

Tax Evasion: Need for Remodelling the System

Continued from page 17

DISCUSSIONS



Mr. John Noel, Chairman and Managing Director of Lever Brothers Bangladesh Ltd. Tax evasion in Bangladesh has unfortunately become endemic. It has become the norm rather than the exception and I have to say that within my industry it has been increasing dramatically over the last three years. I know that action has for the first time been taken recently which helps to curtail to a degree this major problem.

Let's be clear. Tax is like death, absolutely inevitable. You have to pay taxes, you have to die. The government needs revenue and has to collect it in the form of taxes. The only thing is this tax should not be just from the few. It must be from everyone equally in relation to their activity. Why is it that some 100 foreign investors pay 60 per cent of the total revenue to the exchequer? It certainly isn't because they are 60 per cent of the industry.

The World Bank has projected the potential of Bangladesh. Obviously by the year 2020 there is great potential. This could only be achieved with economic and administrative reforms. At the same time though, to most foreign investors, it is abundantly clear that this potential cannot be realised if tax evasion is allowed to continue as it has been in the past.

Tax evasion has an enormous cost to the country. There has been a few words about the difference between tax evasion and tax avoidance. Tax avoidance is basically legitimate ways of minimising tax. Tax evasion is a totally different matter. Tax evasion contravenes the law and is a willful act of fraud. A lot of people think that under-invoicing or putting up goods without challans or manipulating values is a business norm. This is evasion. This cannot be accepted since and the attitudes of businessmen must be made to change.

Like all acts of theft, it has been practised throughout the ages. This does not mean that it can be condoned. It means that we need a strong administration which would take the necessary action to stop the rot. Throughout history we have seen that countries had to take measures to check the practice of tax evasion, measures aimed at making the penalties caught are greater than the benefit that could be gained from tax evasion. These measures have been enforced by strong administration and examples have to be made.

In simple terms, tax evasion is stealing. It's nothing less. It's a theft just as same as if a man goes out and breaks into a shop or takes money of someone at gun point. There is no difference. It is stealing from the poor

of Bangladesh because without correction it will work against the initiatives of poverty alleviation. Why should corrupt businesses finance be financed, using the government money for the detriment of the country, driving out honest businesses in the process. Why should basic products be more expensive to the poor while crooks line their pockets through tax evasion?

Tax evasion is a circle. Tax evasion means an increase in tax rate. An increase in tax rate means an increase in tax evasion. And then of course you have further increases in tax and so you go on and on and on and on. The evasion has an effect of ever-increasing tax rates and the honest business is left with two alternatives: to become dishonest or to leave. Speaking from my own company, it is quite clear what we will do. If this is allowed to continue, we will close our operations and leave the country because our code of ethics would not allow us any other option.

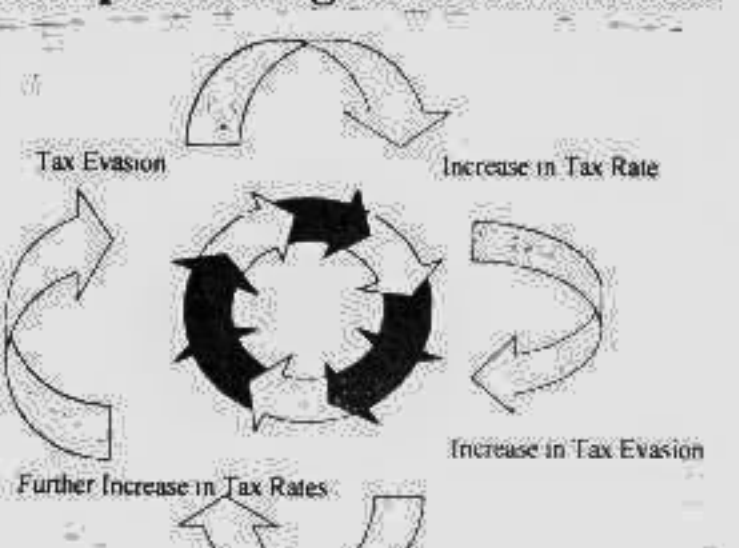
I am going to use my own company and examples. Last year because of the revenue shortfalls, the Finance Minister had to increase taxes in the budget. Supplementary duties then led automatically to higher prices which leads to a decline in sales which led to, in our case, a 12 per cent reduction in the payment to the exchequer. I don't agree with using basic commodities such as soap as a means of collecting tax, but I do understand the Minister's urgent need to find a source of revenue in the absence of an adequate tax collection system. The net effect though is lower sales and increase of tax rate, but a decline in payment to the exchequer. So the losers are the general public, the honest taxpayer and the government.

Not only did this rise in taxes cause internal problems, it means that we are less competitive than our neighbours. This is particularly so when direct imports get an advantage on the present VAT system compared to local production. I have drawn a quick comparison to see where has all this led us to and I have compared India and Bangladesh. I have used Hindustan Lever in India and Lever Brothers Bangladesh in Bangladesh. We pay as a percentage of gross sales 50 per cent more taxes in total than in India. This automatically will create further and further problems for the future. It's a Catch-22. High tax leads to high tax evasion, distorted competition, inflation and even higher taxes.

If I use as a basis the tax paid by Lever Brothers since the introduction of last year the budget for our industry, these are the figures which come out as to what Lever Brothers pays in a year and what should be collected. I don't know what is collected, but it is nowhere near this figure. I guess 50 per cent of this is collected. If it is true that it is 50 per cent that means we are paying 60 per cent of this total industry when we should only be paying 30 per cent if we look at our market as based on independent survey of the market by research agents. That is not exactly a level playing field.

Two of our competitors have been told to give 8 and 10 per cent times more VAT on a monthly basis. I certainly welcome this and I have to say that this is the first time that we have seen any government taking this type of action so I give full credit for this kind of

action. But I have to say that our company's foreign investors and our shareholders do not accept that tax can be negotiated in this way. It is not transparent if it is just a basis of saying, pay 8 or 10 times more because the 8 or 10 times more is still insufficient. If someone is found to be evading 90 per cent of the taxes because if anyone is told to pay 8 of 10 times more, then a minimum 90 per cent evasion has been taking place. No action has been taken. No shareholders find this totally unacceptable. Any negotiated payment on the basis of not harassing companies for not paying their tax in full is not acceptable to a foreign investor. Blatant tax evasion must be treated as a criminal act. Action must be taken. We would expect that action to be taken to curb such activities. They got to be against taken the companies, against individuals



Tax Evasion causes

- Corruption
- Destabilisation of Monetary Policy
- Inflation
- Constraint on Poverty Alleviation
- Reduction in Foreign Investment
- Flight of Capital
- Slower Growth rate

Path to Middle Income			
	1971	1996	2020
Population M	71	128	160
Growth %	2.6	1.8	1.2
Per capita GDPs	120	260	1200
Growth %	1.3	5.6	7
% Below poverty line	83	53	11
Literacy %	25	38	95
Unemployment %	40	30	10
Food grain			
Production in tons	10	18	25

Source World Bank

and against anyone, be it a civil servant or anyone else involved as an accessory in that theft.

We would accept that it is very difficult to totally eliminate tax evasion. I would be the first one to say that I know that tax evasion does happen all over the world, but it is normally only the small companies that avoid it because they can escape. What we also know is that here it would be easy for the government to take action on the large and blatant evasion which is clearly evident anywhere around. It would be nice to think that the outcome of this roundtable would be that all individuals and businesses suddenly become honest. I am afraid it won't happen. Firm action is needed and it can only come from the government.

Let's see what happens in other countries, what happens on the statute books? In India a fine can be levied twice the tax evasion and three years in prison. In USA half a million dollars, five years in prison. In the UK, three years tax evaded and up to seven years in prison. Japan, a fine up to ten times tax evaded. The Netherlands, 25 thousand guilders, four years in prison. And Pakistan, 50 thousand rupees and five years in prison. It can be seen that most countries have had to introduce heavy penalties to curb tax evasion. Having such penalties on statute books is only a first step. They must be enforced in an exemplary manner. The problem is grave and strong action is needed if the country is to meet its full potential.

What is caused by tax evasion. Corruption. The level of corruption because of the tax evasion. And the higher the tax rate, the more money goes into the evader's pocket and more is used for corruption. It destabilises the monetary policy. It causes inflation. As a result, there is a constraint on poverty alleviation which is so desperately needed to move the country forward to its full potential. There is a reduction in foreign investment because certainly when people see that there is no proper tax collection system in the country, foreign investors are frightened to come in. Flight of capital. So far it may not have happened, but if it continues, it will. Flight of capital will be foreign investors deciding to pull out. Local people who are honest will think it is better to invest their money elsewhere. Tax evasion will create, if it is allowed to continue at the incredibly high level that it is going at the moment, a flight of capital. All of this, of course, gives a slower growth rate.

Why should basic products be more expensive for the poor while crooks line their pockets through tax evasion?



SAMS Kibria, Finance Minister of Bangladesh: I was very impressed by the presentation. Mr. Moazzem's was like a dissertation and Mr. Noel got the problem by its neck. I would like to make a comment on the last point first.

His idea about legislating imprisonment for tax evasion appeals to me. If India, UK, Japan, Netherlands, Pakistan, all have very tough laws on tax evasion, I don't see why we should not have similar laws.

I do not support negotiated settlements on tax payment, but I would like you to understand that for all these years, this problem has not been addressed. Those who have been evading, they have been permitted to evade. And suddenly, here we are, the present government has taken this challenge. We are now dealing with evasion, corruption and all kinds of irregular activities. I would like you to give us time to deal with the problem.

This seminar is taking place at my suggestion. When the President of the Foreign Investors Chamber had a meeting, this idea came up. It shows that the present government is determined to deal with the problem.



Forrest Cookson, President of AmCham: I want to start by trying to summarise the revenue situation as I see it. There is a summary of the revenue situation on the screen. The time and years are not continuous. What we see is that there has been an increase in revenue

collection from 76 billion taka in 1991-92 to our estimate of '98-99 of 147 billion taka, a growth rate of about eleven per cent per year. I want to look at this briefly in terms of the shares and import revenues have varied between 53 and 57 per cent of total revenues, let's say on the average of 55 per cent and the domestic indirect taxes were about 25 per cent and the income tax has varied between 13 and 17 per cent of total revenue with a slight decline.

I have tried to calculate what the rates of revenue might be. In table 5 of my paper, we see the total import tax collected to adjusted imports. In adjusted imports, I have subtracted the fabric, the back-to-back LCs and the back-to-back LCs financed imports for the garment sector in food, grain imports. What we see here is that the average tax rate varies between 41 per cent and the lowest was 31 per cent with a tendency to increase. The last year we estimated it at 37 per cent. The total indirect taxes to what I call adjusted GDP, adjusted GDP subtracts agriculture and covers administration and defence, two sectors that are not taxed. That ratio is three and a half per cent now.

I finally look at the income tax to adjusted GDP same definition and the income is two per cent of the adjusted GDP. The total collection of GDP not counting the import tax, is then running at about five and a half per cent. The revenue situation then is very dependent on the imports.

The income tax has been growing at considerably less than GDP and there is a disturbing indication of the difficulties in collecting income tax. The fastest growing revenue in real terms are from the import taxes.

About the ideas I wanted to put forward, I begin with the import related taxes. About 55 per cent of total government revenue is coming from imports and it's about 37 per cent of adjusted imports. There are two big problems here. One is under-invoicing and the other is smuggling. Smuggling is an extremely difficult issue, but there are two things that can be done. One of them has a positive impact on under-invoicing. This is to greatly improve the management of remittances flowing into the country. There is a vast volume of remittances which comes through the informal system, perhaps equal to what comes through the banking system. This is largely due to the inadequacies of the banking system to handle the remittances quickly and easily for the recipients. If that is improved, those involved in the informal money markets will have to put up the costs of their operations and it will tend to lean against importing.

The second is that there should be much more aggressive customs checks at the check points of the transportation, most of all at the ferries and at the bridges. I do not expect this

to stop smuggling, but I expect it to increase the price of smuggling. By raising the price of smuggling, we will lift imports more into the form of channels.

Another thing that can be done is to impose a mandatory pre-shipment inspection system. As the keynote paper suggested and as the evidence overwhelmingly suggests from all over the world, this will raise revenue collections immediately and significantly. It is not really clear to me why there is so much resistance to this by the government. This is the quickest and most effective way to raise revenues.

Next I talk about the domestic indirect taxes. These represent about 25 per cent of total revenues. The domestic part of VAT collections are about 1.7 per cent of adjusted Gross Domestic Product against what would be 6 to 7 per cent. Domestic VAT collections are about 25 per cent of what the potential is. What to do about this?

VAT is a beautiful tax for tax authorities because when properly managed it is self-enforcing. Compliance follows from the processing. Company X sells to company Y and both companies are forced to record that transaction correctly in order to get their value added estimate correct. However, the way that VAT is administered in Bangladesh, the self-enforcing characteristic is not achieved. I grant you that it is not easy to do this, but the quicker one starts on this, one begins the introduction of the computer systems, the cross checking, bring in the self-enforcement, the more rapidly the VAT collection will increase and this is something NBR has been dragging its feet on and not moving fast enough and the need for proper computerisation for the VAT system to generate this self-enforcement characteristic is really essential. One does not try to do everything, but you begin by working with the largest firms first and ensure them that the computer system is cross-checking. Once you have achieved that, then it is possible to keep expanding.

Finally I turn to the vested interest of income tax. The best thing to do with income tax is to abolish it completely. It doesn't really collect that much revenue and it certainly has generated a lot of pain. However, I can't see the Finance Minister agreeing with such a step. This is collecting about 14 per cent of total revenue and as we know, a handful of individuals pay most of the tax and a handful of companies pay most of the tax.

I have pretty radical ideas here. I want to start with the individual income tax. This is not the area where revenue collections are going to increase from administrative action. Instead of trying to put emphasis on that, the emphasis on administrative improvement should go to the VAT which will be a great revenue in the future. But you want to begin to build the tax system—the direct tax system—for reasons of equity and because the world seems to believe that direct tax, income tax is a very simple idea. That is that for almost all tax payers, nobody files income tax returns. Instead, each income in wages and salaries, rent, interest dividends, there is withholding according to some weights and schedules that NBR will propose and the Ministry and Parliament will approve and that's the end of it.

The NBR's job is not to deal with individuals, but to be sure that firms are withholding their taxes from the wages and forwarding it to NBR, that banks are withholding taxes from the interest payments on deposits that listed companies are withholding from their dividends. I don't pretend that all of this is easy to do, but at no point in this system do you ever add your income together. Instead you pay on each stream. You do this concept for several years and at the end of those several years you will have got everybody tagged with a taxpayer number and then you can begin to go back to the integrated tax return. This is in line with the keynote paper's ideas that lower rates and try to build a tax is the correct thing. The United States' Internal Revenue Service had started with our present tax code when they began the income tax, the rate of evasion in the United States would be the way it is in Bangladesh. But they started very low tax rates and very small coverage and then built up gradually over time.

Then we come to corporate income tax. Most economists of my generation believe there shouldn't be any corporate income tax rate. Why should corporations pay taxes? People pay taxes. You pay taxes on dividends, why you should pay taxes on other things is never clear to me. But once again I believe that the Finance Minister is not going to throw away the corporate tax rate. So we look for some simple things to do. Most of these things are pretty obvious and have been discussed a lot in the past.

Four things I believe would help compliance. One is reducing rates, the same point that was made by the keynote paper. The second is to unify the rate among different classes of corporations. There really is no reason for the present system. The next is to abolish tax holidays completely. There is no

reason for tax holidays whatsoever. But what does work in the context of Bangladesh is perfectly flexible depreciation schedules so that the firm can depreciate any amount it wants at any time as long as it doesn't depreciate more than the cost of the capital bids and also that you are allowed to correct the cost of your capital for inflation and changes in the exchange rate. These are reasonably straightforward things to do, but will treat the companies more fairly. Finally NBR, perhaps already has, should establish a large taxpayer unit which concentrates on the large firms. Instead of a conflict position with these firms, it should try to find ways to work together. You cannot really force compliance, but you can get the cooperative approach and recognition that is the only way that tax collections will help, then cooperation will follow.



Prof. Wahiduddin Mahmud, Former Advisor to the Caretaker Government: I wouldn't even go as far as demanding jail for tax evasion, knowing the practicalities. The important point would be to take some examples of court procedures against tax defaulters. If we were to go for jail sentence, I would have asked the government first of all to put in jail the illegal tax collectors parading throughout the economy. There are news items on that everyday on the increasing phenomenon.

I have found some practical suggestions in the keynote paper. I take the last point first which is also a point made by Dr. Cookson, is that a large portion of tax comes from import taxes and although tax evasion is comparatively less in import taxes, in the short term some steps can give more benefits in terms of higher collection in import taxes. Evasion of import taxes, as Mr. Noel pointed out, creates an uneven phase because tax evaded on imported raw material is not very fair to those industries who pay taxes. On import taxes, contrary to popular idea that this is one of the areas where tax collection must be much better, if you reconcile different sources of data, if you look at the actual import in terms of foreign exchange spent from say Bangladesh Bank data and compare with the expected revenue from import taxes and compare with the actual collection rate, then there is a 20 to 30 per cent disparity. Some of it may be explained by some tax exemptions, but most of it is tax evasion. So there is a need in the very process of tax collection for a reconciliation of data. Somehow in the very process of import tax collection, if one could reconcile different sources of information, then tax collection may be better. There is information from banks about how much foreign exchange is used to back the value of import.

The potential of PSI has been underestimated. We prematurely withdrew our attention from PSI. If it has worked in other countries and if it is made comprehensive and even compulsory, then PSI could give better results.

Introduction of PSI brings us to another point in the keynote paper. That is independent auditing. This is not only for our import taxes, but in all other taxes. In the tax administration at present there is no independent auditing. Even if there is no independent department

within the administration, some independent auditing should be created. We should make more use of information technology. But we can take advantage only if we make use of this information for different purposes. I will give you an example. Many taxes that come tax were collected at source on imports, exporters' earnings, on consultancy payments, on house rent, but there is no cross checking of actual income generated and the actual tax payers liability with these income taxes which are deducted at source, then at once the income tax deducted at source can be collected with the liability of the actual tax payers. It can be verified if the original tax is at all paid beyond these taxes deducted at source.

We know that in domestic Value Added Tax, there is a force on many areas of income taxes, there is huge tax evasion. One way to start dealing with this is to have some idea of the extent of tax evasion. Bangladesh Bureau of Statistics could try to collect actual information on tax collection and various other information like the number of business establishments, the number of professions, the number of doctors in Dhaka city, the number of lawyers, what is their average income, and try to relate it to the actual collection of taxes. That should be the starting point.

Then how do you start taking action in these areas remains to be seen. There were some proposals made last year that in one area for one type of businessman you negotiate a flat rate of income tax. I agree that income tax is something which should not be negotiated, but in actuality where record keeping is so poor, some sort of arbitrary negotiation is inevitable. I don't know how far that tax was imposed on some types of businessmen, why not on some types of lawyers? Same types of doctors? They should pay a minimum tax. This should be an approach for domestic value added tax for many producers who are not even listed in NBR. A survey will reveal that the NBR list has large deficiencies, some omissions here, some omissions there.

There are some growing areas of income generated like house rent in apartment houses, professional incomes. These are potential areas wherefrom some steps can be taken.

Lastly one area which has been neglected where taxes can be collected is every year we talk about increasing taxes on cars and jeeps. These are luxury items. But another way to look at this problem is that there is huge public investment in infrastructure. There are no returns coming from that. Instead of going for higher and higher taxes on import of vehicles, why don't we increase road taxes of vehicles? This is immensely justified. The scope of tax evasion is rather limited here so good results may be obtained.

I differ with Mr. Moazzem Hossain when he says discretionary powers should be eliminated. In a country like Bangladesh, I cannot see how this can be done. Even the level of reports on VAT, personal taxes and consultancies, there are no reports. So in areas where discretionary powers can be reduced, that is okay. But in other areas where discretionary powers remain, this is one of the problems of how honest tax payers are harassed. When we proposed that there should be an auditing system for supervising the action of actual tax administrators, then instead of looking at how a tax administrator deals with one particular case where, under the given rules and under the vagueness and lack of data and records, the tax administrator can always justify his action and can harass any tax payer in Bangladesh, I think that those who look after the accountability of the tax administrator should make him produce records on how he deals with other cases to justify why he is so harsh in one case and why he has let other similar cases get

Continued on page 19

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"Shell is committed to helping people build a better world."

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