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Tax Pilferage—Causes and Cures

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SOME CONCEPTUAL ISSUES

"Tax pilferage" is an English equivalent of the well-known Urdu phrase "*Tax Chori*". The formal expression is tax evasion. To begin with, we draw a distinction between tax evasion and tax avoidance. Tax evasion is defined to include all illegal acts of omission and commission which result in tax loss to the exchequer. According to the United Kingdom Royal Commission on the Taxation of Profits and Income, the term "evasion":

> "...denotes all those activities which are responsible for a person not paying the tax that the existing law charges upon his income. *Ex hypothesis* he is in the wrong, though his wrongdoing may range from the making of a deliberately fraudulent return to a mere failure to make his return or to pay his tax at the proper time." [U. K. (1955).]

To be more specific, evasion refers to the nonpayment of tax as a result of failure to submit a return without reasonable excuse, or underpayment of tax, by submitting an incorrect return where incorrectness is due to gross neglect or fraud, or due to omission, or understatement of income or the deduction of an inadmissible or a fictitious expenditure, or loss.

Tax avoidance, on the other hand, is defined by the Royal Commission as follows:

> "By tax avoidance, ... is understood some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement. Thus the situation which he brings about is one in which he is legally in the right." [U. K. (1955).]

For our purpose, tax avoidance will refer to every attempt, by legal means, to prevent, or reduce tax liability which otherwise would be incurred, by taking advantage of loopholes in the tax law. It excludes fraud, concealment and other illegal measures. Thus tax evasion is illegal while tax avoidance is not. However, both have the same effect on government revenue, or taxpayer's after-tax income and on fiscal equity. Both can be considered alternate ways of coping with high tax rates and both are interdependent.

Another clarification is also in order. The word "tax" popularly refers to a tax on

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income or wealth. Technically, however, indirect taxes like excise duty, import and export duties, and sales tax are also taxes. All taxes are subject to evasion and avoidance. However, we shall focus on the evasion of only income tax.

EFFECTS OF TAX PILFERAGE

Tax pilferage not only deprives the government of much needed revenue but also plays havoc with the moral fibre of a society. Vast hoards of black money resulting from tax pilferage cause social corruption, wasteful consumption, real estate speculation, and luxury construction. A high degree of tax pilferage sharply reduces the value of tax incentives for economic development and affects investors' allocative behaviour. It vitiates economic indicators which lead to inappropriate policy responses. It retards attempts at monetisation of the economy. It also affects income redistribution. It should, however, be emphasised that it is not the existence but the extent of tax evasion which is a matter of major concern.

MAGNITUDE OF TAX PILFERAGE

The measurement of tax pilferage is inherently difficult both because of its illegal nature, requiring secrecy, and because of conceptual problems. Two estimates are often used as proxies for tax pilferage: an estimate of the underground economy and that of tax non-compliance. The former measures income that is unaccounted for in official estimates of GNP; the latter measures income that is unreported or under-reported in tax returns.

There are no firm estimates of how much tax money is pilfered in Pakistan. Research work on tax evasion is extremely limited. There is no agreed methodology for the estimation of tax evasion. Professor Nicholas Kaldor, a renowned economist, made a pioneering attempt, in 1956, to estimate tax evasion in India. He estimated the loss in 1953-54 to be of the order of Rs 200 to Rs 300 crores as against the actual collection of only Rs 164 crores. The Central Board of Revenue, however, expressed the opinion that the tax evaded in 1953-54 could not have exceeded Rs 20–30 crores. Later Prof. Kaldor in an oral testimony clarified that his estimate included tax evasion as well as tax avoidance. That indeed could make a lot of difference to the estimate.

There have been some rough estimates of tax evasion in Pakistan but it is not clear whether they include also tax avoidance or not. My hunch is that they do. The following is a typical example of such estimates:

> "Assume that 75 percent of incomes are from non-agricultural activities, then in 1993-94, the income liable for taxes was around Rs 1,180 billion. If 50 percent of this income had accrued to the richest 20 percent households, then the potential base for income tax would have been Rs 590 billion. Even at 15 percent tax it would have yielded over Rs 88 billion whereas total receipts from income tax

were Rs 45 billion. In other words, only 50 percent of potential incomes are being taxed". [Kardar (1995).]

The problem with the methodology that makes use of national income estimates is that the concept of income used in national income accounting is much broader than that used in Income tax. Estimates of tax evasion based on National Income estimates ignore the important distinction between tax evasion and tax avoidance. Unless national income is adjusted for exemptions, exclusions, allowances and deductions to make it compatible with the taxable base, it would be inadvisable to use national income data to estimate tax evasion. In the absence of the needed information, therefore, any estimate of tax evasion will be a shot in the dark.

CAUSES OF TAX PILFERAGE

(i) Basically, all tax pilferage arises from personal greed which is an essential ingredient of human nature and is universal. Whether the individual concerned is a trader, an industrialist, a professional, or a director of a company, and no matter in what way he effects his manipulations, the prime motive is of personal gain, or material advantage to an individual or his family.

(ii) An enabling factor responsible for tax evasion is the secrecy shrouding personal finances and the department's virtual inability to determine true income. J. R. McCulloch (1789–1864), the first professor of political economy at London University observed as follows:

"...it neither has been, and, we are bold to say, never will be, possible to determine the incomes of farmers, manufacturers, dealers of all sorts, and professional men, with anything like even the crudest approximation to accuracy... The investigations would be worthless; and the Commissioners of income tax would in the end have nothing to trust to but the declarations of the parties. Hence the tax would fall with full weight on men of integrity, while the millionaires of 'easy virtue' would well nigh escape it altogether". [Encyclopaedia Britannica (1963).]

McCulloch showed remarkable foresight about the current day problems of income tax administration. The income tax department is hardly equipped to determine the true incomes of the assesses. The income tax officials usually increase the reported incomes arbitrarily at the time of assessment. Most of the assesses anticipating such an increase are forced to underreport their incomes. Only some men of integrity report their true incomes in their returns. And when their incomes too are increased arbitrarily at the time of assessment, they too begin to underreport incomes.

(iii) Our honourable law makers who legislate taxes for the nation, exempt themselves on the major sources of their own incomes. They do not even care to pay whatever little they are liable to pay. The recent income tax directory of taxpayers in this regard is painfully revealing. In such an environment, the rulers lack the necessary moral authority and the political will to enforce tax compliance. Tax thieves feel morally justified to emulate the example set by the rulers.

(iv) Huge amounts of black money, and large cash hoards of drug barons have compounded the problem by giving rise to large scale unlawful business activity, monstrous corruption, degeneration of values, and erosion of governmental authority, all leading to non-compliance.

(v) There is no accountability or fear of punishment for tax thieves especially the big and the powerful. Absence of deterrent punishment breeds widespread tax evasion, even by those who are not so big.

(vi) Lack of documentation in the economy due to general preference for cash transactions is both a cause and an effect of tax pilferage. Business men neither like to receive payment by cheque nor do they make any payments by cheque. In the absence of such documentary evidence, it becomes extremely difficult to investigate tax pilferage.

(vii) Erosion of moral values and domination of materialistic culture result in excessive greed, dishonest practices and boundless lust for worldly comforts and pleasures. Tax pilferage provides the wherewithal to satisfy this lust.

(viii) Although tax rates have been lowered from time to time, tax pilferage remains unabated. The reason seems to be that the Government's demand for more and more revenues from a limited number of assesses leads to their being squeezed more and more by tax officials who are given higher and higher collection targets. This compels the harassed assesses to resort to various form of tax evasion.

(ix) Complexity of the tax system, the tax structure and the tax laws with frequent changes create tax loopholes, inconsistencies, uncertainty, and confusion which promote tax avoidance and tax evasion.

(x) Exemption of some economic sectors and regions from income tax leads to tax evasion. Agriculture, for instance, serves as a convenient cover for explaining untaxed incomes and investments. Loans from agriculturists and from tribal people are offered as an explanation of assets created with black money.

(xi) Poor public services, e.g. hospitals without medicines, schools without furniture, power breakdowns, broken roads, law and order breakdown, poor and crowded railway trains, dead phones and similar other miseries breed contempt for the government and its tax collection efforts. Also, when taxpayers see their taxes being used to provide privileges and perks to the rich and the powerful, their resistance against taxation, and their temptation to evade taxes increases.

(xii) Uncontrolled inflation and high cost of living, low government salaries and unfettered discretionary powers of tax officers provide a conducive setting for corruption and tax pilferage.

(xiii) Low level of literacy among taxpayers who are unaware of their civic responsibilities and who are incapable of keeping reliable accounts may be another reason for the low level of tax compliance.

(xiv) An anti-tax culture prevails in the country. Tax pilferage has become the rule, and compliance an exception. There is no social stigma attached to tax pilferage. In fact, it has become a privilege of the high and the mighty to not to pay any tax. On top of it, they interfere in tax administration to help even others to evade taxes.

(xv) Tax officials of "easy virtue" often play a negative role. Instead of apprehending the tax thieves, they help them get away after reaching a "compromise" for mutual benefit. Tax consultants too are often a party to this unholy alliance. Scrutiny of tax returns is often too superficial and hurried to unearth tax evasion. In fact, there is little incentive to do so after the 'compromise'.

(xvi) Repeated tax amnesties amount to a premium on tax pilferage. Honest taxpayers are distressed to see the tax thieves getting successive amnesties after benefiting from repeated tax evasion. They too are tempted to emulate them.

(xvii) When a taxpayer exploits loopholes in the tax law to minimise his taxes, he lowers the general level of tax morality. Some of the country's best lawyers, accountants and tax consultants are engaged in the battle of tax avoidance. And tax avoidance leads to increased tax evasion as those who have little opportunity to practice tax avoidance and see others using legal means to reduce their tax liability are tempted to use illegal means to achieve the same result.

EVALUATION OF THE CAUSES

The long list of causes given above does not assign them any weightage or order of priority. Obviously, some of the causes are more important than others. A careful assessment of the causes is, therefore, necessary to identify the more important ones. Some of the listed causes e.g. lack of tax morality, low degree of voluntary compliance and anti-tax culture etc. as causes of tax evasion are not very convincing. The notion that taxpayers of some countries are more prone to evade taxes than those of others is a myth. The general impression that the U.S. or the British taxpayers have less predisposition to evade taxes than those of the developing countries is unfounded. According to a U.S. tax expert:

> "Many years of experience in the Internal Revenue Service, the Board of Tax Appeals, and the Department of Justice have convinced me that the American taxpayer is not motivated in his compliant behaviour by any love of taxes but, on the contrary, he has a well-developed capacity for tax resistance". [Bird and Oldman (1975).]

Likewise, a German survey found tax morality to be rather low in that country. A French study on tax psychology concluded that 59 percent of French industrialists and businessmen and 61 percent of professionals thought that tax evasion was justified. Another study shows that tax evasion is widespread in Italy. It all shows that the predisposition to evade taxes is universal. What, however, differs in different countries is the probability of being caught and punished. In the U.S. taxpayers do not evade taxes because if they did, the chances of their being caught would be high, and the consequences could be very serious.

Another cause of tax evasion listed above is the high degree of illiteracy. It too is not very convincing. Significantly, in Pakistan, nearly 80 percent of the income tax revenue comes from the companies sector where illiteracy is not the problem. Further, the concentration of income in the country is such that the top 10 percent of the households with taxable capacity are probably all literate or can employ literate managers. Thus the low level of literacy in the country is probably not a major cause of tax evasion.

One would want to examine the significance of all the listed causes to exclude the less important ones but it is not possible to do so in this limited space. Instead, it would be more appropriate for our purpose to identify directly the most important causes of tax evasion for a possible remedial action. In our estimation, out of the listed causes, the most important are the following:

Most Important Causes

(a) Absence of deterrent punishment for tax thieves;
(b) Lack of documentation in the economy;
(c) Political interference in investigation work and lack of political will for stricter tax enforcement;
(d) Negative role of tax officials and 'facilitating' role of tax consultants; and
(e) Slow processing of tax returns and lack of swift follow up action.

MEASURES TO CHECK TAX PILFERAGE

Every taxation commission set up since Independence has been aware of the problem of tax pilferage. Many recommendations have been made and quite a few implemented. Measures implemented in the recent past to check tax pilferage include the following:

(a) Setting up of a Survey and Registration organisation.
(b) Installation of computers for processing, collation and cross-checking of information.
(c) Introduction of the self assessment scheme to enable the department to devote more man-hours to the detection and investigation of concealment cases.
(d) Introduction of withholding tax regime with its network having been extended from time to time.
(e) Strengthening of the department by providing additional personnel, and training.
(f) Reduction of tax rates, and
(g) Introduction of NTNs and other documentation.

It is important to note that revenue collection through withholding tax regime has increased remarkably since 1990-91. In 1992-93, 71.3 percent of the total collection of income tax came from withholding taxes. Another 23.2 percent came from voluntary payments. The remaining 5.5 percent represented the department's effort in taxing undeclared or underreported incomes and levying of penalties. This shows that although the yield of income tax revenue has increased significantly, the department's contribution to it has been limited. The insignificant growth in collection of "Tax on Demand" indicates that the department is relying more and more on Self Assessment Scheme, Summary Assessment Scheme, and the Presumptive methods of taxation whereby the declared income has to be accepted.

Apparently, the government has already taken most of the measures that needed to be taken. Undoubtedly, the revenues have increased with the widespread use of withholding and presumptive flat rate taxes but the problem of detecting and investigating undeclared and under-reported incomes still remains largely unresolved. The Government firmly declares every year at the time of the budget that substantially large revenues would be mobilised by improvement of tax administration. Tax administration improvement, however, is an exceedingly slow process. Surrey and Oldman have observed that:

> "The most important point learned from this experience [in Chile and other Latin American countries, India, Korea, the Philippines, Turkey and Vietnam] so far, is that significant improvement in tax administration takes a great deal of time and administration often cools before sufficient change has been brought about. Governments which wish to rely on administrative improvement rather than changes in tax laws as a way to increase revenues cannot count on immediate results,..... often the complete rebuilding of a tax administration as a human institution is required." [Radian (1980)].

The lesson here for us is that the Government must keep on making administrative improvements to increase revenues even if immediate results are disappointing. Its enthusiasm should not cool down. In fact, every year it should start with a fresh determination to detect and investigate tax pilferage. It should be realised that even with the most sophisticated techniques it is very unlikely that tax pilferage will be completely eliminated. The aim should be to minimise it by making it increasingly risky to pilfer taxes. In view of the limited staff available for combating tax pilferage, it would be advisable for the department not to waste time on speculative cases but to concentrate on more obvious and remunerative cases. It should be borne in mind that the assesses who have to gain most from tax evasion are the ones who are already suffering tax at the highest rate. They are the most remunerative cases from the department's point of view. Since large assesses use the skilled assistance of accountants and tax consultants, it is most unlikely that their books of accounts will have obvious errors. The departmental sleuths should be able to outsmart them; For this the department must have the best brains available.

REMEDIAL MEASURES

Although the Government has taken most of the needed measures to combat tax pilferage, the results achieved so far have been rather disappointing. We have here some specific measures that need to be enforced more vigorously than at present on a priority basis to achieve better results in the immediate future. These include the following:

Deterrent Punishment of Tax Thieves

Tax evasion can be due to ignorance of law, through oversight, or wilful fraud. In the first two cases, punishment by imposition of fines will do. However, cases of wilful tax fraud must be awarded deterrent punishment. How the degree of compliance changes when such punishment is practised can be seen by the example of Chile where tax evasion had been very high and no one had ever gone to jail for evading tax. In 1964, among other administrative changes, a tax fraud department was set up; several people were tried and some went to jail for tax evasion. This had a tremendous effect on the psychology of the taxpayer and revenue from income tax jumped up by 55 percent in one year. [Bird and Oldman (1995).] Lack of deterrent punishment gives a wrong signal to taxpayers to risk tax evasion in the hope that if they are caught, they can still get away scot free or with a minor penalty. The Government must have a target of cases every year for deterrent punishment including imprisonment. The very knowledge that there is a fair chance that a tax thief may go to prison, would in many cases be enough to convince a taxpayer to go straight or limit his evasion to marginal amounts. It is pertinent to observe here that judges are not inclined to view favourably jail sentences for tax evasion so long as prosecutions are few and far between as they rightly feel that it is unfair to make scape-goats of a few persons when many others are let off.

Additionally, to exercise social pressure, in addition to the regular publication of taxpayers' directories every year, profiles of well-known tax defaulters should be serialised in newspapers highlighting their payment of income and wealth tax, their economic position in society and the privileges enjoyed by them at Government expense.

Computerisation

Computerisation should become an essential tool of management in the department *at all levels*, from top to bottom. It is not enough to train a handful of people required only to run the machine. Since this small group is not responsible for data input nor indeed trained for it, the data input which is a very laborious task is poor and incomplete. The result is that the processed output is no better. The first principle of computer processing is that it can work well only when *everyone* handling information input is capable of meticulously checking returns and feeding the relevant information to the computer. Computer literacy, therefore, should not stop at the officer level. In fact, it is much more important to have the lower staff fully trained in computer processing and storage of relevant information of each assesses for collation and cross-checking. It will not only speed up assessment work but also help in catching tax thieves. For all new entrants in the department, a diploma in computer training must be a requirement. For the existing staff, an incentive of computer allowance and a phased programme of training should be introduced.

Documentation of the Economy

If documentation has to be effective in checking tax pilferage, there has to be an elaborate network of aggregate as well as person to person data. There must also be extensive storage and retrieval capacity to conduct complex collation and cross-checking to discover engineered evasion. Gathering of the relevant data is costly and laborious. It may be provided in tax law that payment for every transaction above a certain amount, say Rs 25,000 shall be made through bank draft, pay order, bank transfer or a crossed cheque to payee's account failing which the transaction may not be accepted for tax purposes. Also, strategic information such as expenditure on mobile phones, foreign travel, educational expenses at private schools, maintenance of luxury cars and private planes etc. must be collected, despite all agitation from the tax dodgers.

SELF-ASSESSMENT

The basic idea behind self assessment is that instead of calculating the tax liability for each taxpayer, let the taxpayer do it himself. The department can then concentrate its audit capacity on a small number of returns where potential evasion seems to be substantial. If, however, the self assessment system is to succeed, it is vital to institute a deterrent system consisting of early and comprehensive detection of evasion, swift, uncompromising and tough legal action. Without this the self assessment system may collapse.

NEGATIVE ROLE OF TAX OFFICIALS

If the contact between the taxpayer and the tax official is minimised, it could help in reducing the chances of collusion. The self assessment scheme, the withholding and presumptive tax regime, deduction at source and voluntary tax payment are measures which have already reduced the chances of direct contact between the taxpayer and the tax official. This arrangement should continue and may be extended where possible. On no account should the department make any additions to income without documentary proof. Tax officials making arbitrary assessments which are quashed at appellate stage should be penalised. The registration of tax advisors should be restricted and the authority to cancel registration should be exercised more frequently to check malpractices.

TOTAL AUDIT

The big operators in tax pilferage rarely make obvious mistakes. Their's is a carefully concealed evasion. To catch them, total audit so as to trace the hidden capital no matter where and in what form it may exist is essential. Since the number of assesses and the taxed items is so large, the sheer magnitude of data and the complexity of tax laws defy any attempt at comprehensiveness and accuracy. Although it may be desirable to check every return and every item in it, it is simply not possible to do so. There is no doubt that a great number of returns contain inaccuracies but it has to be assumed that these inaccuracies are small and too numerous to be detected economically. The number of returns selected for audit should not exceed the level of expertise available and the department's capacity to investigate effectively.

CONCLUSION

These are only some of the measures which in our estimation are strategic and which need to be pursued vigorously for making tangible progress in reducing tax pilferage. They are, however, by no means, new measures. Only the order of importance of each measure may differ in the minds of its advocates. In the ultimate analysis, however, no matter what techniques are employed and no matter what organisational changes are made, the success or failure of the drive to combat tax pilferage depends primarily on the political will of the Government and the personal ability, integrity, conscientiousness and commitment of the individual tax officers.

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