opposite direction. In 1950-51 direct taxes accounted for 37 per cent of total tax revenues of the Centre, States and Union Territories. By 1982-83, this share had declined to 17 per cent, Such an atypical trend suggests that the problems of evasion of direct taxes have been unusually severe in India and have militated against the "normal" growth in the share of these taxes in total tax revenues[5].

Among major taxes, the evasion aspects of Union excise duties were seriously studied by the Venkatappiah Committee (Government of India, 1974). Though the Committee refrained from offering quantitative estimates, it concluded (p.65) that "evasion is considerable and in some sectors pervasive". The Committee attributed the widespread evasion to a number of factors:

i. "Slack, non-existent or dishonest supervision",
ii. "unnecessarily complicated tariff items", particularly "the differential rates for different categories and sub-categories of the same tariff item or of allied products in different items".
iii. "unrealistically designed exemptions", which offer enormous scope for abuse,
iv. "high tax rates".

Of these, the last three clearly relate to the level and structure of excise duties. Similar conclusions have been arrived at in the detailed, commodity-wise studies of excise evasion in copper (NIPFP, 1982), plastics (NIPFP, 1983b) and cotton fabrics (NIPFP, 1984) carried out by the National Institute of Public Finance and Policy. Chapter 6 of this report presents a somewhat different view in the case of sugar.

However, most of the debate regarding the relationship between the level and structure of tax rates and evasion relates to taxes on income, and especially, non-corporate income. And the focus is on tax *rates*, to the exclusion of other characteristics of the tax, such as provisions for exemptions and deductions. The claim that high rates of personal income tax are a prime cause of evasion is almost invariably based on *a priori* arguments, which link evasion to the high marginal rates of taxation, especially when such rates are viewed in combination

with the structure of wealth tax rates. For example, the Wanchoo Committee Report pointed out when "the marginal rate of taxation is as high as 97.75 per cent, the net profit on concealment can be as much as 4,300 per cent of the after-tax income . . . We will not be surprised that placed in such a situation, it would be difficult for a person to resist the temptation to evade taxes."

Rates of personal income taxation have been reduced since the early 1970s, once in 1974-75 and again in 1976-77, and, most recently, in the 1984-85 budget. These reductions refer to nominal rates. As Bagchi (1982) has shown, when inflation is allowed for, the effect has been to reduce the average burden of taxation (over the period 1971-72 to 1981-82)for the lowest and highest levels and increase it for those in the "middle", that is, those earning gross income between Rs 29,950 and Rs 2,34,000 per annum in 1981-82 prices (see Table 9.2.1). Given the rather ample span of the "middle" we would be excused from concluding that the reductions in nominal rates have been more than nullified by inflation for most categories of income tax payers. So, if the rate structure of the personal income tax was regarded as a significant cause of evasion in 1971-72, logically, it would be inconsistent to resile from this view in 1981-82. And since the rate of inflation between 1981-82 and 1984-85 has been greater than the percentage-wise, across-the-board rate reliefs offered in the budget for 1984-85, the same argument applies to the position in 1984-85.

Furthermore, the EARC's Report No. 22 has highlighted the high tax burden imposed on individuals through a *combination* of taxes on income and wealth. Table 9.2.2, which is based on a table in the EARC report, displays the combined effect of income and wealth taxes at different levels of wealth and assuming a pre-tax rate of return of 10 per cent per annum. A glance at column (10) of the table indicates that though the highest marginal rate of income tax (inclusive of surcharge) was 67.5 per cent in assessment year 1984-85, when this was combined with the wealth tax, the combined marginal rate of tax on income from wealth reached 97.5

TABLE 9.2.1

Burden of Income Tax at Selected Income Levels (1971-72 and 1981-82)

(Rupees)

Gross income	Deduc-tions	Taxable income	Tax	Tax as per cent of gross in come	Gross income*	Deduc-tions	Taxable income	Tax	Tax as per cent of gross income
		1971-72				1981-82			
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
5000	900	4100	Nil	—	11700	3020	3680	Nil	—
7500	1090	6410	155	2.07	17500	4900	12600	Nil	—
10000	1400	8600	396	3.96	23400	6780	16620	535	2.29
12500	1870	10630	668	5.34	29250	8825	20425	1791	6.12
15000	2300	12700	1055	7.03	35000	9510	25490	3484	9.95
20000	3700	16300	1896	9.48	46800	12500	34300	7062	15.09
30000	7600	22400	3703	12.34	70200	16500	53700	16005	22.80
50000	11300	38700	11903	23.81	117000	23500	93500	39188	33.49
100000	16400	83600	45655	45.66	234000	25500	208500	114730	49.03
250000	16400	233600	176616	70.65	385000	25500	559500	346390	59.21
500000	16400	483600	410366	82.07	1170000	25500	1144500	732490	62.61

Note: Equivalent in real terms to the gross income shown in column (1).

Source: Bagchi (1982) p. 735.

TABLE 9.2.2

Combined Impact of Income and Wealth Taxes Assuming an Yield Rate of 10 Per cent per Annum

Wealth	Income from wealth	Income tax*	Wealth tax*	Total tax	Tax as per cent of income	Post-tax income	Increments in income	Tax on increments in income	Tax on increments in wealth	Total incremental tax	"Total Marginal" rate of tax col.(11) as per cent col.(8)
(Rs)	(Rs)	(Rs)	(Rs)	(Rs)		(Rs)	(Rs)	(Rs)	(Rs)	(Rs)	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
2 lakhs	20000	1406	1000	2406	12.0	17594	—	—	—	—	—
5 lakhs	90000	14063	3750	17813	33.6	32187	30000	12657	2750	15407	51.35
10 lakhs	100000	44578	13750	58328	58.3	41672	50000	30515	10000	40515	81.03
12 lakhs	120000	58076	19750	77828	64.9	42172	20000	13500	6000	19500	97.5
15 lakhs	158000	27328	78750	107078	71.4	42922	30000	20250	9000	29250	97.5
18 lakhs	180000	98578	43750	142328	79.1	37672	30000	20250	15000	35250	117.5
20 lakhs	200000	112070	53750	165828	82.9	34172	20000	13500	10000	23500	117.5
30 la0hs	300000	179578	103750	283328	94.4	16672	100000	67500	50000	117500	117.5
40 lakhs	400000	247078	453750	400828	100.2	-828	100000	67500	50000	117500	117.5
50 lakhs	500000	314578	203750	518328	103.7	-18328	100000	67500	50000	117500	117.5
100 lakhs	1000000	652078	453750	1105828	110.6	-105828	500000	337500	250000	587500	117.5

Note : At rates applicable for assessment year 1984-85.
Source: Based on EARC Report No. 22 (p. 154, Table 11).

per cent for net wealth of 12 lakhs and exceeded 100 per cent for net wealth of 18 lakhs and above.

The key empirical question is how significant is the rate structure of personal income taxation in inducing evasion. The one good study in this area is by Bagchi and Rao (1282). They set out to estimate the elasticity of the non-corporate income tax in India. In the process they noted that the budgets for 1974-75 and 1976-77, in which personal income tax rates were reduced, made no estimates for revenue loss from these reductions, on the assumption that such losses would be exactly offset by revenue gains from improved compliance. They proceeded to challenge this assumption by making independent estimates of assessable incomes over the years 1974-75 to 1977-78, based on regressions of assessable income on GDP for the period 1962-63 to 1973-74, when changes in the tax were minor and could be adjusted for. Based on their regression equation *forecasts* for assessable incomes in 1974-75 to 1977-1978, Bagchi and Rao concluded that assessable incomes and tax yields would have been significantly greater in these years but for the rate reductions. In other words, the tax compliance effects of rate reductions were much lower than had been presumed in the Budgets. From this Bagchi and Rao moved to a broader conclusion: "The results . . . raise doubt about the validity of the widely held presumption that a reduction in tax rates leads to a higher yield of income tax because of better compliance", (p. 1452).

Though the Bagchi and Rao paper is the best available, their analysis and conclusion can be subject to several criticisms. First, there is the usual problem with AIITS annual data on assessed incomes, namely that each year's data relate to several assessment years; any conclusions based on this data have to be treated with some circumspection. Second, their key regressions link assessable incomes to only one variable, GDP at factor cost, if we leave aside a dummy variable for certain tax structure changes in the sample period. Yet theory would suggest that the total of reported and assessed incomes should also be influenced by a number of other factors, such as the rate of inflation (which influences

the effective burden of taxation), trends in other taxes, the climate for enforcement, detection and penalties, and so on. True, the statistical attributes of the Bagchi-Rao equations are good, but unless they are seriously tested against more complete formulations, it may be unwise to accept them uncritically for the purposes at hand.

Third, it is one thing to use the analysis to challenge (and revise) the budget assumptions regarding revenue loss attributable to discretionary rate reductions; it is quite another to arrive at broad conclusions about the links between tax rates and compliance (or evasion). The latter is a complex subject, where the influence of tax rate reductions may reasonably be expected to take some time to work, especially after a long history of tax hikes. Those concealing income cannot be expected to turn honest overnight, if for no other reason than this could lead to dangerous anomalies in their histories of tax returns! Yet, over time, a lower structure of rates could have a significant positive effect on compliance, both by existing tax dodgers and, perhaps more importantly, by new potential assessees, especially once the populace is convinced that the rate reductions are not temporary gimmicks.

To sum up, while the Bagchi-Rao paper provides a strong precaution against making unrealistically rosy estimates of improved revenues from better compliance in the short run, its wider doubts about a policy of combating evasion through reduced rates are not so securely founded. So where does this leave us? Essentially with our judgements and prejudices. And to put those on the table, we side with those who believe that high effective rates of taxation are a major contributory factor to tax evasion and black income generation in India. Improved tax compliance *can* result from significant and sustained reductions in the effective tax burdens of those who are liable to tax.

3. Controls on Economic Activities

The range and complexity of controls over economic activity in India is awesome. This is the principal impression that strikes the reader of the Dagli Committee's unique and

valiant attempt (Government of India, Ministry of Finance, 1979) to compile and analyse the consequences of controls on the Indian economy. And this impression is strengthened when the reader absorbs the full import of the Committee's admission that it "has been able to make only a beginning in the matter of the study of the extant controls in the Indian economy, as it has been able to examine only a sample of the existing controls..." (p.(ii)). The Committee's testament to the complexity of the control system is also worthy of quotation : "The control system today has become so complex that even the executive authorities responsible for implementing the controls are unaware at senior levels of the exact control system which they have to implement".

The main contours of the control system as described in the Dagli Committee Report have remained in place, though individual components have been modified from time to time. There is little point in repeating, or even summarising, the description of the control system provided by the Dagli Committee Report. However, we should take note of the principal components. These are:

i. Controls on industrial activity;

ii. Controls on imports through licensing and canalisation procedures;

iii. Foreign exchange controls;

iv. Controls over prices and distribution of a wide range of commodities;

v. Controls on rents and on use of urban land.

In each of these areas knowledge of the control system requires knowledge of the relevant economic law such as the Industries (Development and Regulation) Act or the Essential Commodities Act, the statutory Control Orders, the numerous notifications issued under each statutory Control Order, and the array of administrative and informal controls and procedures which often buttress (and sometimes substiture for) statutory controls.

There are several dimensions to the manner in which controls contribute to the generation of black incomes. First, and most obviously, in areas such as import licensing, foreign

exchange control, rent control and commodity price controls, the institution and operation of controls spawns scarcity premia over and above the official or controlled prices, and these are usually reaped by operators in the black market for the relevant item As the Wanchoo Committee Report noted (p.9), since "the transactions in violation of statutory restrictions had to be entered secretively, these had necessarily to be kept back from the tax authorities. In consequence, evasion of tax on incomes thus made illegally follow inevitably".

The dimensions of such scarcity premia have fluctuated over time with the nature of the controls and the underlying conditions of supply and demand in the relevant markets. Comprehensive estimates are hard to come by. Mohammad and Whalley (1983) provide an estimate for 1980-81. According to them the total scarcity premia or "rents" associated with four major sets of controls (import licenses, capital market controls, commodity price controls and labour market controls) was in the order of 32,500 crore to 45,000 crore, or between 30 and 45 per cent of GNP. The basis for their estimates is somewhat rough and ready. For example, Mohammad and Whalley assume that the differential between controlled and black market prices for all non-agricultural price controlled items (including steel, cement, fertiliser, automobiles, chemicals, pharmaceuticals, sugar, paper, petroleum products and tractors) was 100 per cent. They apply this premium to the estimated value of production of those commodities to obtain an estimate of Rs 17,000 crore of scarcity premia attributable to price controls on the specified non-agricultural commodities. Similarly, they conclude that the real rate of return on investment was at least two to three times higher than the real rate of return accruing to savers, with the difference being attributed to controls on credit and interest rates. By multiplying this "premium" by the annual flow of household financial savings, they estimate that the scarcity premia in this area were in the order of Rs 8,500 crore to Rs 17,000 crore.

Quite clearly, these estimates are based on rather weak foundations. Perhaps more important, it is difficult to know

what proportion of the scarcity premia are actually realised in the form of illegal black incomes and what proportion is implicitly (but legally) enjoyed by recipients of the controlled allocations. Nevertheless, informed sources attribute great significance to controls as a cause of black incomes. For example, Pendse (1983) considers them so important as to come to the judgement that the aggregate of illegal source black incomes (principally the illicit premia spawned by controls) is larger than that of legal source, tax-evaded incomes in India.

Second, the present system of controls typically require anyone setting up a new activity to get *de facto* approval from a number of different agencies and departments; one might pass judgement on the foreign exchange implications, another on the project's consonance with Plan priorities, and still another on the foreign collaboration proposed. And obtaining the industrial license may only be the beginning. Further approvals may be required from the relevant State government (on land use, on environmental implications, etc.), term lending institutions, suppliers of infrastructure such as power and transport, and so on. At each stage of approval there is potential for graft, and that too at different levels. As an experienced Union Cabinet Minister puts it, "we have allowed a huge bureaucratic network to develop as a constraint on them (trade and industry). This apparatus exists only to say 'yes' or 'no' to a project whose file has to pass from the lowest section officer to the highest ministerial office. . .This merry-go-round goes on not only for months but for years. The only way to expedite matters and to obtain a 'no objection' certificate is to resort to the lubricant of unaccounted money which is used at every decision-making point, fom the lowest to the highest level. This is how corruption becomes the rule rather than the exception." (Sathe, 1984, p. 154).

Third, once an economic activity has been established, it continues to interface with many elements of the coutrol system. Import licenses may have to be negotiated, access to credit, coutrolled inputs and infrastructure (such as power, telecommunications and transport), secured. The enterprise

may become subject to monitoring by a whole new set of government departments such as labour, health, environment and so on. Once again, in each case, the regulators have to be propitiated, typically through some form of graft.[6]

Fourth, the operation of a complex and discretionary system of controls invites corruption and lobbying of another form. Economic agents do not rest content to confining their bribery to speeding up the processing of their various applications or to securing advantangeous intepretations when the regulations are ambiguous. They can also use their money power to change the scope and content of the controls. For example, there have been cases where the zoning of urban land has been altered to suit individual developers in return for appropriate considerations. In effect, changes in public policy are purchased, thus further vitiating the original rationale of the controls. Conversely, the *design* of the control system, and not just its administration can be used as a powerful instrument for conferring windfall gains (or promising to do so) and inflicting unforeseen costs (or threatening to do so) in a highly selective manner, which facilitates its use for raising money for political or private purposes.

In all of these cases the bribes themselves constitute black incomes in the hands of the recipients. What is perhaps even more significant is that the need to pay regular bribes to different elements of the control apparatus provides productive enterprises with a good reason to *generate* black income in their operations. "Greasing the wheels of business" is a significant rationale for enterprises to keep some of their income "off the books". And this need is high because the spread, complexity and discretionary content of the control system is great.[7]

A couple of general points merit emphasis. First, the system of economic controls and permits is not limited to the Central government; it extends to State and local levels. We were frequently told that though recent years had witnessed some relaxation in Central government controls (e.g., with respect to imports, price controls on cement and steel), the operation of the "license-permit raj" at the State and local levels had become more burdensome and corrupt, for

example, with regard to the distribution of liquor license and use of urban land. Second, as we already hinted above, the culture of corruption which is spawned (or at least, nurtured) by a system of complex discretionary controls on economic activity does not remain confined strictly economic controls.

General Laws and Regulations

The giving and taking of bribes goes well beyond strictly economic controls. For example, it is common practice for traders to give general purpose "haftahs" to local policemen and various municipal inspectors as well as special considerations to overlook unauthorised pavement retailing or other specific transgressions. Unauthorised constructions are frequently "regularised" through appropriate pay-offs. Corruption is, reportedly, rampant in the lower echelons of the general administration and the judiciary. Simple registrations of documents frequently require petty bribes. Placements of students in schools and colleges can often be secured only at a price. In some States the power to transfer officials is abused to extort bribes from the victims. In others, appointments to public jobs are "sold". These examples can be multiplied readily. It is their general characteristics which may be more interesting.

Laws and regulations grant a certain amount of monopoly power and capacity for harassment to those responsible for interpreting and administering them. The discretion is intended to serve the public interest. All too often in India it is used to enhance private (and illegal) profit. In effect, in the hands of the unscrupulous, regulatory authority becomes transformed into levers of "private taxation" through which tolls are levied on the public. As in the case of economic controls, the actual bribes received constitute black incomes in the hands of the recipients, though from a national income accounting perspective they are in the nature of transfer payments. However, to the extent such bribes are predictable, they encourage the donors to *generate* black incomes, typically by concealing legal source incomes and turnover from tax authorities.

Another noteworthy, general point is that when public offices are systematically abused to enrich the incumbents, the posts themselves frequently come to command a monetary price. In Chapter 8 we cited the work by Wade indicating that posts of engineers in canal irrigation systems fetch high prices. In our interviews, we were told that it was quite common for police postings to "fetch a going price", depending on their location and "revenue-earning" potential. Indeed, we were informed that recruitment to public services, in general, and especially at the lower levels, was becoming increasingly "monetised". Even jobs of public school teachers were often "on sale", though they were associated with little regulatory authority (such posts do however have earning potential in excess of salaries, to the extent that permanent teaching jobs provide both a certification and a clientele for remunerative—and tax-evading—private tuition). Of course, such "sales" of jobs are more likely to fetch high prices when they carry significant regulatory authority over lucrative economic activities.[8]

5. The Scale of Government Spending

We have noted how a regime of detailed and discretionary controls provides opportunities to those who design and administer the system to selectively confer benefits and inflict costs on different groups of economic agents. Similarly, government spending can be a potent source of economic patronage. As far back as 1964, the Santhanam Committee Report had warned about the "unprecedented opportunities for acquiring wealth by dubious methods" that was afforded by rapid increases in government expenditure. Even then the Committee received complaints about a virtually universal practice of cuts and kickbacks in "all contracts of construction, purchases and sales".

In the past three decades, government spending has increased nearly fifty times in absolute nominal terms; even as a ratio of GNP, government spending has increased from 9 per cent in 1950-51 to 27 per cent in 1982-83. There is no reason to believe that the accountability of expenditure has improved over time. In fact, our information suggests that

matters have worsened considerably, especially with the reported growth of political fund raising through government contracts. Furthermore, this period also saw a very rapid increase in the operations and turnover of public sector enterprises, some of which also offer substantial opportunities for making illicit commissions. Thus, it is difficult to resist the conclusion that rapid increase in public spending has been a significant factor behind the growth of black incomes.

The most common method of making black incomes from government spending is to "siphon off" a chunk of the reported expenditure and diminish the actual materials supplied and work done (in quantity or quality) by a corresponding amount. In effect, the "siphoning off" can be viewed as an illegal transfer from the public treasury to the recipients of the cuts, kickbacks and commissions. This set of issues and practices was discussed in Chapter 8.

6. Political Funding

Back in 1971 the Wanchoo Committee Report (p.9) had identified political finance as a significant factor in black income generation. Many of those we interviewed singled out (illegal) political fund-raising as a prime cause of black income generation. Under the present law no candidate to a Lok Sabha election is permitted to spend more than Rs 35,000 towards his election, and, since 1969, companies are disallowed from contributing towards the election expenditure of parties and candidates. It is common knowledge that these legal limitations are not taken seriously. Chief Election Commissioner R.K. Trivedi is reported (Advani, 1983) to have commented on the role of money power in elections in the following terms:

"This malady, I am afraid, during the last decade, has assumed alarming proportions. The huge expenditures incurred by candidates and political parties have no relationship to the ceiling prescribed under the law. The candidates and their political parties look to big money-bags for their funds to contest elections, thereby adopting a formula which establishes

the chances of winning in direct proportion to the money spent. That in course of time this triggers chain reaction leading to corruption at various decision-making levels, does not seem to bother them." Similar views are expressed by Union Cabinet Minister Sathe in his recent book (Sathe, 1984, p. 156).

Some attempts have been made to gauge the dimensions of the expenditure involved Based on some rough norms, Pendse (1983) estimates that Rs 170 crore of "black money" was spent in the 1980 Lok Sabha elections. Allowing for leakages en route, he suggests that something like Rs 400 crore of black income would have had to be generated to assure that Rs 170 crore became available for actual election expenditure. And this is for Lok Sabha elections alone. When we take account of elections to State Assemblies and to various local bodies, as well as the inter-election requirements for political campaigning and manipulation, it is quite clear that the demand for political funds could easily average several hundred crores per year.[9]

Such funds are in the nature of transfers, but the greater the demand for such transfers the greater is the inducement for *generation* of black incomes. Political contribution are raised from a wide range of sources of which industry and trade are believed to be the principal ones. Black incomes made through tax evasion of legal source incomes along with black incomes from all manner of illegal sources provide the "base" for the political "contributions". Political domination over the apparatus for licenses and permits and over public expenditures ensures means by which this base can be enhanced at will and individual enterprises induced to contribute. As numerous commentators have pointed out [e.g., Trivedi (1983), Kabra (1982) and Jha (1980)], such a close nexus between political funding and black incomes is extremely dangerous as it places public policy on the auctioneer's block. And, if the black incomes in question have been made through outright illegal activities, such as smuggling, then the prospect for effective and impartial administration of laws and regulations is that much weaker [see, for example, Jha (1981) and the cover feature in *Business India* of July 30-August 12, 1984].

What is especially pertinent to the generation of black incomes is that the growth of linkages between the black economy and political authority at all levels of government can severely weaken voluntary compliance with tax laws and other economic regulations. We have noted earlier that there is some evidence from other countries linking tax compliance with social norms and people's perceptions about equity. If people come to believe that their political masters are direct or indirect beneficiaries of black incomes, their motivation towards voluntary compliance is likely to suffer. Furthermore, political dependence on black incomes weakens the effectiveness of the government's administrative machinery for deterring evasion of tax laws and other economic regulations. When special leniency has to be frequently shown towards politically well-connected transgressors, the chances of achieving fair administration and effective deterrence are slim.

7. Standards of Public Morality

The Wanchoo Committee Report (p. 10) pointed "to the general deterioration in moral standards of our people" as a significant factor fuelling the growth of tax evasion. That such a decline has occurred seems beyond doubt. Everyone we interviewed agreed that standards in public life had declined over the last three decades, perhaps more rapidly in the years since the Wanchoo Report. B.K. Nehru (1982) observes, "Corruption is rampant in every sector of our society . . . A large number of politicians and ministers are corrupt, corruption is universal in the lower ranks of the public services, it has affected the middle ranks as well and is now infecting the apex of our administrative structure, the All-India Services. . ." Nor does Nehru believe that this was always the case but rather that we have "degenerated, in one single generation, from being an honest society into a dishonest one . . ."

Among the reasons cited by Nehru and others for this precipitous drop in public morality are: the relative decline of old elites and their established values and the rise of new, moneyed elites with little to offer except their example of material success; the example set by the political rulers in using public

office to advance party and private interest and their apparent ability to flout the rule of law with substantial impunity;[10] the sharp decline in real incomes of government servants coupled with growing opportunities for deploying their discretionary authority for personal profit; the cumulative character of corruption; and the growing weakness of established institutions and sources of authority.

Whatever the reason, the effects on tax compliance cannot be anything but adverse. The moral inhibitions against tax evasion and participation in other black transactions have clearly weakened. The process has been hastened by two orher factors: the growing role of specialised middlemen who intermediate between the citizen and the revenue (or other) authority; and the virtual universality of black transactions in certain markets (such as urban real estate) which obliges otherwise honest citizens to flout tax statutes if they are to participate in these markets at all. The Wanchoo Report had pointed out (p. 10) that "some tax advisers do not hesitate to lend their support in shielding, and even assisting tax dodgers" By all account, this practice has become far more prevalent. The assessee/client does not himself directly bribe the revenue official to get his assessment reduced, or a false return accepted. He shifts the burden of the act (and the associated guilt) to the intermediary tax consultant. Since reports indicate that revenue officials frequently harass even honest taxpayers, it is hardly surprising that the use of intermediary consultants and accountants has become virtually universal. A similar role is played by clearing agents with respect to customs authorities. In either case the intermediary may provide genuine professional services; but he also eases the process by which irregular tax returns are tendered and accepted and revenue lost to the State.

8. Inflation

There are several ways in which inflation enhances the incentives and opportunities for making black incomes: First, with a progressive income (and wealth) tax structure, defined with respect to *nominal* values, inflation results in "bracket creep" which increases the effective burden of taxation at any

given level of *real* income (and wealth), and hence the incentive to evade. Second, general inflation is usually accompanied by pronounced scarcities and windfall gains in certain sectors which are unlikely to be fully declared to the revenue authorities. Third, in a system where some prices are fixed by legal or executive fiat, adjustments in these prices are likely to lag behind the changes in market-clearing prices. The likely consequence is increases in the illegal scarcity premia, at least temporarily. Fourth, inflation reduces the real incomes of those whose nominal incomes do not keep pace with rate of change in prices. This includes government servants, many of whom have access to various forms of discretionary authority which can be bartered for money. Thus inflation, especially when it is prolonged and severe, increases the incentive to succumb to such temptations.

Notes

1. For a sampling of the general literature on the causes of black income generation in India, see the Wanchoo Committee Report (Government of India, Ministry of Finance, 1971). Sundaram and Pandit (1976), Chugh (1978), Kabra 1982), Pendse (1983), Sandesara (1983a) and Monga and Sanctis (1984).
2. These and subsequent papers have been surveyed by Sisson (1981).
3. For qualifications to this view see Sisson (1981).
4. The Wanchoo Committee Report is the most cited document on direct taxes. For Union excise duties the Venkatappiah Committee Report (Government of India, Ministry of Finance, 1974) found that evasion was widespread, although they were unwilling to venture quantitative estimates. Similar conclusions have been arrived at for State level taxes. See the references cited in Chapter 2.
5. Other reasons may also have been at work, such as differing requirements for sharing taxes collected by the Central Government with the States.
6. Informal estimates by Raj Krishna indicate that a going concern may have to keep functionaries from 25 to 30 public agencies happy.
7. Complexity of provisions and discretionary procedures also breed corruption in the case of other instruments of government policy, such as subsidies. Minhas (1977), p. 229) comments on India's export subsidy system as it operated in the mid-1970s in the

terms, "The infinite layers of contacts which exporters have to maintain with the bureaucracy, lead to colossal corruption."

8. In part, the illicit premia for such jobs also reflect excess supply of qualified candidates at the going rate of salary or wages.
9. In Raj Krishna's words "Indian politics has been becoming increasingly capital-intensive".
10. Nehru (1982) estimates that in one State at least thirty per cent of the legislators were involved in criminal cases of one type or another.