

Measuring Illegal Activity and the Effects of Regulatory Innovation: Tax Evasion and the Dyeing of Untaxed Diesel

Justin Marion [†]
Erich Muehlegger [‡]

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Abstract

This paper examines tax evasion in the diesel fuel market. Diesel fuel used for on-road purposes is taxed, while other uses are untaxed, creating an incentive for firms and individuals to evade on-road diesel taxes by purchasing untaxed diesel fuel and then using it for on-road use. We examine the effects of a federal regulatory innovation in October 1993, the addition of red dye to untaxed diesel fuel at the point of distribution, which significantly lowered the cost of regulatory enforcement. We find that sales of diesel fuel rose 26 percent following the regulatory change while sales of heating oil, which is an untaxed perfect substitute, fell by a similar amount. The effect on sales was higher in states with higher tax rates and in states likely to have higher audit costs. We also find evidence that heating oil sales are less responsive to demand factors such as temperature prior to the dye program, indicating that a significant fraction of pre-dye sales was illegitimate. Furthermore, we find a pattern of price and tax elasticities consistent with innovation in new evasion techniques subsequent to the regulatory change. Finally, we estimate that the elasticity of tax revenues with respect to the tax rate was 0.60 prior to the dye program, yet would have been 0.85 in the absence of evasion.

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[†]University of California, Santa Cruz. Marion@ucsc.edu

[‡]John F. Kennedy School of Government, Harvard University. Erich_Muehlegger@ksg.harvard.edu.

1 Introduction

Tax evasion and tax collection are important elements of fiscal policy. Lack of compliance with tax laws are likely to alter the distortionary costs of raising a given level of government revenue and may affect the distributional consequences of a given tax policy. Furthermore, resources spent evading taxes represent a deadweight loss to the economy. Despite the central importance of tax evasion in public finance, our understanding of the degree of evasion and its response to the rate of taxation and government enforcement is limited.

Detecting tax evasion and estimating how it responds to tax and enforcement policy have traditionally been difficult since those engaging in evasion wish to keep this behavior concealed. Furthermore, disentangling the effects of tax rates and audit intensity from other unobserved factors is not straightforward. Audit intensity is likely to be endogenously related to the propensity to evade, as auditors focus collection resources toward groups of taxpayers likely to evade. Also, variation in tax rates across individuals or firms is often correlated with evasion opportunities. For instance, higher income individuals face a higher marginal tax rate and at the same time may have more income from sources that are easier to conceal. The value of providing empirical evidence regarding these questions is high, as even theoretically the response of evasion to tax rates is not clear.¹

The diesel market provides an interesting setting to study tax evasion. The taxation of diesel fuel varies significantly by use. Despite being virtually identical to the diesel used for on-road purposes, diesel fuel consumed for off-road use such as residential heating, industrial use, farming or off-road travel is untaxed. In 2005, consumers using diesel fuel for on-road purposes faced federal highway taxes of 24.4 cents per gallon in addition to state highway taxes that range from 8 to 32.1 cents per gallon. Some localities tax on-road diesel as well, altogether placing the tax burden at over 50 cents per gallon in many states. The close substitutability and differential taxation of on-road and off-road diesel create strong incentives for firms to evade diesel taxation by purchasing untaxed diesel fuel and using or reselling it for on-road use.

In this paper, we consider the impacts on tax evasion of a regulatory innovation that greatly decreased the cost of monitoring compliance with on-road diesel fuel taxes. In October 1993, the Federal Highway Administration began adding red dye to untaxed diesel fuel. The dye allows inspectors to readily check for untaxed diesel through simple visual inspection, reducing the cost of auditing for regulators and increasing the cost of achieving a given level of diesel tax evasion

¹Allingham and Sandmo (1972) analyze the evasion decision, finding that evasion is positively related to tax rates. However, Yitzhaki (1974) shows that this result depends on the nature of penalty imposed on audited evaders and on the preferences of potential evaders.

for firms.

We estimate the effects of fuel dye using two identification strategies. Our first identification strategy examines the magnitude of the discontinuity in sales of diesel fuel and untaxed fuel oil, a perfect substitute, upon the introduction of fuel dye. We estimate a 25 to 30 percent discontinuous increase in sales of diesel fuel at the start of the fuel dye program, or 0.067 gallons per person per day for the average state. Sales of untaxed fuel oil fell 0.066 gallons per day. Consistent with the predictions of a model of tax evasion, the magnitude of the discontinuity is greater in states with high tax rates and states likely to have high initial monitoring costs.

Our second identification strategy formalizes a test for evasion that compares diesel's elasticity with respect to taxation with its elasticity with respect to prices. Importantly, the test is based only on sales of the taxed good and, thus, applicable to contexts in which we do not see illicit sales of untaxed alternatives.² We find a significant gap between diesel's response to prices and taxes in the pre-dye period, rejecting the null hypothesis of no evasion. This gap disappears for four years following the introduction of fuel dye as previous methods of evasion were made less effective. Beginning in 1998, the gap reappears, consistent with criminal innovation in response to the dyeing program.

We show how the estimates of the price and tax elasticities can be used to obtain an estimate of the derivative of evasion with respect to the tax rate. We estimate that a one cent increase in diesel taxes raises evasion by 16.5 thousand gallons per day. While this estimate requires observing only taxed sales, we can compare it with a more direct estimate obtained from fuel oil sales. We estimate that fuel oil sales increase by 25 thousand gallons per day in response to a one cent change in the tax rate.

Finally, we use the estimated tax and price elasticities to describe how evasion affects tax revenues. We estimate that the tax revenue elasticity with respect to the tax rate is 0.60 in the pre-dye period and 0.71 after the implementation of the dye program. If no evasion existed in this market, these values would be 0.85 and 0.90, respectively. Therefore, the impact of tax changes on revenues increased in the post-dye period, and over half of this increase can be attributed to decreased evasion.

Our paper relates closely to the literature measuring tax evasion and its responsiveness to incentives, and more broadly to empirical studies attempting to uncover evidence of illegal

²The techniques we use to infer evasion by comparing tax and price elasticities relate closely to the work of Chetty et al (2007). They examine consumer tax salience by comparing the demand response to changes in specific liquor taxes, which are incorporated in the price quoted to consumers, with the demand response to changes in ad valorem taxes, which are not part of the posted price but instead paid at the register. Similarly, Rosen (1976) compares the response of female labor supply to taxes and wages. Tax salience is unlikely to be an issue with diesel sales, as the tax is incorporated in the price quoted to the consumer.

activity. Several approaches have been taken in prior literature to measure tax evasion. An indirect approach involves observing aggregate quantities such as currency demand or national income and product accounts and inferring evasion from these quantities.³ A second approach utilizes cross-sectional variation across taxpayers in observed levels of compliance using the Taxpayer Compliance Monitoring Project (TCMP), which describes the outcome of IRS audits of randomly chosen tax returns.⁴ A third approach taken in the literature uses experimental methods to investigate tax compliance and its response to tax rates and enforcement.⁵

The approach most closely related to that taken in our paper is that of Fisman and Wei (2004), who examine the misclassification of Chinese imports from Hong Kong. They find that the gap at the detailed good level between reported Chinese imports from Hong Kong and reported exports from Hong Kong to China is largest for goods with high tax and tariff rates. In a similar vein, Hsieh and Moretti (2006) uncover evidence of underpricing and bribes in Iraq's oil for food program by comparing prices charged by Iraq for oil with prices of close substitutes sold on the world market. DellaVigna and La Ferrara (2006) use the response of the equity prices of weapons manufacturers to armed conflict events to uncover evidence of illegal arms sales.

Section 2 presents some background related to diesel markets and taxation and Section 3 describes a model of the firms' tax evasion decision. Section 4 describes the data to be used. Section 5 presents the primary empirical evidence, the response of sales to the dye program. Section 6 provides results implementing the test of evasion and derives estimates of the responsiveness of evasion to tax rates. Section 7 concludes.

2 Regulatory Background

The taxation of diesel fuel varies by use. Diesel fuel used on-road is subject to federal highway taxes of 18.4 cents per gallon and state highway taxes of 9 to 32.1 cents per gallon. Federal fuel taxes are the primary source of funding for the Federal Highway Trust which funds infrastructure

³See for instance Gutmann (1977), Feige (1979) utilizes total dollar transactions relative to GDP, and Pommerehne and Weck-Hannemann (1996).

⁴Clotfelter (1983) finds a positive relationship between individuals' marginal tax rates and the degree of evasion. Feinstein (1991) pools two different years to address the simultaneous relationship between income and marginal tax rates and finds a negative relationship between tax rates and tax evasion. Dubin and Wilde (1988) and Beron, Tauchen, and Witte (1992) find that increasing the chances of an IRS audit is associated with higher reported adjusted gross income.

⁵Slemrod, Blumenthal, and Christian (2001) study the distributional impact of tax evasion in an experiment where randomly selected taxpayers were sent letters warning of close scrutiny of their tax returns. Treated low and middle income taxpayers reported higher AGI than the control group, but treated higher income individuals reported less. Other experimental approaches include Wenzel and Taylor (2004) and Alm and McKee (2005)

investment. In addition, environmental regulations limit the amount of allowable sulfur content of on-road diesel fuel.⁶ Diesel fuel consumed for farming or off-road travel, or as fuel oil for residential, commercial or industrial boilers is not subject to highway taxes and is not required to meet similar sulfur limits.

Variation in taxation and environmental stringency by use create strong incentives for firms to evade taxation. Evaders purchase untaxed diesel fuel and use or resell it for on-road use without paying the appropriate highway taxes. In the 1980's, the most common method of evasion was the "daisy chain", in which a company would purchase untaxed diesel fuel and resell the diesel fuel to an affiliate to make it more difficult to audit the transaction. The affiliate would then resell the fuel to retail stations as diesel for which highway taxes had been collected.⁷ In 1992, the Federal Highway Administration estimated that firms evaded between seven and twelve percent of on-road diesel taxes, approaching \$1.2 billion dollars of federal and state tax revenue annually. While evasion was also a concern for other fuels, including gasoline, kerosene and jet fuel, diesel fuel presents a special situation. Both taxable and non-taxable uses are significant. In 2004, 59.6 percent of distillate sales to end users were retail sales for on-highway use.⁸ This creates the incentive to develop evasion schemes for on-road diesel taxes, as well as provides access to large quantities of untaxed diesel fuel.

In response to "daisy chain" evasion, the Internal Revenue Service (IRS) and the Environmental Protection Agency (EPA) innovated. Beginning October 1, 1993, new regulations required fuel dye be added to all diesel fuel not meant for on-highway use.⁹ Beginning January 1, 1994, the point of federal highway taxation for diesel fuel was moved to the wholesale terminal. As a result, any untaxed diesel fuel sold at the wholesale terminal was required to be dyed and consumption or sale of dyed fuel was made illegal.¹⁰

The IRS and EPA regulations reduce the cost of enforcement, and increase the cost of common evasion schemes like the "daisy chain." Fuel dye allows regulators to randomly test trucks through a simple visual inspection, substantially reducing the cost of monitoring. Moving

⁶From October 1993 to August 2006, the allowable sulfur content for on-highway diesel fuel was 500 parts per million. Regulations did not constrain the sulfur content of diesel intended for other uses. Beginning September 1, 2006, diesel sold for on-highway use must meet Ultra Low Sulfur Diesel Fuel requirements, with sulfur content not exceeding 15 ppm.

⁷For documented examples of evasion, see the Federal Highway Administration Tax Evasion Highlights.

⁸Fuel Oil and Kerosene Sales Report, Energy Information Administration, 2004.

⁹EPA regulations relating to sulfur content began Oct 1993. IRS regulations relating to diesel on which on-highway taxes had not been collected were enacted as part of the Omnibus Budget Reconciliation Act of 1993 and began Jan 1994.

¹⁰The federal penalty for consuming or selling dyed fuel ("red diesel") for on-road use is the greater of \$10 per gallon of fuel or \$1000. In addition to penalties for evading federal taxes, individual states penalize firm caught evading state taxes. Denison and Eger (2000) document fuel evasion penalties for a subset of states in 1997.

the point of taxation to the point of sale at the wholesale terminal serves a dual purpose. Prior to 1994, the government collected fuel taxes from both wholesale terminals and the diesel distributors - firms who transported diesel from the wholesale terminal to the retail station. Moving the point of taxation reduces the number of firms responsible for collection on-road taxes, making it less costly to collect taxes and enforce dyeing of untaxed fuel. In addition, moving the point of taxation increases the costs of evasion for standard “daisy chain” evasion. IRS monitoring rose following the introduction of fuel dye.¹¹ In addition, funding for fuel tax enforcement increased in 1994 and has risen subsequently.¹²

3 A Model of Fuel Tax Evasion

To motivate our empirical model, we consider a model of fuel tax evasion with a continuous measure of firms purchasing diesel fuel for on-road (taxed) use.¹³ Although we consider the case of a firm evading taxes on an input to production, we could analogously frame the problem as one of a consumer choosing quantities of a legally and illicitly purchased good. Firms jointly choose how much diesel fuel to purchase, q , and the proportion of untaxed (illegal) diesel fuel, α , to produce output $x(q)$. Firms purchase taxed diesel fuel at price $p + t$. Firms which purchase untaxed diesel fuel at price p incur a heterogeneous cost of evasion which is quadratic in purchases of untaxed diesel fuel, and are assessed a fixed penalty if caught evading taxes by the regulator. Prior to the firms’ decisions, the regulator observes the punishment associated with evasion, the distribution of heterogeneous evasion costs, the cost of auditing, and p and t and chooses the probability with which it will audit firms, p_a , to maximize total tax revenues less the cost of auditing.

Depending on the firm’s cost of evasion, firms either choose to fully evade the regulations by purchasing only untaxed diesel fuel, partially evade the regulations by purchasing a mix of taxed and untaxed diesel fuel, or fully comply by purchasing only taxed fuel. Diagram 1 graphically represents how taxed and untaxed diesel consumption vary with the evasion cost parameter, γ .

For firms with values of γ above the partial/non-evasion cutoff, $\hat{\gamma}_{NE}$, the expected penalty outweighs the benefit of evasion. These firms fully comply with the regulations by only purchasing \bar{q} units of taxed diesel. The discontinuity in taxed fuel consumption at $\hat{\gamma}_{NE}$ is a result

¹¹Baluch (1996) tabulates IRS staff hours related to audits and enforcement of diesel fuel taxes and finds that staff hours rose approximately three and a half times, from 151,190 hours in 1992 to 516,074 hours in 1994.

¹²The initial budget for fuel tax enforcement in the Intermodal Surface Transportation Efficiency Act was \$ 7.5 million per year. The budget for 2008 is \$ 12 million per year. In addition, states can spend up to one percent of their Surface Transportation Program funding on fuel tax enforcement.

¹³Here we present the intuition and relevant results - see the appendix for a formal presentation of the model.

of the fixed punishment. With a fixed penalty, purchasing an epsilon amount of untaxed fuel is dominated by non-evasion. Partially-evading firms, with heterogeneous costs of evasion between $\hat{\gamma}_{FE}$ and $\hat{\gamma}_{NE}$, also purchase \bar{q} total units of diesel fuel. Partial-evaders purchase untaxed fuel up until the point at which the marginal cost of evasion is equal to the tax rate. Firms below the full/partial evasion cutoff, $\hat{\gamma}_{FE}$, only consume untaxed fuel. Fully-evading firms consume untaxed fuel up until the point that marginal revenue is equal to price plus the marginal cost of evasion, which is strictly less than the tax-inclusive price. As a result, fully-evading firms consume more than \bar{q} units of diesel fuel.

Anticipating firms' choices, the regulator endogenously chooses the probability with which to audit, p_a , to maximize tax revenues less auditing costs. Consistent with intuition, audit intensity decreases with the cost of auditing, c_a , and increases with the tax rate, t . An increase in t increases the marginal benefit of auditing - an increase in c_a increases the marginal cost of auditing.

3.1 Empirical Predictions

We derive three sets of testable predictions which we would expect to hold if fuel tax evasion exists and if the use of fuel dye reduces evasion: (1) predictions of the magnitude of the discontinuity in sales before and after the introduction of the fuel dye, (2) predictions of the seasonality in fuel oil sales pre- and post-dye, and (3) predictions of the price and tax elasticity of taxed and untaxed diesel fuel.¹⁴

We derive predictions of the magnitude of the discontinuity in sales at the time of dye introduction from the derivative of market demand for taxed and untaxed fuel, Q_t and Q_u , with respect to the cost of auditing c_a . In our context, fuel dye reduces the cost of monitoring diesel fuel tax compliance. With lower auditing costs, the regulator optimally increases audit intensity. As a result, we expect consumption of untaxed diesel to fall and consumption of taxed diesel to rise as a result of the regulatory innovation. In addition, the theoretical model predicts correlations between state characteristics and the magnitude of the discontinuity in sales at the time of the fuel dye introduction. High state tax rates create greater incentive for evasion as well as a greater change in enforcement following a decrease in audit costs. Thus, our model predicts that the magnitude of the discontinuity in sales should be greater for high tax jurisdictions than low tax jurisdictions. In addition, if monitoring is initially more difficult in states with substantial markets for untaxed diesel fuel, we would expect the discontinuity to

¹⁴We include the formal derivation of the testable predictions in the appendix.

be greater in jurisdictions with high legal demand for untaxed diesel fuel.

A second set of testable predictions compare pre- and post-dye seasonality in fuel oil sales. Seasonality of fuel oil demand differs substantially by use - residential demand for home heating is greatest during the winter, while industrial and commercial demand exhibit little seasonality. We expect illegal purchases of untaxed fuel oil, for use on-highway, to reduce seasonality in states where a large proportion of households use fuel oil for home heating. In addition, if evasion declined in the post-dye period, seasonality in fuel oil sales should increase post-dye in states with substantial residential fuel oil demand.

We derive a final set of testable predictions based on the short-run price and tax elasticity of taxed diesel fuel. Absent evasion, a change in either the tax-exclusive price or the tax rate should reduce sales of taxed diesel equally. If firms evade taxes, an increase in the tax rate causes partial evaders to substitute from taxed to untaxed diesel and causes marginal firms at the non-evasion and full-evasion cutoffs to begin to partially or fully evade diesel taxes, respectively. Thus, we would expect taxable sales to respond more to a change in taxes than a change in prices if evasion exists. If evasion declines as a result of fuel dyeing, the gap between the response of diesel sales to taxes and prices should decrease. We derive analogous predictions for sales of untaxed fuel oil. If firms evade taxes by purchasing untaxed fuel oil, we would expect an increase in the tax rate to increase sales of fuel oil. Furthermore, the effect of the tax rate on fuel oil sales should decline post-dye.

4 Data

We use state-level data from the Energy Information Administration (EIA) and the Federal Highway Administration (FHWA). The EIA tracks monthly Prime Supplier sales of No. 2 diesel fuel and No. 2 fuel oil by state from 1983 to the present. Although the chemical properties of No. 2 diesel fuel and No. 2 fuel oil are essentially equivalent - the two products can be used interchangeably - the EIA defines diesel fuel as No. 2 distillate sold for use in an engine and defines fuel oil as No. 2 distillate sold for residential, commercial or industrial use in a boiler or furnace. Thus, diesel fuel is predominately taxed diesel sold for on-road purposes, while fuel oil is entirely untaxed diesel fuel sold for off-road purchases.

Two of the main results of the paper can be seen by examining the monthly time series of U.S. sales of No. 2 distillate. In Figure 1, we show the time path of sales of No. 2 diesel, No. 2 fuel oil, and total No. 2 distillate sales. In the month of the implementation of the diesel dye program, sales of diesel increased noticeably. In September of 1993, 82.0 million gallons of

diesel were sold per day in the United States, and this figure increased to 97.4 million gallons per day in October of 1993. Sales of No. 2 fuel oil declined noticeably in the period after the dye program was implemented, even though the discontinuity in the month of implementation is less striking than with diesel due to the seasonality of fuel oil sales. Overall, the increase in diesel is largely canceled out by the decrease in fuel oil sales, at least in the first year of implementation.

The EIA publishes the monthly average price of No. 2 distillate by type of end user for the majority of states. When unavailable for a particular state, we utilize the price in the Petroleum Administration for Defense District (PADD) in which the state is located. To measure the price of diesel for on-road purposes, we use the price to end users through retail outlets. This is virtually a perfect match of the low-sulfur diesel price, which is almost exclusively intended for on-highway use in the post-dye period.

We obtain information about the federal and state on-road diesel tax rates from 1981 to 2003 from the Federal Highway Administration Annual Highway Statistics. Figure 2 plots the state and federal tax rates over time. In Panel A, we show the federal tax in cents per gallon, which was four cents per gallon in 1981, rising to the current level of 24.4 cents per gallon in 1993. The only post-dye variation in the federal tax rate was a temporary 0.1 cent reduction in 1996. In Panel B we plot the average state tax.¹⁵ The average state tax has increased monotonically over time, starting at approximately 12 cents per gallon in 1983 and increasing to over 21 cents per gallon in 2003. This figure also plots the number of states changing their tax rates in each year. It is common for a state to change its tax rate - in most years, between 6 and 23 states change diesel tax rates.¹⁶ Between-state variation also rises throughout the period. Figure 3 displays the distribution of state diesel tax rates separately for 1983, 1993, and 2003. In 1983, state tax rates were concentrated between 10 and 15 cents per gallon, with all but seven states having tax rates below 15 cents. During the course of the sample, diesel taxes grew and became more disperse across states. By 2003, 26 percent of states had a diesel tax rate of at least 25 cents per gallon, higher than the federal rate of 24.4 cents per gallon.

To model legitimate demand for No. 2 fuel oil, we also capture demand factors, primarily

¹⁵Oregon does not tax diesel sold for trucking, instead taxing the number of weight-miles driven in the state. For this reason, we exclude Oregon from the subsequent analysis.

¹⁶The dye program eases tax collection, which creates an incentive to raise tax rates on diesel. Alt (1983), Kau and Rubin (1981), and Balke and Gardner (1991) among others point to the importance of tax collection in shaping the tax structure. We do see the federal government raising tax rates in the period of the dye implementation, however we do not observe a similar response by states, for whom the growth in the average tax rate actually falls post-dye. Political pressure may limit the ability to raise the tax rate. Furthermore, if states are simply trying to meet a revenue target, then the dye program may in fact place downward pressure on tax rates. Finally, the diesel tax is not treated as general revenue for the states, but instead goes into its highway trust fund. This may limit the value of extra revenue through this tax.

related to temperature and prevalence of the use of fuel oil as a home heating source. We obtain data on monthly degree days by state from the National Climate Data Center at the National Oceanic and Atmospheric Administration. The number of degree days in a month is often used to model heating demand and is a measure of the amount by which temperatures fell below a given level on a particular day, summed across the days of the month. We also measure state heating oil prevalence from the 1990 census using the fraction of households in a state reporting fuel oil as the primary energy source used for home heating.

Finally, we instrument for diesel prices using the Brent crude oil spot price and event dummy variables corresponding to the first and second Iraq wars and the 2002 Venezuelan oil strike. Brent crude is a globally-priced commodity commonly used as an instrument for regional product prices.¹⁷ The validity of this instrument depends on the extent to which demand shocks for US diesel are incorporated into world oil prices. This effect is likely to be small given that US diesel demand accounted for approximately 4.6% of world crude production in 1993 and 4.9% of world crude production in 2005.¹⁸

Table 1 displays summary statistics of the data. In the first two rows we show the pre- and post- means for the two primary variables of interest - No. 2 diesel, which is largely used for taxed purposes, and No. 2 fuel oil, which is reported to be used for entirely untaxed purposes.¹⁹ The average state-month in the pre-dye period saw 1.4 million gallons of diesel sold per day, slightly greater than the 1.3 million gallons of fuel oil sold per day. This difference grows considerably in the post-period, when diesel sales rise to 2.3 million gallons per day while fuel oil sales fall to 0.8 million gallons per day.

The average tax in the pre-dye period represents a significant fraction of the purchase price in the typical state. In the pre-dye period, the average state plus federal tax is 30.5 cents per gallon, compared with a tax excluded price of 77.8 cents per gallon for purchasers of diesel through retail outlets. This represents 28 percent of the final purchase price. Taxes are growing over time, representing 35 percent of the purchase price in the post-period. The price of sales to residential users, which is likely to represent sales of home heating oil, is higher than the tax

¹⁷For example, Borenstein and Shepard (2002) use the Brent crude spot price to form an instrument for US crude futures prices on the New York Mercantile Exchange. In addition, Asche, Gjolberg and Volker (2003) find the Brent crude price is exogenous to regional European petroleum product shocks.

¹⁸In 1993, world crude production was 24.7 billion barrels of which approximately 1.15 billion barrels were consumed as distillate in the United States. In 2005, world crude production was 30.8 billion barrels, of which 1.5 billion barrels were consumed domestically as distillate oil.

¹⁹Reported diesel sales also include agricultural uses. The importance of agriculture in reported diesel sales can be assessed by examining low-sulfur versus high-sulfur diesel sales. After the low-sulfur regulations went into effect for on-highway sales, diesel sales were reported separately for low- and high-sulfur. The former is entirely on-highway purchases. In the post-dye period, the average state had 2316 gallons per day of diesel sales in the average month, 2005 of which was low-sulfur, indicating that untaxed uses represent less than 15 percent of reported diesel sales.

excluded retail price of No. 2 distillate, likely due to the incorporation of delivery costs.

Table 1 also reports the average sales of other distillates.²⁰ No. 2 distillate is far more important than the other distillates. In the pre-dye period, 67 thousand gallons of No. 1 distillate and 133 thousand gallons of No. 4 distillate are sold.

Missing values are common in the EIA quantity series. In months where few suppliers are serving a particular state, the quantity value is suppressed by the EIA if it is possible to infer the sales from a particular firm. For diesel, 9 percent of observations are missing in the pre-dye period compared to 20 percent in the post-dye period. In the case of fuel oil, missing values represent 10 and 24 percent of the state-months in the pre- and post-dye periods, respectively. Although we estimate our results off of the non-missing observations, the results change little when we instead interpolate the missing values using state specific time trends.

5 Dye Program and Diesel Misreporting

In this section we examine the response of No. 2 diesel and No. 2 fuel oil sales to the diesel dye program. The main effect of the program was to substantially reduce the cost of monitoring firm tax compliance. Our model predicts that as the cost of monitoring declines, enforcement rises and firms comply more fully, reporting more taxed purchases and fewer untaxed purchases. Since evasion here simply involves mislabeling the use of No. 2 distillate, there should be no adjustment costs in production and therefore the primary effect of the dye program on quantities should be seen immediately.²¹

To evaluate the response of reported taxed and untaxed sales of No. 2 distillate, we estimate a specification of the break in trend of log quantity of the form

$$\ln q_{it} = \beta_0 + \delta_1 \text{postdye}_t + \Pi X_{it} + f(t) + \rho_i + \epsilon_{it} \quad (1)$$

where $\ln q_{it}$ is the log of the quantity of diesel or fuel oil sold in state i in month t , X_{it} is a vector of state-month covariates, and ρ_i represents a state fixed effect. The function $f(t)$ reflects overall time trends in the demand for gallons, which we parameterize using a flexible quadratic polynomial whose slope is allowed to vary in the pre- and post-dye periods.

²⁰These are outputs of the distillation process of crude oil, however are in general not substitutable with No. 2 distillate. Some outputs can be blended with No. 2 diesel to lower the sulfur content or the tax per unit, though this is only possible to a very limited extent.

²¹It is possible that some adjustment may occur over time if firms learn about the effect of the program on the likelihood of getting caught, or if detecting evaders becomes easier as fewer firms evade. While plausible, these mechanisms are difficult to distinguish empirically from unrelated shifts in demand for diesel over time. In addition, anticipation of the dye program would conservatively bias our results.

Table 2 displays the results from estimating (1). In column 1, we show the estimated discontinuity in diesel sales controlling only for the quadratic time trend. Sales of No. 2 diesel rose by an estimated 29 percent upon dye implementation. Panel A of Figure 4 shows the fit of the quadratic time trend to average actual log diesel sales. The quadratic time trend seems highly successful at fitting the time profile of diesel sales. In the specification shown in column 2 of Table 2, we include state effects and other state-month covariates and find that the estimated discontinuity is stable when adding these controls. In the full specification, the estimated discontinuity in diesel is 26 percent.

Counteracting the increase in diesel sales is a decrease in the sales of fuel oil. Columns 3-4 of Table 2 display estimates of the discontinuity of fuel oil sales. We estimate that the average state experienced a 31 percent decrease in fuel oil sales, controlling only for the quadratic time trend. Again the estimated coefficient is fairly stable when adding covariates. In the full specification, we estimate a 39 percent decrease in fuel oil sales due to the dyeing program. As with diesel fuel, the quadratic time trend is successful at capturing the time path of fuel oil sales, as evidenced by Panel B of Figure 4.

Based on the significant increase in diesel sales and corresponding decrease in fuel oil sales, we conclude that there is evidence of a significant response of taxed and untaxed sales to the dye program. Columns 5-6 of Table 2 display the results of a similar specification for fuel oil's share of No. 2 distillate. This specification is desirable as it provides a sense of the importance of the substitution between diesel and fuel oil as a share of all No. 2 distillate, and it provides for a more direct comparison with the evasion parameter α from the model. Fuel oil's share of distillate fell by 11 percent when the dye program was implemented, and this estimated discontinuity changes little when additional covariates are included. In the full specification, we estimate a discontinuity of 12.5 percent in the average state's share of No. 2 distillate.

While the log specification allows one to easily assess the magnitude of the discontinuity in percentage terms, a drawback is that it does not allow for a direct evaluation of the substitution between diesel and fuel oil. The model presented in Section 3 suggests that this substitution will be on a one-for-one basis, however this cannot be evaluated in the log specification due to the different levels of diesel and fuel oil.²² While the log specification will be preferred in estimating demand elasticities, to more directly evaluate the substitution between diesel and fuel oil we estimate (1) using the level of sales as the dependent variable. To account for the

²²The result of one-for-one substitution in the model will not literally be true if the size of the penalty depends on the degree of evasion. In this case, altering the likelihood of getting caught changes the marginal purchase decision for the remaining full evaders, so that they reduce purchases of the untaxed quantity without a corresponding increase in their reported purchases of taxed diesel.

difference in levels across states, we form per capita sales by normalizing quantities by yearly state population.

Table 3 presents the results. In the full specification, diesel sales increased by 0.067 gallons per person per day in the post-dye period, which is matched by a 0.066 gallons per person decline in fuel oil sales. In columns 5-6 we examine the break in the sales of all No. 2 distillate, the sum of diesel and fuel oil sales. We estimate an increase of 0.005 increase in No. 2 distillate sales post-dye, which is both statistically and economically insignificant. These results together suggests a one-for-one substitution between fuel oil and diesel post-dye.

We next investigate the extent to which the break in diesel and fuel oil sales is correlated with factors that alter *ex ante* evasion incentives. First, we estimate the break in trend separately for states with many legitimate uses for untaxed No. 2 distillate. In these states, evaders may find it easier to acquire the untaxed alternative, and it will likely be more difficult for auditors to detect illegitimate users. Second, we estimate the trend break separately for states with high tax rates versus states with low tax rates. According to the model, states with higher tax rates should experience greater evasion, and therefore should see a larger increase in taxed diesel at the dye implementation date.

Panel A of Table 4 shows the results for per capita diesel sales. Column 1 repeats the base specification for the full sample. We first split the sample by the prevalence of heating oil use for home heating as reported in the 1990 census. Consistent with our hypothesis, the dye response is heavily concentrated in high heating oil states. These states experienced an increase in diesel sales of 0.09 gallons per person per day, compared with an increase of 0.04 gallons in states with a low prevalence of home heating oil.²³

We next split the sample between low and high diesel tax states, as measured by states' tax rates in December of 1992, prior to the announcement of the dye program. The estimated break in the diesel series is larger in states with high tax rates, with an estimated break of 0.077 gallons per person per day. The increase is 0.059 gallons in low tax states.

Panel B of Table 4 shows the results of similar specifications for per capita fuel oil use. Similar to the diesel results, fuel oil sales fell by more in states with high heating oil use by households, where sales were 0.079 gallons per person per day lower post-dye, compared to low-heating oil states, where sales were lower by 0.055 gallons. Unlike with diesel, however, the

²³ Agricultural use also represents a sizable block of legitimate users, and a similar test could be performed by splitting states based on the importance of agriculture in state GSP. However, our measure of diesel includes untaxed agricultural uses, which makes such a test less informative than examining high versus low heating oil states. In fact, we find that the break in trend is in fact somewhat larger in low agriculture states, though interestingly we find the opposite result when considering fuel oil's share of No. 2 distillate.

estimated decline in fuel oil sales is similar for high- versus low-tax states.

In Panel C, we present evidence regarding the response of fuel oil's share of number 2 distillate to the dye program, which will summarize the substitution between diesel and fuel oil post-dye. For all states, fuel oil's share of distillate fell by 12.6 percentage points. This decline was greater in high fuel oil states, where fuel oil's share fell by 14.7 percentage points, and in states with high tax rates, where the decline was 14.3 percentage points.

Finally, we provide additional evidence that a greater portion of fuel oil sales were legitimate post-dye, by examining the seasonality in fuel oil sales in the pre- and post-dye period. Seasonality varies by state, depending on the nature of fuel oil demand. Residential demand for fuel oil peaks strongly during the winter. Industrial and commercial demand for fuel oil is slightly higher during the summer, largely from greater use of fuel oil for electric generation. Thus, northern states with a high proportion of households using fuel oil for home heating tend to have much higher demand during the winter than the summer, while states with insignificant residential demand tend to have slightly higher sales during the summer. Based on our estimates that at least 30-40 percent of fuel oil purchases in the pre-dye period were illegally used for on-highway purposes, we expect fuel oil sales in the pre-dye period to exhibit less seasonality, particularly in states with a high proportion of households using fuel oil for home heating.

In Table 5, we present estimates of the seasonality of fuel oil demand pre- and post-dye. In the first specification, we regress log fuel oil sales on the number of degree days in a particular state-month, the number of degree days interacted with the fraction of households in the state who reported using heating oil as the primary home heating fuel in the 1990 census, sets of pre- and post- state fixed effects and a pre- and post- quadratic time trend. To estimate the change in seasonality, we interact the first two explanatory variables with a post-dye dummy variable. Specifications (2) and (3) include state-invariant and state-specific month fixed effects, respectively.

In the first two specifications, we estimate a small, but significant, negative coefficient on degree days and a large, positive and significant coefficient on the interaction between degree days and the fraction of homes using fuel oil. States with substantial residential demand peak strongly during the winter, while states with little residential demand peak slightly during the summer. When we control for state-specific seasonality by including state-specific month fixed effects, we find that both the pre-dye coefficients are positive. Controlling for state-specific seasonality, atypically cold months are associated with increased fuel oil demand - the effect is pronounced in states with high proportion of residences using fuel oil for home heating. Across

all three specifications, we find that the post-dye, degree day, home heating interaction term is positive and significant - consistent with an increase in seasonality post-dye in states with high demand for home heating oil.

6 Evasion estimation using elasticities

In this section, we empirically apply three aspects of the model described in Section 3. First, we test for evasion in the pre-dye and post-dye periods by estimating separate price and tax elasticities. Second, we use these estimated coefficients to obtain estimates of the gradient of evasion with respect to taxes. Finally, we describe how evasion's response to the tax rate alters the revenue effects of increasing the diesel tax. The advantage of each of these applications is that they require only observing taxed gallons, and as a consequence, could be broadly applied outside of the context of diesel fuel. In the current application, we are able to observe the primary untaxed alternative, which we can use to support the validity of our estimates of the evasion-tax gradient.

6.1 Testing for evasion

As shown in the appendix, we can separately identify the tax and price elasticities by factoring price out of $\ln(p + t)$. We will estimate a version of (1) for diesel fuel that includes the log of the price and the log of $(1 + t/p)$ as separate regressors:

$$\ln q_{it} = \beta_0 + \beta_1 \ln(p_{it}) + \beta_2 \ln(1 + \tau_{it}/p_{it}) + \Pi X_{it} + f(t) + \alpha_i + \epsilon_{it}. \quad (2)$$

We estimate the model using the Brent crude spot price and our dummy variables corresponding to the first and second Iraq Wars and the 2002 Venezuelan Oil Strike as instruments for $\ln(p_{it})$ and $\ln(1 + \tau_{it}/p_{it})$.

Absent evasion, demand for taxed diesel should respond equally to a change in taxes and prices.²⁴ As we derive in the appendix, the appropriate null hypothesis to test for the presence of evasion equates β_1 and β_2 - finding that β_1 is significantly greater than β_2 is consistent with the presence of evasion. Since our discontinuity results suggest that the dye program significantly

²⁴One caveat is if firms or consumers view changes in pre-tax prices to be transitory and changes in tax rates to be permanent, in which case these two elasticities could differ. First, if changing demand involves an adjustment cost, the response to a transitory price shock will be lower. Alternatively, if firms can substitute purchases over time, the response to transitory price shocks will be greater. However, we will show that the post-dye elasticities are the same, and that the timing of the narrowing of the difference between these elasticities matches with the implementation of the dye program. The aforementioned bias is unlikely to explain these two patterns.

curtailed evasion, we test the hypothesis separately for pre- and post-dye periods by allowing the coefficients β_1 and β_2 to vary pre- and post-dye.

We present the OLS and IV results for diesel fuel in columns 1 and 2 of Table 6, respectively. In the pre-dye period, our point estimates of β_1 and β_2 are -0.49 and -1.33 – the difference between the two coefficients is statistically significant, rejecting the null hypothesis of no evasion. In the post-dye period, the point estimate of price elasticity falls to -0.24. Although the difference between the pre- and post-dye price elasticities is imprecisely estimated, the direction of the result is consistent with the findings of Hughes, Knittel and Sperling (2008), who find that gasoline demand elasticity was lower earlier this decade than in the late seventies. We find that demand also becomes more tax inelastic during the post-dye period – the point estimate for the post-dye tax elasticity is -0.83. The difference between the post-dye tax and price elasticities is not statistically significant.

We also investigate the response of fuel oil to the tax levied on diesel. In the absence of evasion, the tax on diesel should have no direct impact on fuel oil demand.²⁵ In columns 3 and 4 of Table 6, we present the OLS and IV results of estimating (2) for fuel oil sales. In the pre-dye period, the tax rate has a significant and positive impact on fuel oil sales. When comparing the magnitude of the pre- and post-dye tax elasticities, we document a striking pattern over time. In the pre-dye period, the estimated tax elasticity is 2.184 and marginally statistically significant. Our estimate of the coefficient on the post-dye/tax rate interaction term is -1.995, which implies a post-dye tax elasticity of virtually zero. It is worth noting, however, that our estimate of the post-dye*after coefficient is not statistically significant.²⁶ In sum, the results are consistent with the presence of evasion in the pre-dye period, and suggest that fuel oil has ceased to be a mechanism for evasion in the post-dye period.

We next examine the pattern of elasticities over time by allowing the price and tax elasticities to vary by year. We estimate the following equation:

$$\ln q_{it} = \beta_0 + \beta_{1t} \ln(p_{it}) + \beta_{2t} \ln(1 + \tau_{it}/p_{it}) + \varphi_t + \Pi X_{it} + \rho_i + \eta_{it} \quad (3)$$

where we obtain estimates of β_{1t} and β_{2t} by interacting year dummies with the price and tax rate series. We examine the time path of elasticities for two reasons. First, constraining these coefficients to be constant over time masks any dynamic patterns of evasion. Second,

²⁵This assumes that the tax on diesel has no indirect effects on fuel oil sales through supply.

²⁶The positive coefficient on the price variable leads to some concern regarding the estimation of the demand curve, since the variation in prices may be due to shifts in demand. This is a concern even when only considering the tax coefficient, since price appears in the denominator of the tax rate. To ameliorate this concern, we have also estimated this specification only considering the log of the level of the tax rather than its rate and found identical results.

exploiting the timing of changes in the estimated elasticities ameliorates concerns regarding bias in the demand estimation. Our estimates of the price and tax elasticities could be biased since variation in price could reflect shifts in demand and therefore movements along the supply curve. Estimating the elasticities by year allows us to examine the timing of the shift in the tax elasticity relative to the price elasticity. While estimates of the gap between these two may be biased, there is little reason for shifts in this gap to coincide with the timing of the dye program aside from a reduction in evasion.

In Figure 5, we plot the yearly estimates of β_1 and β_2 for log diesel sales. In the pre-dye period, there is a consistent gap between the estimated tax and price elasticities. Over time, demand appears to become less price sensitive. In the years immediately following the dye program's implementation, the gap between the tax and price elasticities is virtually zero, suggesting that the addition of dye may have significantly curbed diesel tax evasion. An interesting pattern emerges in the latter portion of the sample. During this time, the gap between the tax and price elasticities reappears. This may point toward a dynamic response of evaders, who may have developed new evasion technologies in response to the dye program.

As further evidence that the timing of the tax responsiveness coincided with the dye program, we examine the time path of the elasticity of fuel oil with respect to the diesel tax rate. In Figure 6, we plot the estimated yearly fuel oil tax rate elasticity. For almost every year prior to 1993, we estimate a positive tax elasticity. In 1993, this elasticity drops to close to zero. Unlike our estimates for diesel fuel, the responsiveness of fuel oil to the tax rate does not seem to reappear. This suggests that any new evasion methods did not involve fuel oil.

6.2 Evasion response to tax

A parameter of significant interest in the public finance literature is the responsiveness of evasion to the tax rate. In the previous section, we arrived at a reasonable pre-dye estimate for this measure by examining the response of fuel oil to the tax rate, as this seems to be a primary mechanism for evading the diesel tax. In most settings, observing evasion directly is not possible. In addition to suggesting a test for evasion using estimates of the price and tax elasticities, our model also demonstrates how the coefficients for β_1 and β_2 can be used to obtain an estimate of the degree to which evasion responds to the tax rate.

As derived in the appendix, we can express the derivative of evasion with respect to taxes

as a function of the coefficients β_1 and β_2 from equation (2).

$$\frac{\partial E}{\partial t} = \frac{Q_t}{p}[\beta_1 - \beta_2]. \quad (4)$$

Importantly, this metric of evasion only depends on information about taxed sales, which are typically observable. In fact, the case of fuel tax evasion provides an unusual example in which untaxed sales are also available, and we use this extra information to evaluate the performance of our evasion estimate. From (4), we can obtain an estimate of the derivative of evasion with respect to taxes. We obtain average values for Q_t and p from Table 1 and the coefficients β_1 and β_2 from the first column of Table 6. In the pre-dye period, we estimate that each cent increase in the tax rate increased the quantity of unreported gallons by 16.5 thousand per day. In the post-dye period, this falls modestly to 15.4 thousand gallons per day. These values represent 1.1 percent and 0.7 percent of the average level of taxed diesel sold per day, respectively.

While these estimates rely solely on observing taxed gallons, we can assess their validity by comparing them to the pre-dye response of fuel oil to tax changes. From (2), we use the parameter estimate β_2 to obtain $\frac{\partial Q_u}{\partial t} = \frac{Q_u}{p+t}\beta_2$. Plugging in for the average price, tax, and untaxed quantity in the pre-dye period, and using the estimate of β_2 from the third column of Table 6, we find that increasing taxes by one cent increased purchases of fuel oil by 25.2 thousand gallons per day. This estimate is slightly larger than that obtained from taxed gallons, indicating that the latter may represent a conservative estimate of the evasion-tax gradient.

6.3 Evasion and tax revenues

Ideally we would like to state the response of evasion to taxes as an elasticity, though in a setting where the level of untaxed gallons is unobserved this is not possible. To put the evasion-tax gradient into perspective, we instead examine how tax revenues respond to changes in the tax rate, and how this is altered by tax evasion. The elasticity of revenue with respect to the tax rate captures the change in tax revenues arising from both the decreased consumption of taxed diesel fuel by compliant firms and substitution from legal to illegal purchases by non-compliant firms. These two effects are captured in equation (A21), restated here:

$$\frac{\partial t Q_t}{\partial t} \frac{t}{t Q_t} = 1 + \frac{t}{t+p}\beta_1 - \frac{t}{t+p}(\beta_1 - \beta_2). \quad (5)$$

The term involving only β_1 captures the traditional behavioral response, while the final term reflects the effect of evasion. In the absence of evasion, β_1 and β_2 are identical, leading the

latter term to disappear. We can therefore use our estimates of the price elasticity β_1 to obtain an estimate of the revenue effects of changing taxes if evasion were not present. In the pre-dye period, this implies an elasticity of revenue with respect to the tax rate of 0.85, and in the post-dye period this increases to 0.90. The erosion of the tax base due to greater evasion when taxes are increased, as documented in section 6.2, has a significant impact on the fraction of tax increases that are incorporated into revenues. Allowing for evasion, and therefore for the differing values of β_1 and β_2 , we find a revenue-tax elasticity of 0.60 in the pre-dye period and 0.71 in the post-dye period. A tax increase in the dye regime translates into 11 percent higher revenues than in the pre-dye period. Based on the estimates absent evasion, the lower price sensitivity post-dye can account for less than half of this.

7 Conclusion

This paper considers the evasion of diesel taxes, and how this evasion responds to the large shift in the cost of conducting an audit represented by the addition of red dye to untaxed diesel. The setting we consider provides a unique opportunity to observe both a taxed commodity as well as an untaxed substitute. We find that reducing the cost of audit greatly improves tax compliance, and that diesel tax evasion responds positively to tax rates. The estimated responses of diesel and fuel oil to the dyeing program are strikingly similar, as there are significant discontinuities in the sales of No. 2 diesel and No. 2 fuel oil, yet little change in overall No. 2 distillate sales.

While the current application has the luxury of observing the evasion vehicle, untaxed fuel oil, it is often the case that only taxed quantities are observed. We apply a simple method for detecting the evasion of specific quantity taxes from the observed taxed quantities, and show how this method can be used to estimate the response of evasion to the tax rate. Finally, we use these measures to describe how evasion affects the tax revenue response to tax increases, a parameter of considerable interest in public economics.

The reduction in evasion we document post-dye has potentially large welfare consequences. Resources spent evading taxes represent a pure deadweight loss. The additional tax revenue resulting from compliance efforts represents a first-order approximation of the welfare gain. If firms evade taxes until the marginal cost of evasion equals the tax rate, then the tax rate informs as to the deadweight loss associated with the marginal gallon of unreported taxable diesel, and we can estimate the welfare gain by multiplying the tax rate by the change in taxed gallons. The average state plus federal diesel tax rate in 1993 was 39 cents per gallon. We estimate that

taxed diesel sales rose by approximately 26 percent post-dye, or 7.1 billion gallons per year.²⁷ A first-order approximation of the welfare gain is therefore \$2.8 billion per year.

This should represent an upper bound of the welfare gain for several reasons. First, as Chetty (2008) notes, if the penalty of being caught affects the marginal evasion decision, then the marginal cost of evasion will be less than the tax rate. Second, the marginal cost of evasion is likely to be increasing in evasion, which would imply that the average cost of evasion is lower than the marginal cost of evasion. Finally, the extent of fully evading firms will alter this calculation, as the marginal cost of evasion will be less than the tax rate for these firms and because the enforcement efforts will reduce their supply. Nonetheless, the improvement in efficiency is likely to be large.

Given the large efficiency and revenue gains, it is worth asking if the current level of investment in enforcement technologies is optimal. For instance, Baluch (1996) estimates that taxes assessed as a direct result of enforcement activity are 10 to 18 times greater than the cost of the enforcement activity. However, it is unclear what this tells us regarding the optimal level of enforcement, since we have little idea regarding the marginal return to enforcement efforts even if we have good estimates of the average return. Still, there are reasons to believe the current level of enforcement does not maximize revenue. For instance, both states and the federal government collect taxes, and the enforcement efforts of one generates a positive externality on the collections of the other. Furthermore, governments may have an objective function where revenue is not the primary argument.

²⁷The average diesel sales were 75 million gallons per day in the 12 months prior to the dye program.

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A Appendix

We consider a model of evasion in which a continuum of firms purchase diesel for on-road (taxed) used. Firms choose a quantity of diesel fuel q to produce output $x(q)$ and the percent of untaxed (illegal) fuel, α . Normalizing the price of output to 1, firms purchase taxed diesel fuel at price $p + t$ and untaxed diesel fuel at price p . Firms vary in their cost of evasion - a firm located at $\gamma \sim f[0, \theta]$ choosing to evade incurs a heterogeneous cost of evasion, $c_e(q_u, \gamma) = \gamma(\alpha q)^2/2$. In addition to paying the cost of evasion, firms are penalized if caught evading taxes by the regulator. The regulator deters tax evasion by randomly auditing firms with an endogenous probability p_a and assessing a fixed penalty, z , if $q_u > 0$.²⁸

First, the regulator observes z , $f(\gamma)$, c_a , p and t and credibly commits to auditing firms with probability, p_a .²⁹ The regulator chooses p_a to maximize tax revenues less enforcement costs, given by

$$W = tQ_t - c_a \frac{p_a^2}{2}, \quad (\text{A1})$$

where Q_t is the total purchases of the taxed diesel.³⁰ After the regulator chooses p_a , each risk-neutral firm chooses q and α , conditional on γ , to maximize expected profits given by

$$E[\Pi] = x(q) - (p\alpha q + \gamma \frac{(\alpha q)^2}{2}) - (p + t)(1 - \alpha)q - p_a z I(\alpha > 0) \quad (\text{A2})$$

subject to

$$q \geq 0, \alpha \in [0, 1]. \quad (\text{A3})$$

Let \bar{q} denote the quantity of diesel fuel satisfying (??) for interior solutions of α , given by

$$x'(\bar{q}) = p + t. \quad (\text{A4})$$

The threshold values for gamma separating full evaders ($\alpha^* = 1$), partial evaders ($\alpha^* \in (0, 1)$) and non-evaders ($\alpha^* = 0$) are defined by setting (??) equal to 1, and equating $E[\Pi|\alpha = \frac{t}{q\gamma}]$ and

²⁸The fixed component of the penalty is a sufficient condition for the existence of entirely legal firms, so long as θ , the upper bound on the cost of evasion parameter, is sufficiently high. Our testable implications do not change if we generalize the penalty function to allow for the penalty to vary linearly with the amount of untaxed diesel purchased.

²⁹We treat z as exogenously given. If the regulator can choose both p_a and z , the optimal decision for the regulator is to set extremely high penalties and low enforcement.

³⁰We present the model in which fines do not enter into the regulator's objective function. The comparative static results do not substantively change with this inclusion or exclusion of the fines.

$E[\Pi|\alpha = 0]$.

$$\hat{\gamma}_{FE} = t/\bar{q} \quad (\text{A5})$$

$$\hat{\gamma}_{NE} = \frac{t^2}{2p_a z}. \quad (\text{A6})$$

Conditional on p_a , the optimal choices of $q^*(\gamma|p_a)$ and $\alpha^*(\gamma|p_a)$ are given by

$$q^*(\gamma|p_a) = \begin{cases} x'(q) = p + \gamma q \text{ for } \gamma \in [0, t/\bar{q}] \\ \bar{q} \text{ for } \gamma \in (t/\bar{q}, \frac{t^2}{2p_a z}) \\ \bar{q} \text{ for } \gamma \in [\frac{t^2}{2p_a z}, \theta], \end{cases} \quad (\text{A7})$$

and

$$\alpha^*(\gamma|p_a) = \begin{cases} 1 \text{ for } \gamma \in [0, t/\bar{q}] \\ \frac{t}{q\gamma} \text{ for } \gamma \in (t/\bar{q}, \frac{t^2}{2p_a z}) \\ 0 \text{ for } \gamma \in [\frac{t^2}{2p_a z}, \theta]. \end{cases} \quad (\text{A8})$$

Diagram 1 graphically represents how taxed and untaxed diesel consumption vary with the evasion cost parameter, γ .

Aggregate consumption of taxed diesel, Q_t , and untaxed diesel, Q_u , are given by

$$Q_t = \int_{t/\bar{q}}^{\frac{t^2}{2p_a z}} \bar{q}(1 - \alpha)f(\gamma)d\gamma + (1 - F(\frac{t^2}{2p_a z}))\bar{q} \text{ and} \quad (\text{A9})$$

$$Q_u = \int_0^{t/\bar{q}} q^*(\gamma)f(\gamma)d\gamma + \int_{t/\bar{q}}^{\frac{t^2}{2p_a z}} \bar{q}\alpha f(\gamma)d\gamma. \quad (\text{A10})$$

Substituting (A9) into the objective function, the solution to regulator enforcement problem solves the first-order condition

$$p_a = \sqrt{\frac{t^2}{c_a} f(\hat{\gamma}_{NE})}. \quad (\text{A11})$$

Unlike the firm problem which, conditional on p_a , is independent of the distribution of γ , the regulator's choice of p_a^* depends on the distribution of γ . Since $\hat{\gamma}_{NE}$ is itself a function of p_a , more than one value of p_a may solve the first order condition.³¹ In the event that more than one local solution to the first order condition exists, the regulator selects the solution for which the objective function is maximized.³² The intensity of enforcement, p_a , decreases with the cost

³¹If the distribution of γ has a finite upper bound, note that a trivial solution to the first order condition is given by $p_a = 0$. In the context of diesel fuel tax enforcement, we focus on interior solutions for p_a consistent with regulator revealed preference.

³²A sufficient condition for a unique non-zero solution is $f(\gamma)$ weakly monotonically increasing in γ . The sufficient condition, that there are weakly more consumers with higher costs of evasion than lower costs of evasion, is reasonable in the context of diesel fuel tax evasion.

of auditing, c_a and increases with the tax rate, t . An increase in t increases the marginal benefit of auditing - an increase in c_a increases the marginal cost of auditing. With a fixed penalty, z , the regulator's choice of audit intensity only affects $\hat{\gamma}_{NE}$. Thus, $\frac{\partial Q_t}{\partial p_a} > 0$ and $\frac{\partial Q_u}{\partial p_a} < 0$.

A.1 Elasticity-based tests of evasion

We derive three sets of testable predictions if fuel tax evasion exists and if the use of fuel dye reduces evasion: (1) predictions of the magnitude of the discontinuity in sales before and after the introduction of the fuel dye, (2) predictions of the seasonality in fuel oil sales pre- and post-dye, and (3) predictions of the price and tax elasticity of taxed and untaxed diesel fuel. The first two sets follow from the comparative statics of Q_t and Q_u .³³ We derive the elasticity-based test of evasion by comparing the short-run price and tax elasticity of diesel fuel. Comparing the derivative of Q_t with respect to p and the derivative of Q_t with respect to t , we have

$$\frac{\partial Q_t}{\partial p} = \frac{\partial \bar{q}}{\partial p} [1 - F(\hat{\gamma}_{FE})] \quad \text{and} \quad (\text{A12})$$

$$\frac{\partial Q_t}{\partial t} = \frac{\partial \bar{q}}{\partial t} [1 - F(\hat{\gamma}_{FE})] - 2F(\hat{\gamma}_{NE}) - \int_{\hat{\gamma}_{FE}}^{\hat{\gamma}_{NE}} \frac{1}{\gamma} f(\gamma) d\gamma \quad (\text{A13})$$

Identifying the relative magnitudes of (A12) and (A13) is straightforward. Since $\frac{\partial \bar{q}}{\partial p} = \frac{\partial \bar{q}}{\partial t}$, the first terms in (A12) and (A13) are equivalent - the first terms capture the effect of a change in the tax-inclusive price on total diesel consumption by partial and non-evaders. The second and third terms in (A13), capturing the effects of tax rate on evasion, are negative and imply $\frac{\partial Q_t}{\partial p} > \frac{\partial Q_t}{\partial t}$. The introduction of diesel dye, lowering the cost of regulatory monitoring, affects $\frac{\partial Q_t}{\partial t}$, but does not affect $\frac{\partial Q_t}{\partial p}$.

Under the empirical specification we introduce in the empirical section,

$$\text{Log}(Q_t) = \alpha + \beta_1 \text{Log}(p) + \beta_2 \text{Log}\left(1 + \frac{t}{p}\right) + X\Theta + \epsilon, \quad (\text{A14})$$

we derive the appropriate null and alternative hypotheses.

³³Although omitted from the formal presentation of the model, we allow for the cost of evasion to be decreasing in the size of the legal market for untaxed diesel fuel, Q_u^L . In markets where legal sales of untaxed fuel are rare, evasion is likely to be more costly. If legal sales affect all firms heterogenous cost of evasion, we can model the effects as either a shift or a scalar expansion of $f(\gamma)$. Allowing a more general distribution of γ given by $\gamma \sim f[\theta_1, \theta_1 + \theta_2]$, and allowing $\frac{\partial \gamma_1}{\partial Q_u^L}, \frac{\partial \gamma_2}{\partial Q_u^L} \leq 0$, we can derive comparative statics with respect to Q_u^L .

Taking derivatives with respect to p and t , we have

$$\frac{1}{Q_t} \frac{\partial Q_t}{\partial p} = \frac{1}{p} (\beta_1 - \beta_2 \frac{t}{p+t}) \quad (\text{A15})$$

$$\frac{1}{Q_t} \frac{\partial Q_t}{\partial t} = \beta_2 \left(\frac{1}{p+t} \right) \quad (\text{A16})$$

Absent evasion³⁴, we would expect a unit change in price and a unit change in consumer tax incidence to have the same effect on taxed diesel sales. Thus,

$$\frac{1}{Q_t} \frac{\partial Q_t}{\partial p} = \frac{1}{Q_t} \frac{\partial Q_t}{\partial t} \rightarrow H_0 : \beta_1 = \beta_2. \quad (\text{A17})$$

A.2 Estimating Evasion and the Elasticity of Tax Revenues

To derive the expression for the change in evasion, we use the identity $Q_u = Q - Q_t$. Noting that a change in untaxed quantities from a change in the tax rate arises purely through evasion, we have

$$\frac{\partial E}{\partial t} = \frac{\partial Q_u}{\partial t} = \frac{\partial Q}{\partial t} - \frac{\partial Q_t}{\partial t}. \quad (\text{A18})$$

Expanding the derivative of total diesel sales in (A9) with respect to taxes, we have

$$\begin{aligned} \frac{\partial Q}{\partial t} &= \frac{\partial}{\partial t} \left[\int_0^{\frac{t}{\bar{q}}} q^*(\gamma) f(\gamma) d\gamma + \bar{q} \left[1 - F\left(\frac{t}{\bar{q}}\right) \right] \right] \\ &= \frac{\partial \bar{q}}{\partial t} \left[1 - F\left(\frac{t}{\bar{q}}\right) \right] = \frac{\partial Q_t}{\partial p} \end{aligned}$$

Substituting (A15) and (A16), we can express the derivative of evasion with respect to taxes as a function of β_1 and β_2 above.

$$\frac{\partial E}{\partial t} = \frac{Q_t}{p} [\beta_1 - \beta_2]. \quad (\text{A19})$$

To derive the elasticity of tax revenues with respect to the tax rate, note that

$$\frac{\partial t Q_t}{\partial t} \frac{t}{t Q_t} = 1 + \frac{t}{Q_t} \frac{\partial Q_t}{\partial t} = 1 + \frac{t}{t+p} \beta_2. \quad (\text{A20})$$

³⁴In the multijurisdictional context, it is important to account for cross border sales in the specification. If our empirical specification is $\text{Log}(Q_{it}) = \alpha + \beta_1 \text{Log}(p_i) + \beta_2 \text{Log}(1 + \frac{t_i}{p_i}) + \beta_3 \text{Log}(p_i + t_i - (p_j + t_j)) + \epsilon$, we can work out a very similar result this case. In this case, the appropriate null hypotheses are $\beta_1 = \beta_2$ (no evasion) and $\beta_3 = 0$ (no cross border effect)

To see how evasion contributes to this elasticity, consider adding and subtracting β_1 , giving:

$$\frac{\partial t Q_t}{\partial t} \frac{t}{t Q_t} = 1 + \frac{t}{t+p} \beta_1 - \frac{t}{t+p} (\beta_1 - \beta_2) \quad (\text{A21})$$

$$= 1 + \frac{t}{p+t} \beta_1 - \frac{tp}{Q_t(p+t)} \frac{\partial E}{\partial t} \quad (\text{A22})$$

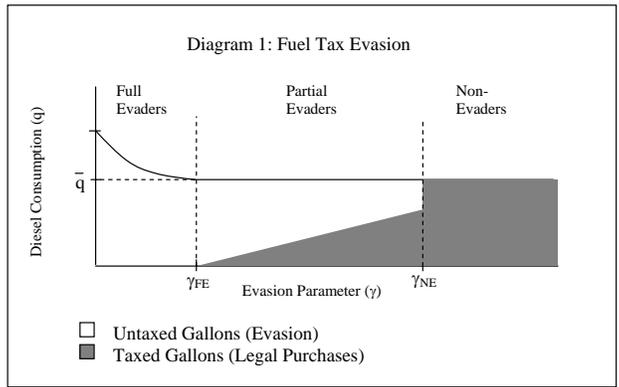


Figure 1: U.S. Sales of No. 2 Distillate

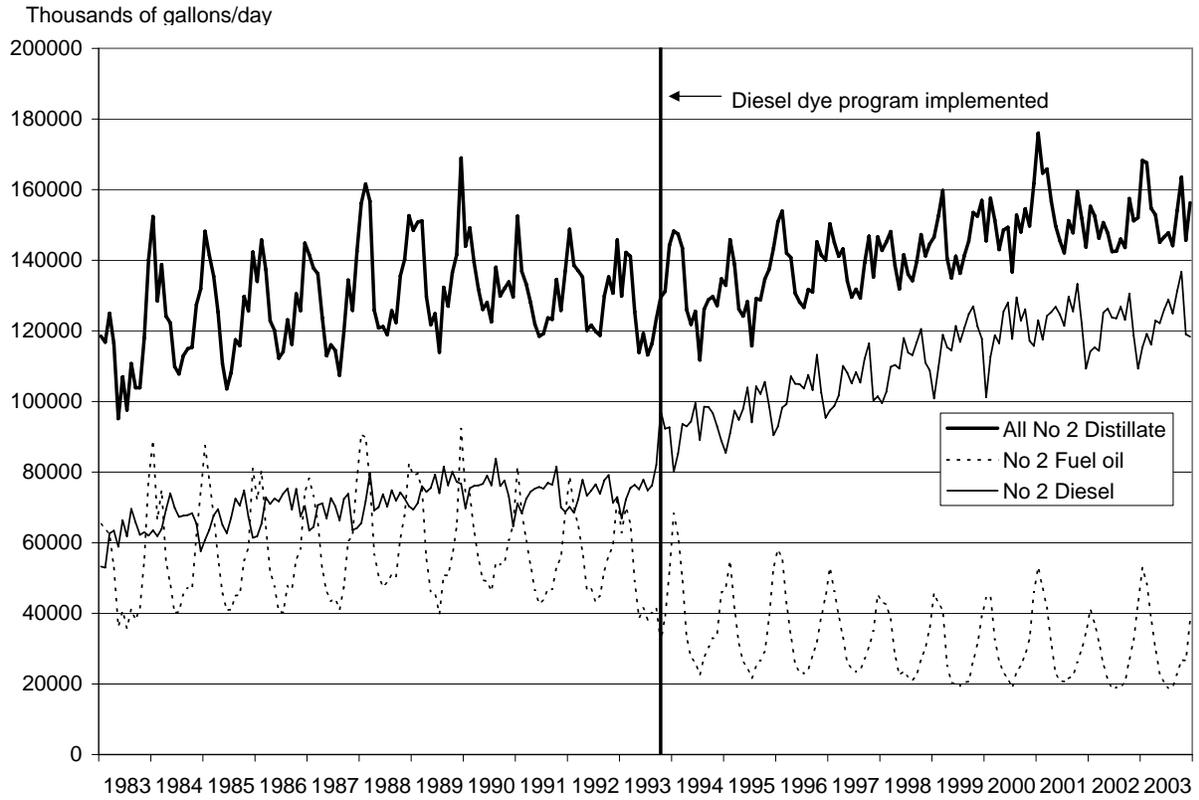


Figure 2: Time Series of Diesel Tax Rates (c/gall)

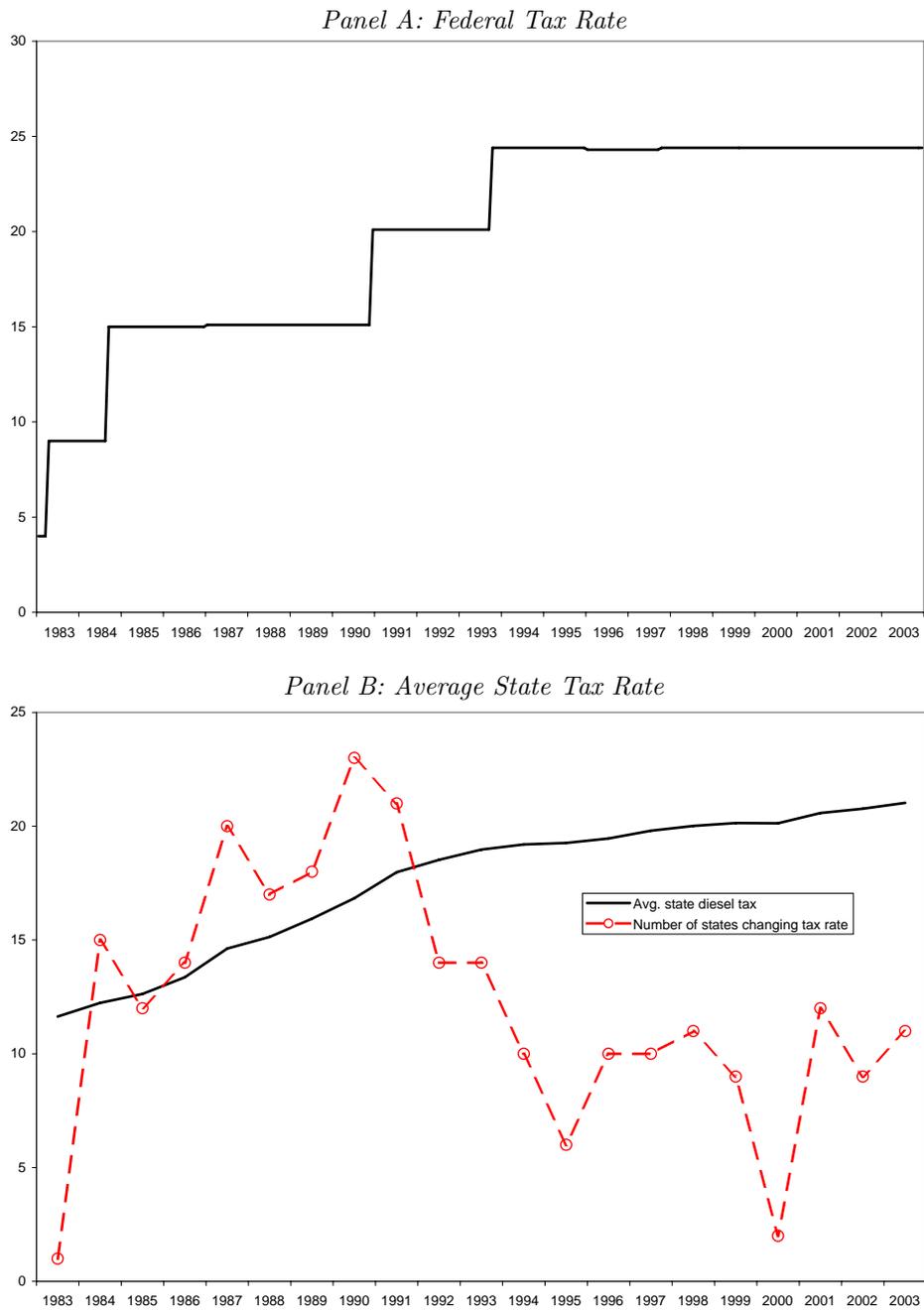


Figure 3: Distribution of State Diesel Tax Rates

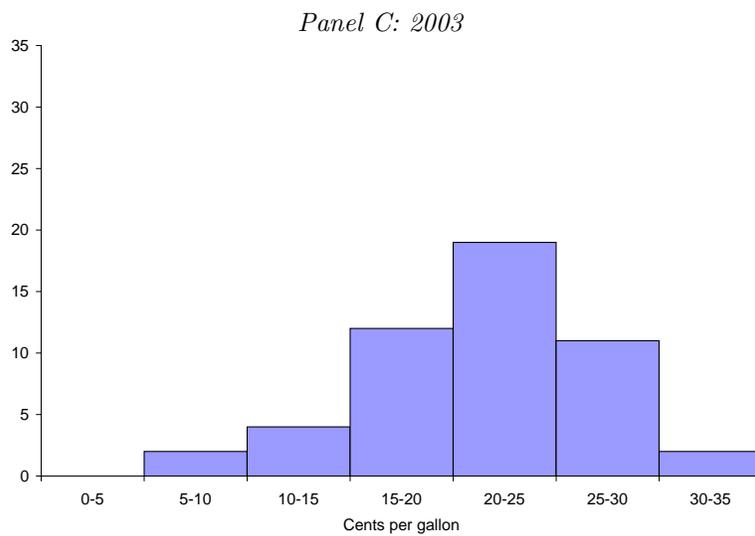
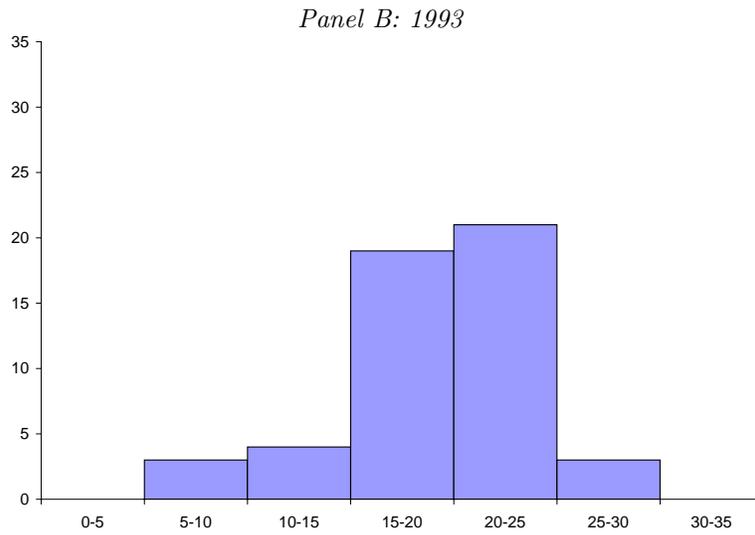
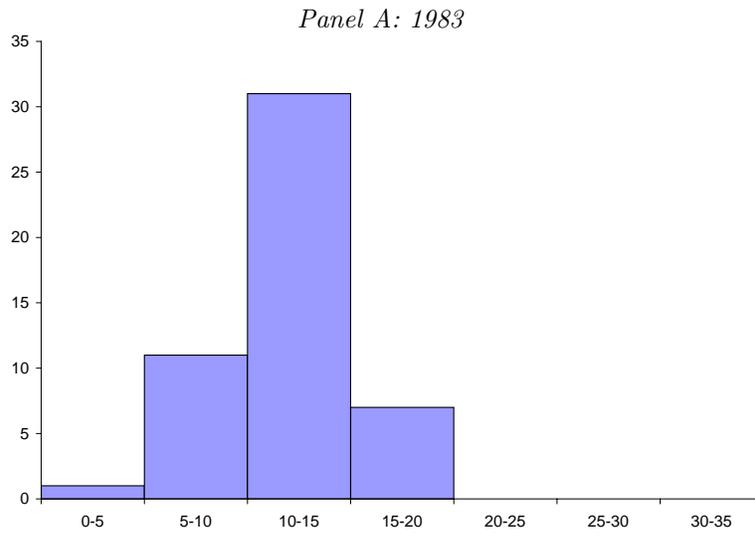


Figure 4: Average Predicted Versus Actual Log Quantities Sold

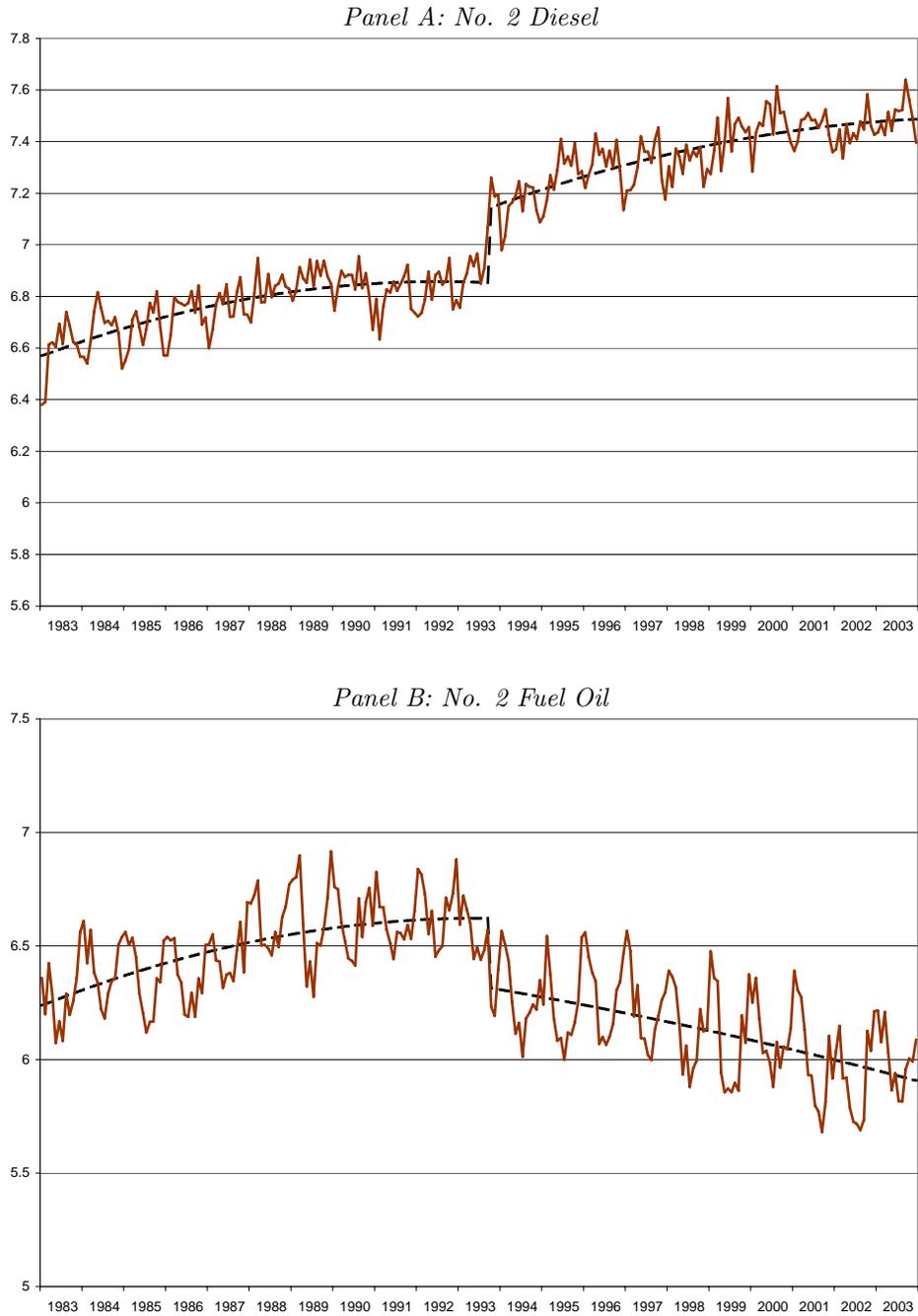


Figure 5: Price and Tax Elasticities by Year, Diesel Sales

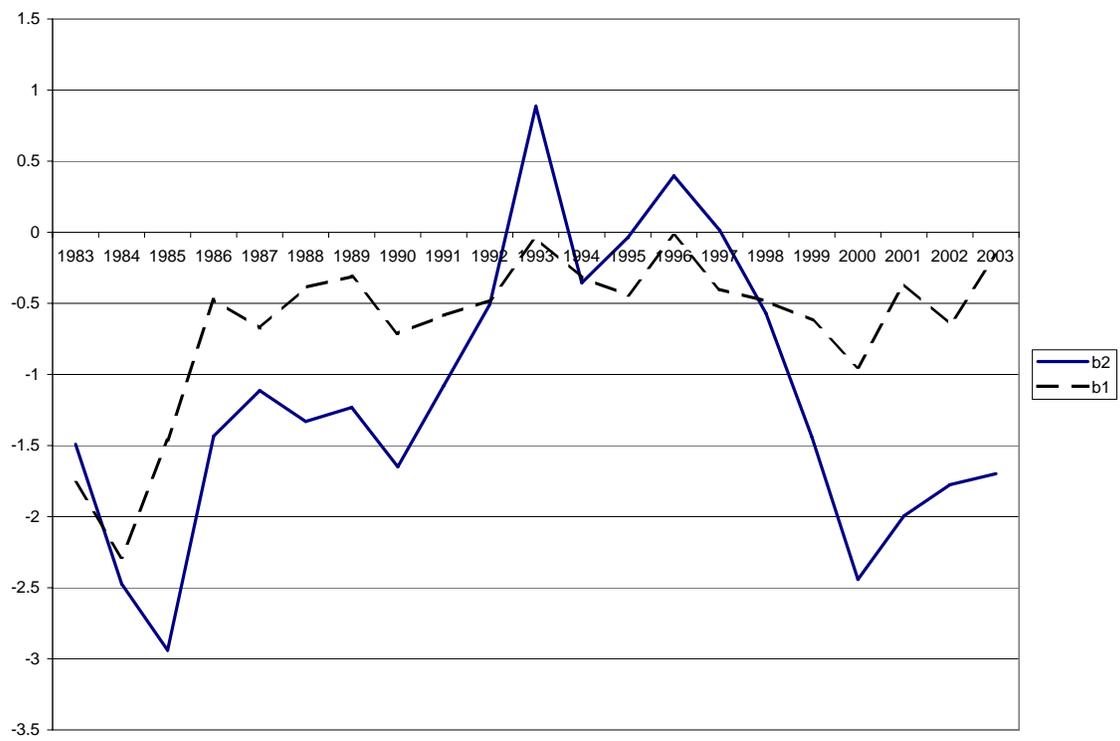


Figure 6: Elasticity to 1+Diesel Tax Rate, Fuel Oil Sales

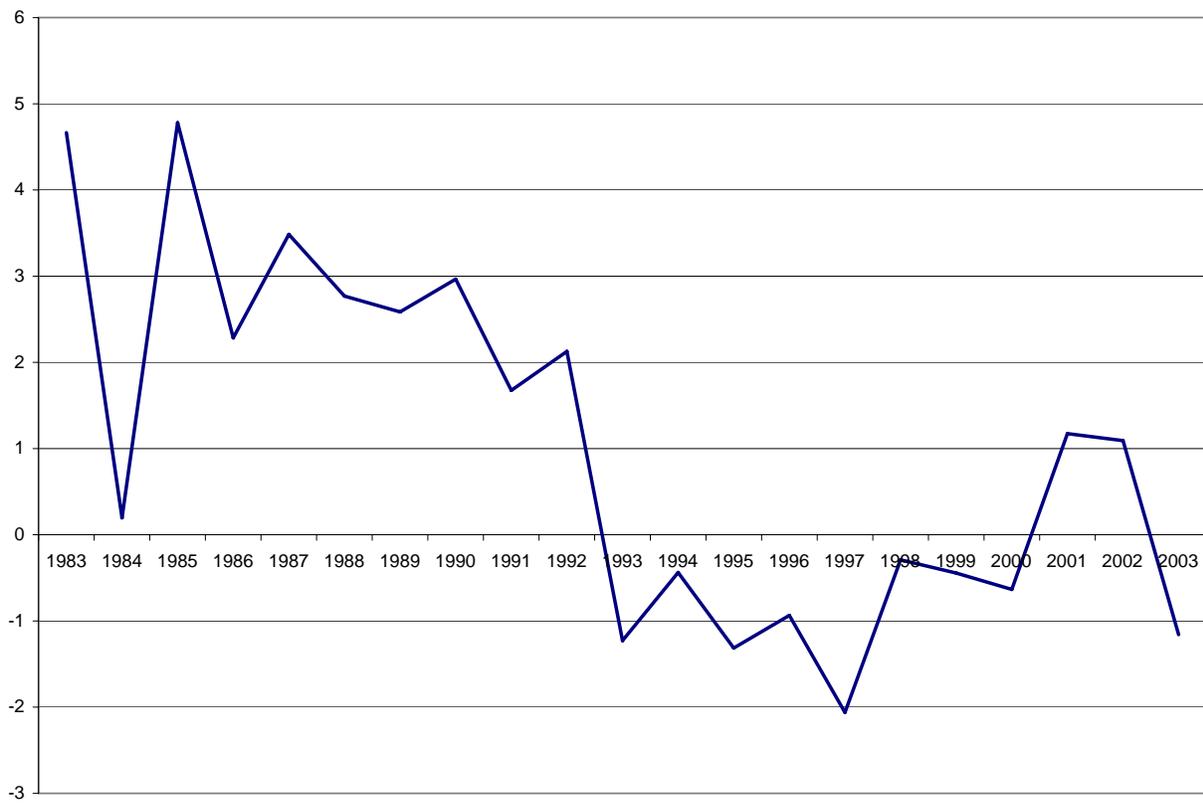


Table 1: Summary Statistics

	Pre-Dye (1)	Post-Dye (2)
Diesel	1449.31 (1855.85)	2315.93 (2134.98)
Fuel oil	1262.08 (1711.04)	859.15 (1169.89)
State + federal diesel tax (c/gall)	30.54 (7.02)	44.47 (4.87)
Diesel and Fuel Oil Price:		
All end users	75.49 (15.32)	81.17 (18.46)
Residential users	88.68 (14.19)	97.28 (19.81)
Sold through retail outlets	77.79 (14.21)	82.61 (17.96)
Other distillates:		
No. 1 Distillate	67.26 (94.84)	85.22 (109.07)
No. 4 Distillate	133.26 (243.26)	130.00 (219.14)
Residual fuel oil	1441.77 (2067.73)	1074.25 (1343.51)
Degree days	441.14 (438.22)	433.40 (419.15)
Missing No. 2 Diesel	0.09	0.20
Missing No. 2 Fuel Oil	0.10	0.24
Fraction of HH using heating oil		0.14

Standard errors are in parentheses. Quantity variables are in thousands of gallons per day. Diesel and fuel oil are chemically equivalent and differ only in intended use. Diesel is mostly used for on-road (taxed) purposes, and fuel oil is used for home heating and in industrial boilers. Other distillates are other fuel formed from the distillation of crude oil. The fraction of households using heating oil refers to the reported mode of home heating in the 1990 Census.

Table 2: Log Sales Response to Diesel Dye

	Log Diesel Sales		Log Fuel Oil Sales		Fuel Oil's Share of No. 2 Distillate	
	(1)	(2)	(3)	(4)	(5)	(6)
Post-dye	0.293 (0.033)***	0.256 (0.020)***	-0.308 (0.054)***	-0.394 (0.032)***	-0.113 (0.015)***	-0.125 (0.008)***
Log (p+t)		-0.134 (0.031)***		0.193 (0.055)***		0.063 (0.009)***
Degree days (X100)		-0.026 (0.003)***		-0.049 (0.008)***		-0.003 (0.002)*
Deg. days*% HH oil		0.04 (0.003)***		0.243 (0.018)***		0.038 (0.003)***
Log of state GSP		0.371 (0.045)***		-0.814 (0.126)***		-0.149 (0.014)***
State unemp. rate		0.000 (0.003)		-0.011 (0.008)		-0.000 (0.001)
Quadratic time trend	X	X	X	X	X	X
State fixed effects		X		X		X
Month dummies		X		X		X
Observations	10606	10236	10236	9866	10061	9710
R-squared	0.09	0.96	0.03	0.83	0.12	0.89

Robust standard errors are in parentheses allowing for clustering by state.

*, **, *** denote significance at the 90%, 95%, and 99% level, respectively. Post-dye is a variable indicating the period after the implementation of the dye program in October of 1993. The variable $p+t$ captures the tax inclusive price of diesel sold through retail outlets. The variable % HH oil represents the percentage of households in the state reporting in the 1990 census using fuel oil for home heating. The price is that charged for diesel through retail outlets. The quadratic time trend is allowed to differ in the pre-dye and post-dye periods.

Table 3: Per Capita Sales Response to Diesel Dye

	Per Capita Diesel		Per Capita Fuel Oil		All No. 2 Distillate	
	(1)	(2)	(3)	(4)	(5)	(6)
Post-dye	0.085 (0.012)***	0.067 (0.012)***	-0.070 (0.012)***	-0.066 (0.014)***	0.014 (0.011)	0.005 (0.013)
Price + tax		-0.001 (0.000)***		0.001 (0.000)***		0.000 (0.000)
Degree days (X100)		-0.013 (0.003)***		-0.021 (0.004)***		-0.034 (0.006)***
Deg. days*% HH oil		0.020 (0.005)***		0.123 (0.014)***		0.146 (0.016)***
Log of state GSP		2.384 (6.285)		-11.316 (6.334)*		-9.490 (9.193)
State unemp. rate		-0.009 (0.004)**		-0.003 (0.007)		-0.010 (0.007)
Quadratic time trend	X	X	X	X	X	X
State fixed effects		X		X		X
Month dummies		X		X		X
Observations	10606	10236	10236	9866	11877	11446
R-squared	0.86	0.87	0.63	0.77	0.72	0.81

Robust standard errors are in parentheses allowing for clustering by state.

*, **, *** denote significance at the 90%, 95%, and 99% level, respectively. The dependent variable is the number of gallons of the stated fuel sold per day in a given state month divided by the state population in that year. For a description of the control variables, please see the notes for Table 2.

Table 4: Sales Response, by State Characteristics

	Base specification	By Heating Oil Use		By 1993 Tax	
	(1)	(2)	(3)	(4)	(5)
		Low Oil	Hi Oil	Low Tax	Hi Tax
<i>Panel A: Per capita diesel</i>					
Post-dye	0.067 (0.012)***	0.044 (0.019)**	0.092 (0.015)***	0.059 (0.019)***	0.077 (0.016)***
Observations	10236	4827	5409	5492	4744
R-squared	0.87	0.87	0.80	0.87	0.87
<i>Panel B: Per capita fuel oil</i>					
Post-dye	-0.066 (0.014)***	-0.055 (0.018)***	-0.079 (0.020)***	-0.069 (0.023)***	-0.061 (0.016)***
Observations	9866	4459	5407	5196	4670
R-squared	0.77	0.60	0.74	0.74	0.81
<i>Panel C: Fuel oil's share of No. 2 distillate</i>					
Post-dye	-0.126 (0.014)***	-0.100 (0.024)***	-0.147 (0.018)***	-0.107 (0.020)***	-0.143 (0.021)***
Observations	9710	4366	5344	5128	4582
R-squared	0.89	0.78	0.86	0.89	0.90

Robust standard errors corrected for clustering by state are in parentheses.

*, **, *** denote significance at the 90%, 95%, and 99% level, respectively.

Other controls match those in the full specification shown in Table 2. The dependent variable is the stated quantity in gallons per person per day. Each column of each panel represents a separate regression estimated for the stated sample. The first column restates the base specification using the full sample. Low oil states are states where the fraction of households using home heating oil is less than that of the median state. Low tax states are those whose diesel tax rate in October of 1993 is less than the median state.

Table 5: Fuel Oil Demand Pre- vs. Post-Dye

Dependent variable: Log Fuel Oil Sales

	(1)	(2)	(3)
Degree days X100	-0.015 (0.007)**	-0.046 (0.009)***	0.014 (0.006)**
Degree days * HH Oil Fraction	0.211 (0.032)***	0.218 (0.031)***	0.028 (0.020)
After * Degree days X100	-0.002 (0.006)	-0.004 (0.006)	0.003 (0.005)
After * Degree days * HH Oil Fraction	0.062 (0.019)***	0.063 (0.018)***	0.056 (0.015)***
Month dummies		X	
State-specific month dummies			X
Observations	10018	10018	10018
R-squared	0.30	0.31	0.65

Robust standard errors clustered by state are in parentheses. All specifications include a quadratic pre- and post- time trend and pre- and post- state fixed effects.

*, **, *** denote significance at the 90%, 95%, and 99% level, respectively.

Table 6: Price and Tax Elasticity Estimates

	Log Diesel Sales		Log Fuel Oil Sales	
	OLS	IV	OLS	IV
Log(1+tax rate)	-1.409 (0.506)***	-1.333 (0.511)**	2.184 (1.246)*	2.162 (1.311) ⁺
Post-dye*log(1+tax rate)	0.579 (0.930)	0.597 (0.965)	-1.995 (2.246)	-2.144 (2.343)
Log(Price)	-0.521 (0.148)***	-0.486 (0.144)***	0.442 (0.407)	0.862 (0.377)**
Post-dye*log(Price)	0.241 (0.335)	0.258 (0.359)	0.077 (0.900)	-0.657 (0.829)
Observations	10236	10236	9866	9866
R-squared	0.96	0.96	0.83	0.83

Robust standard errors corrected for clustering by state are in parentheses.

*, **, *** denote significance at the 90%, 95%, and 99% level, respectively. ⁺ denotes one-sided significance at the 90% level.

Each specification also includes controls identical to those in the full specification shown in Table 2. The pre-tax price in the diesel specifications is the price charged through retail outlets.