

Committee 3
Values and the Social Order:
Order by Rules and Rules by Order

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THE MARKET INSIDE AND OUTSIDE THE LAW:
NATURALLY IMPERFECT VS. POLITICALLY DISTORTED MARKETS

by

Arthur Seldon
Advisor
Institute of Economic Affairs
London, ENGLAND

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I THE END OF THE WELFARE STATES

The Rule of Law

Over-Government and the Escape to Markets outside the Law

Reform of economic life is still sought through the liberal attachment to "the rule of law". Liberal scholars have not, so far, discovered the means to reform within the law. Government remains too large.

Government has weakened Western attachment to "the rule of law" by over-extending its powers into services that the people can escape by flight to the market per se, inside or outside the law.

The argument applies essentially to the welfare state but it extends to both to all services captured by the state that are not public goods and to public goods for which payment can implicitly be rejected by tax avoidance and evasion.

Recognition that the welfare state can no longer be financed by government taxation, compulsory insurance or other levies is spreading in all schools of thought and political parties in the Western world, but the best expectations are that it will take three decades to wind down government education, medical care, housing, insurance for sickness, unemployment and retirement or old age.

In Britain the politician on the Right we have nearest to Newt Gingrich has announced that the state pension scheme

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will begin to be wound down in the year 2016. And on the Left the Spanish Minister of Economy said last week at a meeting of European Ministers that a large part of the European welfare state consists of

"redistributing resources among medium-income groups. We shall have to concentrate on the most disadvantaged and leave the rest to private activity."

"The most disadvantaged" - that is, the majorities in all all countries with the lowest incomes - will not be satisfied with unresponsive bureaucratic state education, medical care and pensions. They are joining the middle-income groups in the move to the private markets inside the law.

But they will not stop there either. Some who find the schools, the hospitals and the pensions they want in the markets inside the law will also find ways to pay for them by selling their services without paying taxes in the markets for labour outside the law.

II THE GOVERNMENT CONCEALMENT OF MARKETS OUTSIDE THE LAW

The Extent of the "Unrecorded", "Informal", "Shadow", "Unobserved", "Black", "Underground" or simply Free Economy

Unofficial

The sale of labour in the growing part of the economy that permits free bargaining and undistorted contracts is much more extensive than revealed by the official statistics of governments - as published by them internally or through international organisations like the O.E.C.D.

To publish the full figures as Inland Revenue officials

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privately estimate would be discouraged by Ministers. Politicians would see them as evidence of incompetence, as encouraging taxpayers to avoid taxes (which could develop habits that would lead to evasion). Bureaucrats are in a dilemma: they would like to make a plausible case for increased expenditure to discover offenders, without confessing incompetence. And they have developed sophisticated techniques of search and surveillance that have aroused public disapproval. But they will always be a long way behind the latest devices of the tax rejecters.

The implausible estimate of 7.5% of national income as the extent of tax evasion in the U.K. was offered by the head of the Inland Revenue, without revealing his method of measurement, in 1979. Even more implausibly the same figure was repeated by the Inspectors of Taxes in 1983, again without evidence and without examining more extensively researched estimates.

In 1981 Edgar Feige reached 15 % by his researches into the flow of transactions as a constant proportion of official GNP. Friedrich Schneider recently discussed the technical advantages and weaknesses of the methods of measurement and assembles the findings of the two used by most O.E.C.D. countries - the demand for currency method and the model approach. The two methods seem to show very broadly similar results but Schneider warns the comparison is crude. The latest estimates for the U.K. in 1978 are 3 to 11 % by one

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method and % by another. His and others' comparative figures for the shadow economies of 17 European and North American countries and Japan as % of their official GNPs are shown in the table.

	currency demand (1978 except where shown)		model approach (1978)
Europe			
Italy	30.0		11.4
Spain	23.0		6.5
Belgium	20.8	1980	12.1
Sweden	11.9-12.4	1980	13.2
U.K.	3.3-11.0	1979	8.0
Norway	10.2-10.9	1980	9.2
Germany (West)	10.3-11.2	1980	8.6
Denmark	6.9-19.2	1980	11.8
France	6.7	1978	9.4
Ireland	8.0		7.2
Netherlands			9.6
Switzerland	6.5		4.3
Austria	3.1	1980	8.9
Finland			7.6
North America			
Canada	10.1-11.2		8.7
U.S.A.	3.9-6.1	1980	8.3
Far East			
Japan			4.1

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The methods have been refined over the years, but there remain difficulties of measurement. Schneider suggests that improved techniques would probably yield higher figures. I would take the calculations, or estimates, for the U.K. with a large lump of salt, and guess some could be doubled.

These figures are mostly 15 years old and are now mostly higher, perhaps substantially. (Schneider's detailed estimates for Austria show an increase from 1.16 % in 1965 to 5.32 % in 1991.)

Common experience of the increasing use of cash to pay for services in the U.K., and the readiness of people in all income groups to discuss the "law-breaking" more openly, suggests that it is becoming generally common and acceptable. For the U.K. whatever the causes - rising taxes or other - I would say the most realistic figure, including the apparently increasing use of barter (below), is nearing 20%. We are still a long way from measuring the extent of tax rejection by the citizens of the advanced countries.

What is clear is that growing "black" economies reduce the accuracy of official (O.E.C.D. and other) statistics as foundations for macro-economic policies of government. The state is working increasingly in the dark.

III BETTER STATISTICS - ASK THE CITIZENS WHO PAY

The difficulty of obtaining "sincere" replies by asking

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samples of people the work for which they are paid in cash is that they will understate the amounts or refuse to reply. A potentially fruitful solution used at the Institute of Economic Affairs was suggested by Marjorie Seldon, who will outline the method and the findings.

IV BARTER

The extent of tax evasion has also been growing by what seems to be new forms of barter.

Acquaintances or friends who exchange what they may call gifts may be consciously or unconsciously helping each other to evade taxes. A dental surgeon who draws the teeth of a architect patient who draws the plans for an extension to his surgery may be exchanging services unpaid and untaxed in a market outside the law.

My impression is that this practice has been growing. A conservative British newspaper researcher reported last year (1994) 200 local barter groups virtually exchanging goods and services in mult-lateral markets outside the law. The system originated in Manchester - the historic birth-place of free trade - with 380 members. It has spread to other towns in northern England and more recently in the South..

To facilitate bargains they use a medium of exchange that is legally unidentifiable as "money" - cotton bobbins. A hairdresser used eight bobbins to "pay" for a bicycle inner tube, one for a portion of pizza at a cafe, 100 to have her

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garden landscaped, and a large (unrevealed) number for legal advice from a solicitor. The legal law may have to recognise economic law.

There were over 200 local unofficial "currencies" in the country as a whole, with a new one appearing every fortnight. The bobbin-currency has spread to local government: a Manchester councillor has said it may accept bobbins in part-payment of local taxes ! Local informal currencies are accepted by stores in Wales and English counties. A journalist in Kent has launched a private currency that she believes will replace legal tender among people who know one another well.

The motives may be various - perhaps to help unemployed with too little cash. But the effects on tax revenue are incalculable. The idea may spread to other countries.

V THE DEMAND FOR WELFARE IN TERMS OF TAXES

For 50 years since the end of the war social surveys claimed to have discovered a massive readiness to pay higher taxes to provide more or better state welfare services. The flaw, unrecognised by the sociologists who mostly sponsored these opinion polls, was that they contained no prices.

In 1965 J.M. Buchanan had asserted, in an IEA Paper on the financing of the British "free" National Health Service, that the people would not pay in taxes as much as they expected from the state in "free" education and medical care.

In 1963 the Institute had begun to introduce pricing into field studies designed to discover the "demand" for education and medical care, using the voucher as a method of indicating several residual prices. In further surveys in 1965, 1970, 1978 and 1987 the priced options discovered, not surprising to economists, that demand varied inversely with price. And it was possible to construct rough demand curves with measures of price- and income-elasticities.

The price-less polls had encouraged politicians in all parties for perhaps 40 years since the war to believe that rising taxes would be popular and that there was no risk of massive loss of votes. It may also have encouraged the Inland Revenue to believe that advising higher taxes would not reduce the revenue.

A political shock came in 1992. It was then still believed by the Labour Party leader, the late John Smith, a lawyer with no economic understanding, that the people would be willing to pay higher taxes to pay for higher social benefits for pensioners and others. He lost the General Election; the reason was generally thought that he had continued to believe the post-war myth that the people wanted to pay higher taxes. *with them* *with them*

What the post-war governments had misunderstood was the sizeable expansion in the underground economy. They had not enquired into the growth of the demand for welfare services wherever they could be found - in markets inside the law for

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which they could pay if they earned the payment from their untaxed labour services outside the law.

VI THE EVIDENCE OF THE COUNTER-FACTUALS

The state in Britain - and elsewhere - has frustrated the inclination of the common people to better their condition by paying or insuring for welfare services as soon as their real incomes began to rise sufficiently in the 1870s and 1880s.

The "cost" of the welfare state is usually measured in the taxes required to finance it. More fundamentally, as the Austrian Wieser taught, the true "cost" has been essentially the alternative private services weakened or destroyed by the state that would have continued to grow - the opportunities sacrificed. Yet this real cost has rarely been made apparent by the historians in documented counter-factuals.

The graphic effect was shown by a series of historical surveys last year designed to present the education, medical, housing, insurance for sickness, unemployment and old age that would have emerged in our day if government had not been misled into building welfare states. ("The Lost Century", ten authors, Economic Affairs, October, 1994.)

The private institutions are now being rebuilt in the market after 100 years of disuse because the state cannot finance the welfare services and benefits it has promised but cannot supply from tax revenue. "The Lost Century" of

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consumer-preferred private welfare was created by the state system that required 11.5 million employees in 1911 to insure against unemployment when nine million had been insured for over 30 years since the 1870s with private institutions. But once captured by the state they were unable to escape - for some 80 years until recently. That was the century lost for the people by the state. Once installed it could not free its hostages. (Michael Beenstock explained the "lost century" by Simon Kuznets' and Arthur Lewis' work on the course of low incomes during industrialisation.)

VII ESCAPE INTERNATIONAL
NATIONAL WELFARE STATES CANNOT BE FINANCED
BY NATIONAL INCOMES

Increasing avoidance or evasion of taxes is likely to follow the realisation that government in the West cannot finance rising costs of welfare state benefits and may have to turn to the high-earners. The wealthy will look for new ways to escape. (The richest family in Britain are refugees from Swedish taxation.)

The information revolution will enable more people in the highest-taxed countries to earn and pay lower income taxes overseas. A former Editor of The Times has reviewed the prospect. One % of American taxpayers pay 25 % of U.S.A. income tax, 5 % pay 50 %. By the use of telephone, fax and the Internet it has been estimated that more than half of the

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5 % could earn their incomes in other jurisdictions. I gather the Clinton government has "panicked" at the feared loss of revenue. No doubt other governments are apprehensive.

The new technology could enable people everywhere to live in their home country and earn their incomes with lower taxes elsewhere.

24 million Americans are connected to the Internet, more than 10% of the working population. The Internet has been changing from a reference library to a mass world market catering potentially for most larger business transactions.

The Internet does not - perhaps cannot - protect copyright. It apparently seems doubtful whether it can protect tax revenue. National tax authorities cannot record the Belize mutual betting system which pays managers 2 % of the proceeds. Most countries have betting taxes. Britain has recently established a national lottery - to provide revenue for cultural and other worthy causes judged by impecunious government.

If Inland Revenues cannot record Internet transactions, national governments cannot tax them. I gather that enscription of voluntarily recorded Internet transactions cannot be traced in cyberspace.

The subscribers to the Internet is said to be doubling every year. A meeting in Maryland in mid-May concluded that the countries in t2he Group of Seven would not be able to raise the prevailing 40-50 of GNP in taxes. A suggestion at

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the meeting was that it might have to fall to the 20 % of Hong Kong. Others doubted whether it would rise much above the 10 % of the 19th century.

The national welfare states in the West will then not survive if working citizens with taxable earnings in other countries cannot be traced in an international communications system. Markets outside the law will be generating income that governments cannot reach.

We shall be back to the century in which the market was beginning to supply the spontaneous welfare services that the state has almost destroyed and now cannot emulate because it cannot close the escapes from its over-ambitious expansion. After a century in which the people will have been forced to accept the inferior quality of state welfare, they will be able to cock a snook at the over-expanded state.

VIII THE MARKET WILL PREVAIL OVER THE STATE

Even if this process takes no more than a few decades the ordinary people with rising real incomes will not wait. They will pass increasingly from the state to private welfare services in the market, and they will pay incomes augmented by tax rejection. They will, in effect, pass from markets within the law to markets outside the law. And it is the state that alienated them. It is the politicians, not, as Marx asserted, the capitalists, who would alienate the people.

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The state has had its chance to widen choices in its state services without waiting 20 or 30 years. It could have done it with two or three years - by devices like vouchers, rejected by the British Conservatives in 1983 but now being anxiously reconsidered in the search for votes. They have most recently experimented with annual budgets for schools and hospitals to introduce a measure of internal competition. But they leave ultimate control with government. The state has so far yielded to the organised interests among the politicians, the bureaucrats and the producers - teachers, doctors, nurses... As the General Elections approaches in 1996-7 they may be advised that there are more voters among consumers than among producers.

The state is rolling back not because scholars advise it, but because over-government can be increasingly escaped to the market .

The "lost century" in which the state triumphed over the market is ending.

IX THE ULTIMATE QUESTION

Liberalism or Conservatism

One question for Western liberals remains.

Despite his life-long teaching of (European) liberalism Hayek turned in his late years to conservatism in the trust to tradition, custom, continuity to indicate the institutions that best survived the test of time. From Edmund Burke to

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Michael Oakeshott the conservatives are quoted as the ultimate sources of wisdom.

Hayek was denying his own teaching that the market is essentially the supreme vehicle of discovery. If we are ruled by the apparent lessons of the known past, we shall be denied the opportunity to use the market in learning from mistakes by taking risks with the unknown future.

The lesson of the last century is that if we are to avoid the excesses of over-government we have seen in Europe, not least in Britain and Sweden, we must take the risks of under-government.

And this truth applies to markets whether they emerge spontaneously or are constructed as the best mechanism the world has known for exchanging information and benefiting both sides to voluntary exchange. The market has discovered hitherto unknown information whether it is shaped or tolerated by the law made by the fallible process of politics or suppressed by politicians serving their self-interests.

Markets outside as well as inside the law serve the human race.

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(Last pages of Seldon
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Supplement to Arthur Seldon

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MARKETS INSIDE AND OUTSIDE THE LAW
TAX EVASION - A NEW SOURCE OF INFORMATION
Marjorie Seldon

A method to check on a widespread source of the cash economy occurred to me in 1976 when the I.E.A. was compiling Readings 22 on "the economic, legal and moral relationships between avoidance and evasion". The authors were considering a sample survey but were doubtful of the value of the usual questions asking the sample, even in confidence and anonymously, how much they had received in cash for work done. The implication would be that they were involved in tax evasion.

A survey based on the suggestion that the sample comprise people who had paid for services rather those who had received the payment was incorporated into the published essays and reports (Tax Avoision, 1979.)

Although it is not illegal to pay in cash, the onus is on the recipient to declare it as taxable income. But the payer may be less reluctant to give the information.

The services surveyed were:

window cleaning	painting and decorating	carpet-laying
plumbing	electrical work	gardening

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carpentry	chauffeur	car maintenance
home help	baby-sitting	secretarial
medical	dental	coaching
accounting	architectural	

The pilot sample of 712 comprised 512 men and 200.

It confirmed the view that such casual services were often paid in cash.

One revelation was the wide spread of income and social classes engaged in the cash economy. Another was that cash was paid for services from all age-groups.

55 % of the sample had used one or more of the services in the preceding month. 83 % had been paid for by cash, the rest presumably in barter or were unpaid. The larger the payments the more likely they were to be paid by cheque.

The recent British Rowntree Report on Poverty seemed to reveal a wide difference between the low recorded income of people on social benefit and their everyday life-styles. While all the recorded incomes, earnings and social benefits, were expected to be fully used for the necessities of food, rent, clothing, heating and lighting, they had apparently also furnished the homes with items that would mostly have been paid for out of extra cash income earned by the parents from part-time housework, decorating, gardening or other unskilled or semi-skilled jobs.

The market in household goods and services is evidently fuelled substantially by non-recorded income.

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The I.E.A. survey also revealed a high degree of tolerance of tax evasion and a reluctance to condemn the evaders. In the last 30 years in Britain, and perhaps in other countries, the rise in taxation has been paralleled by a belief that there is nothing necessarily immoral in strenuous efforts to avoid (or possibly also evade) tax abetted by tax consultants, insurance firms, and other advisers, including family, friends and neighbours.

More and more ingenious schemes are designed to keep the citizen one step ahead of the Inland Revenue inspector. Indeed many former inspectors hold lucrative jobs as tax advisers or consultants to private firms and individuals.

Like a snowball gathering speed and volume and knocking down barriers, the impetus for tax evasion has rolled over moral barriers. Few people seem to have scruples in paying a lower price for cash rather than a higher price including value-added tax (8% to 17%).

The Inland Revenue has tried, but mostly failed, to check the tax evasion prevalent in the market of bed and breakfast for tourists. The lack of a sense of immorality was made plain when the church-going wife of a farmer asked for cash for our two days, adding "And please don't give me the money on the Sabbath as we are strict sabbatarians".

She later told us she used the money earned in cash tourism to send her son to a fee-paid independent school.

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