

# Tax Evasion: Need for Remodelling the System

The level and extent of tax paid in Bangladesh is scandalous, to put it mildly. Too many people here are evading and underpaying taxes to the detriment of the country. Evading taxes is, in a sense, stealing from one's ownself. How can the government and public institutions provide the basic services to the people without the public paying due and legitimate tax? Our situation gets complicated by the fact that those who are put in charge of collecting tax are underpaid, under-equipped, under-trained and regrettably under-motivated to do justice to the crucial task entrusted to them.

It is with a view to finding a way out of this situation that *The Daily Star*, in collaboration with the Foreign Chamber of Commerce and Industries (FCCI) organised a roundtable discussion with all the relevant actors. The following is a record of what the main speakers have said. It is our hope that our modest effort will generate a national debate on this crucial subject.



**A. K. M. Shamsuddin, President, FCCI:** We all realise the gravity of the topic, **Tax Evasion**. It was the Finance Minister himself who one day proposed that we hold a roundtable discussion on this important subject.

Just to tell you how big is this problem, though estimates vary, many estimates put tax evasion between 1.2 and 1.5 billion US dollars. And if you add to this the 2.5 billion losses of state-owned enterprises, that makes almost four billion US dollars. Imagine what this country could do with this money if it was available.

That is only one side of the coin. The other side is, the common citizens of this country somehow or the other have to bear the burden of this leakage of four billion dollars.

Let's be practical. I would like to quote from the Russian Foreign Minister, that it takes two to tango. So let's not blame the tax evaders alone. There are other parties to it. It is said that

this leakage is split 50-50 between the private and the public sector persons. Usually the government is the big one, but in this case there seems to be a parity between the private and public sector.

This problem has another dimension, that is tax evasion discourages normal tax payers to pay their taxes and they think of ways, if not to evade taxes, at least to avoid paying taxes. So society at large is at stake and, as a result, people suffer. The civil society in general and the business community in particular should come forward and do something about it.

Somebody once said that if just 20 per cent of this evaded tax could be collected, there would not be any shortfall in revenue collection of the government.

In our chamber, whenever we discuss about seminars, there is a perception that we talk, but nothing happens. Hopefully, when the proceedings of today's dialogue are published, it will generate some discussions and initiate some action on the part of those who matter. So we are not limiting ourselves to the roundtable of today. We will further follow it up. Now the key-note paper by Mr. Moazzem Hossain, Editor of the daily Financial Express:

## KEY-NOTE PAPER



**Moazzem Hossain:** Tax evasion, as you will all appreciate, exists in varying degrees all over the world. The moot question here is, to what degree does it continue in Bangladesh?

The problem in its essence relates to the size of the black economy. It is a problem for Bangladesh as it is for many other countries. What is more worrying for Bangladesh is that many analysts and observers with a good deal of logic assess as the unabated and growing dimension of the black economy which, by its very definition, covers the entire gamut of untaxed income on undisclosed earnings from various activities.

Black economy is not the monopoly of the businesses or the private sector. It covers also the graft, corruption, speed money and a whole range of rent seeking activities in the government or the public sector. The size of the latter would be no smaller than the one run, managed, operated in the private sector.

As such, the impact of tax evasion on the economy is multi-dimensional, affecting resource use allocation. One measure of tax evasion, whether willful or managed in connivance with the tax officials is the penalty that it imposes on the genuine tax payers. And to that extent, the playing field is made uneven for them.

Tax evasion or tax avoidance is extremely high in Bangladesh. The problem is further compounded by the fact that genuine tax payers have hardly any reward while the evaders are not tried properly under the law.

Some experts estimate that the sum could be in excess of Tk. 600 crore a year. In the last three years the revenue collections of the government were about one thousand crore taka below the target. Collecting 20 per cent of the estimated amount of tax evasion would have allowed the government to exceed its normal revenue target.

Loss of government revenue is only one side of the coin. Widespread tax evasion or tax avoidance creates excessive an unnecessary tax burden on those who pay the tax at the correct rate. Because of excessive burden, eventually such tax payers become tax evaders or avoiders.

A line should be drawn here between tax evasion and tax avoidance. Tax evasion is under-payment of taxes or concealment of income that the law does not permit. Tax avoidance uses loopholes in the tax law to reduce payment. Although similar and complementary, tax evasion is illegal whereas tax avoidance may not be economically equitable.

The economic consequences of tax evasion and tax avoidance are more or less the same. Both deprive the national exchequer of revenue. The government cannot only focus its attention on controlling tax evasion without closing the loopholes which allow tax avoidance.

Both tax avoidance and tax evasion are related to the efficiency of the tax administration. The tax administration set up at the beginning of this century in most developing

countries and some industrial countries worked with tax codes that are often internally inconsistent. Subsequent modifications of the tax code were also often *ad hoc* in nature. This increased the inconsistencies further, eventually making the tax code unintelligible to the ordinary citizens.

The problem has also been compounded by the moth-eaten bureaucracy and governance problems. Reforms require that the government departments be reorganised in a manner so that it can accomplish its assigned task. Internal procedures and day-to-day operations need to be transparent and subject to scrutiny by the citizens. Compensation structures for government and tax employees should be comparable to private sector salaries. The salaries for government employees may not be uniform across departments and such salaries should depend on skills, professional quality and experience of the officials.

Advancement should be dependent on performances and not on seniority alone. Senior appointments should be made strictly on merit.

Tax officials in developing countries like Bangladesh still enjoy a great deal of discretionary power in interpreting the tax code and imposing penalties. The arranged deals on collection of Value Added Tax are examples of this.

Tax officials are not personally liable for wrongdoings in official capacity. As a result, tax administrations end up being corrupt. Tax payers find it less expensive and expedient to pay bribes than to pay the correct tax.

Anecdotal evidence suggests that corruption in tax departments in countries like Bangladesh is internalised while the entire chain of command plays a role in extracting bribes.

Actual investment in urban housing, apartment or landed property and ownership thereof may provide some clues here. Often tax collectors are unwilling to accept the correct tax payment and demand bribes from the taxpayers in exchange of ideas and assistance for evading or avoiding taxes. Some of the wealthiest people in the country like Bangladesh are current and former employees of the tax department.

Most such individuals did not acquire this wealth through inheritance or by investing their government salaries. They were able to acquire this wealth because they helped tax payers to evade and avoid taxes. The tax officials, like most other public officials, hardly pay any taxes on their actual income.

While tax evasion or tax avoidance leads to shortfall in government revenue, the government tends to react by either imposing new taxes or by raising the rate of existing ones. Such actions seldom have the desired effect. In many cases, government revenue actually declines because of such measures. The compliance largely depends on tax rates. Empirical evidence for several countries shows that the rate of taxation the higher the degree of tax compliance.

When things are going bad for the government, they are probably not going well for the tax payers either. During bad times tax payers have a high propensity to evade and avoid taxes. This is more pronounced in countries where tax payers can get away easily without paying taxes. The evidence should furthermore suggest that government can increase the tax collection by reducing taxes and bringing in more businesses and individuals under the tax umbrella.

Many developing countries have difficulty in embracing this concept for fear of losing their core revenue during bad times. An explanation for this approach may be that tax officials who formulate tax policy



do not wish to lose their power of earning discretionary income by reducing tax rates.

Even in Bangladesh, evidence is that lower tax rates increase aggregate government revenue collection. For instance, certain revenue related statistics improved after introduction of voluntary pre-shipment inspection even though voluntary PSI in general has been a disincentive as far as government revenue is concerned. After the introduction of voluntary PSI, the ratio of import-related tax to total revenue collected by NBR showed an upward trend starting 1994-95, the year voluntary PSI was introduced. The Chittagong House exceeded its revenue target. An explanation for this phenomenon is that when the importer had to pay less duty on individual consignments, more imports were cleared through customs stations instead of being smuggled in, thus allowing the government to tap into economic activities that were hitherto outside the tax administration.

It is notable that voluntary PSI came under serious attack from customs by citing cases of revenue loss from individual items that eventually led the government to reduce the scope of voluntary PSI programmes. Could it be that customs opposed PSI because it interfered with their opportunities of discretionary income?

Although widespread corruption in the tax department is probably a necessary condition for extensive tax evasion, it is not a sufficient one. While corruption exists in every country, in developed countries there is internal revenue system and law enforcement will detect systemic corruption. Once detected, corrupt government employees and their patrons are prosecuted vigorously through the judicial system. The likelihood of getting caught is a deterrent to widespread corruption and disregard for the law.

Ineffective law enforcement coupled with the judicial system where judgements may be purchased and proceedings drawn out long over the years, allow tax officials to pursue corruption with impunity.

One only has to visit a customs station or any other office in Bangladesh to catch the magnitude of the problem. Money is passed openly to tax customs official. Import consignments are cleared as raw materials. Quantities and values are misstated in the bill of entry, resulting in large revenue losses to the government.

However, if there was a credible likelihood that corruption would eventually be detected and prosecuted, then perhaps tax evasion would not be so endemic.

I would now like to speak on the discretionary powers of tax officials that increase tax evasion or avoidance. When the tax code is ambiguous or it completely depends on the tax official's interpretation on issues of deductions and exemptions, the tax payer is beholden to the tax officials. The problem is serious when the interpretation varies from official to official and if it is arbitrary and capricious. In such a scenario, the tax return becomes a matter of negotiation between the tax official and tax payer. The persuasive abilities of the tax payer may directly depend on his willingness to pay bribes. This discretionary power of tax payers may result in depriving the government of revenue.

The situation described is probably an accurate portrayal of the state of affairs in Bangladesh. Widespread submission and acceptance of fictitious tax returns create large accumulations of wealth from untaxed income. This then creates the basis of an underground economy.

Experts estimate that the underground economy in Bangladesh accounts for about one fourth of its Gross Domestic Product. And the estimate here may be much lower than if the large scale tax evaded in informal and underworld trade is

taken into consideration.

Smuggling has a serious impact on domestic production base. This makes the tax design irrelevant to those who are smuggling. Local industries have to bear the brunt of uneven competition from free-flow of tax-evaded smuggled goods. This results in production loss, below capacity production, shut-downs and also further loss of government revenue. This does not encourage investment in productive sectors and diverts funds to trading operations.

Complex tax regulations increase tax evasion and avoidance. A complex tax system with too many exemption and exceptions is too difficult to implement and administer. The inevitable result is abuse of the system by both tax payer and tax administrators. That leads to lower revenue for the government. It is important to recognise that complex regulations may be by design so that those who administer the system have more discretionary income and freedom to extract discretionary income.

In well-functioning democracies, the legislative staff draft tax legislation including the rules for implementation. Sometimes the legislative staff seek assistance from experts who are not government employees.

However, in new democracies like Bangladesh, those who implement the taxation system draft tax legislation. Furthermore, rules for implementation are often not considered in detail in the legislature. Typically the rules come out as statutory regulatory orders that allow tax officials to insert seemingly innocuous items that may eventually increase their discretionary authority. Such innocuous items can make a tax reform or legislation ineffective.

In an extreme case, opponents of reform may make an argument for a return to the old ways because the reform did not have the desired result.

Tax evasion is generally high in countries where tax collection and tax audit functions are not separated. In many developing countries, including Bangladesh, the audit of tax return including duties and VAT assessment is performed by the tax collector. This probably negates all possibility of discovering any tax evasion especially if the tax collector assists the tax payer in devising evasion.

However, if the third party auditors such as private firms or an independent wing of the tax administration conducts such audits, detection of tax evasion and over-assessment becomes a real possibility.

Absence of reconciliation makes tax evasion or avoidance difficult to detect. An essential element of a tax system, specially for indirect taxes such as customs, duty and VAT, is reconciliation of the collected income with the trade documentation and statistics.

Reconciliation allows the government to detect weaknesses in the tax system and initiate corrective actions. Reconciliation is most cost-effective if it is done by third party contractors such as accounting firms or other third parties who do not administer the tax system. Countries who do not have PSI programmes such as the Philippines, Peru and others find PSI by reconciliation firms to be cost effective and efficient.

Reconciliation requires a system for compiling and collating trade documentation. Most developing countries, including Bangladesh, do not have such a system. Therefore it is difficult to control tax evasion.

Reconciliation allows the government to set realistic tax targets and initiate meaningful reforms in the tax administration including the identification of officials who are good performers.

Tax evasion or avoidance is high in countries where tax administration does not use in-

formation technology. Effective use of information technology allows timely compilation of reports and reconciliation that is essential for good decisions.

Many tax administrators in developing countries are resistant to computerisation of their departments. In extreme cases, personnel of the tax department even sabotage such efforts by arranging break downs of the computer equipment.

Besides, discriminatory tax code may cause a high degree of tax evasion or avoidance. The incidence of tax evasion or avoidance will be low if the tax code is uniform for all citizens of the country and not discriminatory.

In Bangladesh, income tax for government employees is deemed to be paid by the employer, that is the government. However, if a private employer pays income tax for its employees, such payments are considered income which creates additional tax burden for the employee of the private firm. This is discriminatory, that encourages employees of private firms to avoid or evade taxes.

Similarly, if MPs have the facilities of importing a vehicle without paying import duties, citizens of this country may want to reduce duty by under-invoicing vehicle imports if they can get away with it.

One may argue that income tax of government employees or import of vehicles by MPs is not significant in terms of the revenue that the government loses. That may be correct. But the issue is not the direct revenue that the government forgoes, but the indirect consequences of the discriminatory privileges and the response the it engenders from the citizenry.

The citizens may raise the question, how is the government using the taxes and for

what purpose? Raising tax rates arbitrarily for meeting the needs of the government's expenditure-induced budget without considering the social or economic impact of the same may invite public criticism. This has certainly some bearing on the moral of tax payers.

Tax evasion or avoidance is usually found to be high with-out a freedom of information act. Freedom of information allows public watchdogs access to information that would otherwise be privileged. Such access can prevent potential avenues of power and corruption by those in powerful positions in the society. In developed countries such as the United States provisions of the freedom of information are there by instrumental in exposing abuse of the tax code by powerful members of the society.

In Bangladesh it is virtually impossible to get an information on revenue and taxes from the National Board of Revenue. Details of government revenue cannot be a state secret.

In context of the tax evasion problem, the government is the principal and tax officials are his agents. Government will not resort to indiscriminately tyranny. Nor will it undertake measures that will put the national economy in a recession because economic and social hardship will eventually result in the removal of the government from power.

As agents of the government, tax officials do not always want to maximise the government's revenue collection, nor do they have any vested interest in ensuring that any income goes to the government in power unless it serves the interest of the tax officials.

The agents aims to maximise his personal pecuniary and non-pecuniary benefits. This

means collaborating with tax payers in exchange of bribes, depriving the government of its revenue as long as the agent can get away with such behaviour.

There is a third factor. The tax payer is involved in tax problem. The tax payer is interested in maximising his wealth. He likes paying neither taxes nor bribes. The tax payer will choose to make a payment of taxes only or taxes and bribes or only bribes as long as the total payment is minimised and there are no criminal penalties for his behaviour. He selectively collaborated with the government as well as the tax officials.

On matters of tax policy, the tax payer will collaborate with the government to reduce tax rates. And on matters of his individual taxes, he will collaborate with the tax officials to reduce his payment.

In developed countries, the distinction between the principal and the agent is clear. The legislature passes the tax laws and approves rules and regulations commanding the tax administration including the initiation of changes in the existing tax framework. The legislature monitors the functioning of the tax administration.

In developing countries the distinction between the principal and the agent is not quite clear. Although the ruling party proposes the budget and changes the tax framework, in effect it is the tax officials, the agents who prepare such proposals.

Additionally the budget and tax proceedings are only an annual exercise that usually lasts for about 15 days and many of the speeches in the budget legislature are not related to budget at all. There is virtually no monitoring for the legislature for the ensuing year on the government's revenue situation or the performance of the tax administration. Thus it is no surprise that tax law accompanying rules and regulations in developing countries generally favours tax officials with discretionary powers for discretionary income.

In the last decade, several developing countries have successfully reformed the tax administration and increased government revenue collection using the agency theory. The solutions of some underlying theme of aligning the incentive of the agent, tax official with that of the principal government, may be cited here.

In the area of direct taxes, Mexico used incentive oriented reforms to improve tax collections. Under the Mexican scheme, each field income tax office that exceeds its target, retains 60 per cent of the individual collections as a bonus fund. Bonus is distributed to employees of the field office on the basis of the field collection. Maximum bonus is 250 per cent of the annual salary. The average bonus in 1990s was 130 per cent of total wages. As a result of this reform, additional taxes went up by 90 per cent in 1990 and number of audits almost doubled.

Furthermore, if a tax official

used his authority and harassed tax payers, he was subjected to prosecution. The private sector had a role in deciding whether a tax official abused authority. By means of these reforms of the tax administration, things improved in Mexico.

In 1990-91, Peru reformed its customs duty, indirect tax collection system, using agency theory, but its approach was different from Mexico and Brazil. The government of Mexico employed two agents, PSI companies to inspect and evaluate imports and customs officials to collect import duties on the basis of PSI evaluation and verification and to monitor the performance of PSI companies. Customs carried out random inspections of import consignments to verify if what PSI companies were certifying was indeed correct. By instituting this reform, Peru shrank the size of its customs administration by two thirds and increased tax collection from 5.4 per cent of GDP to ten per cent of GDP within one year. By 1997, customs duty collection increased by 355 per cent and clearance of import consignments decreased from 15 days to less than 24 hours. By saving less than three per cent of the savings from the PSI scheme, Peru was able to increase salaries of its revenue officials by almost tenfold. The Peruvian customs is currently seeking ISO 9001 certification as a result of these reforms.

Bangladesh tax administration is a relic of the past and requires urgent reforms. The present tax administration is incapable of accomplishing its task. Bangladesh has urgent needs for its very survival all of which will require that the government has more resources at its disposal. If the tax administration doesn't accomplish its task, Bangladesh will not change the predicament in phases. Hence reform of the tax administration is the most important economic and political question that the country faces.

In reforming the tax administration, it is important that Bangladesh learn from the experience of other countries that have successfully reformed the tax administrations.

Reform of the tax administration is a monumental task. It would not be possible to undertake all the reforms at the same time or from day one. Therefore it is essential that there be priorities that reflect the economic realities of Bangladesh. In developing that priority list, it is important to keep in mind that the government of Bangladesh receives about 46 per cent of its revenue from import duty and complementary duties, 31 per cent from VAT, about 12 per cent from income tax and the remaining from other taxes and levies. Furthermore, more than half of the tax collection comes from taxing imports. Therefore, reforming the import taxation should precede reforms in other areas.

Finally, the purpose of this paper was to raise some relevant issues so that the participants can come up with meaningful answers for dealing with the issue of tax evasion and avoidance in Bangladesh. I am certain through open and free discussion the participants will be able to come up with practical and meaningful answers.

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## Declaration on Tax Evasion

### Recommendation of the Roundtable on Tax Evasion in Bangladesh and its Social and Economic Consequences

Jointly organized by the Foreign Investors' Chamber of Commerce and Industry (FICCI)

and  
*The Daily Star*

Held on Thursday, March 25, 1999 at the Dhaka Sheraton Hotel

Tax evasion deprives the Government of Bangladesh of the resources it needs to tackle the country's most pressing problems. It has far reaching political, social and economic consequences to the Government to effectively deal with poverty, education, health, security, infrastructure, and the economy to improve the quality of the lives of the people.

#### The seminar resolves that :

- Tax evasion creates social and economic distortions, and widespread tax evasion encourages evasion by those who are willing to pay the correct tax. Society at large has a responsibility to address tax evasion meaningfully. Consistent with this responsibility the civil society in general and the business community in particular will, therefore, co-operate and render all assistance to the government in developing effective strategies and programmes to deal with tax evasion.
- Dealing with tax evasion effectively in Bangladesh will require comprehensive reform of the tax administration. The tax laws, rules and regulations have to be simplified; discretionary authority of tax officials need to be streamlined; the application of the tax laws, rules and regulations should be uniform for all taxpayers and the administration of the National Board of Revenue should be transparent.
- Complex tax regulations with too many exceptions and exemptions encourage tax evasion. Hence, to increase revenue collection, the Government of Bangladesh should devise a simple tax code with reasonable tax rates that will bring more taxpayers under the tax umbrella. Tax legislation, collection and audit should be separate functions independent of each other.
- Tax evaders when detected should face criminal punishment including imprisonment as appropriate under law without fear or favour. In order to discourage tax evasion, names of honest taxpayers may be prominently published each year in December in the national dailies.
- Provision of reward and punishment for tax administration officials will help minimize tax evasion. This should also be adequately publicized. Corruption when detected within tax administration should also be treated as a criminal offence and punishable accordingly.
- Compulsory PSI system should be immediately introduced.