Chapter-IV : Privatization of Customs in Bangladesh

Bureaucratic tax enforcement has a number of problems of which taxpayer non-compliance leading to tax evasion is the most crucial one. The problem of non-compliance by the taxpayers is complicated by agency-theoretic problems like moral hazard, adverse selection and accountability conspiracy. Of these, accountability conspiracy (Dowding, 1995), which in effect means corruption by tax-officials, is the most widespread of the problems of bureaucratic tax administration in a large number of developing countries[20]. Governments lose large amounts of revenue in leakage because detections made are not reported to the authority and eventually, no action is taken. The authority fails to control corruption due to information asymmetry, as it cannot observe the true behaviour of the tax-officials. The cost of monitoring is prohibitively high.

Hood [1986] suggests that there are three options when faced with tax enforcement problems. First, leave it well alone; second, ensure stringent enforcement with higher penalties for non-compliance; and thirdly, change the enforcement structure through privatization of revenue collection functions. While stricter enforcement has been frequently emphasized in tax evasion as well

20 Admittedly, accountability conspiracy may also be based on nepotism rather than bribery.

as economics of crime-deterrence literature, privatization of tax enforcement is yet to receive any significant attention from the researchers.

However, involvement of private sector in the tax enforcement process is not a novel idea. Unlike modern regimes, ancient rulers depended on and involved the private sector in a substantial way in the tax collection process known as 'tax farming'. Some researchers consider tax farming of ancient Rome as a way of privatizing tax system to overcome the problems of bureaucratic tax enforcement [*vide* Stella, 1992].

Tax farming started as early as 1750 BC in Mesopotamia where country's assembly of elders delegated the task of tax collection to local merchants and bankers [Webber and Wildavsky, 1986]. It appears that, during the pre-Christ period, Romans appointed tax farmers as a reliable and predictable agency of generating revenue. From the point of view of the rulers, tax farming had a number of features that made it advantageous over bureaucratic mode of revenue generation. First, tax farming was a method whereby governments could generate revenue without the need for an elaborate administrative structure. It was a system to minimize the cost of collecting tax revenue by involving the private sector.

Second, with tax farming, government was spared the need for monitoring the tax collection performance. It was a system of agency with guarantees and monitoring devices already built in [Levi, 1988]. Since it was effectively a fixed rent contract, the tax farmers tried hard to maximize revenue collection so that they could make a profit after recouping their investments.

Third, tax farming was a mode of obtaining public loans from the private tax agents. Tax farmers purchased contracts through open auction and government received the fund in advance, prior to actual collection of taxes. So, it implied certainty of the resources available for public expenditure.

Fourth, tax farming maximized generation of revenue. Tax farmers purchased contracts to collect revenue from agricultural income in a given area and for a particular period. Agricultural income was, however, highly unpredictable because of natural factors and cultivators' ever-changing choice of production plan. Tax farmers were influential people in the local community who could motivate the cultivators into choosing a production pattern that would enhance revenue generation.

But is tax farming a practicable way of reforming the revenue generation system today? According to Azabou and Nugent, "where taxes are likely to be difficult to collect (i.e., the transactions costs of their collection are relatively high), the advantage of tax farming or fixed rent methods of collecting the taxes may be rather sufficiently substantial" [1988]. They suggest, ". . . serious consideration by government should be given to the possible use of tax farming contracts in collecting their taxes in other high transaction cost situations" [*ibid*].

However, for a modern government, already equipped with an experienced tax bureaucracy and multiple instruments of public borrowing, the only attraction of tax farming is its promise of overcoming the compliance and enforcement problems. But the promise is rendered less attractive since the modern tax systems are largely based on the principle of 'quasi-voluntary compliance', rather than state's coercive power [Levi, 1988]. Moreover, tax farming is hardly desirable in its original form. It is evident that, in 'tax farming', an indeterminate amount of public revenue was appropriated by the tax collector which is obviously an unacceptable proposition in the modern world. They could retain all of the revenue collected in excess of the rent paid to the rulers. Since appropriation of public fund remains unaccounted for, so 'tax farming' in its original form is inconsistent with the democratic principles and prevalent norms of public spending.

Although tax farming is unsuitable and while tax enforcement largely remains outside the privatization agenda, modern tax systems have gradually involved the private sector in the tax collection process. Modern tax systems have progressed towards greater involvement of the private sector in two major ways: first, the move from official assessment to self-assessment and second, externalization of collection. In the former, the taxpayer himself assesses his tax liability and deposits the amount with the treasury. In the latter, on behalf of government, a corporate body collects taxes from taxpayers that are under its organizational control. That is how tax collection is externalized.

Against the backdrop of such a state of affairs, Bangladesh established an illustrative case in recent times by involving the private sector in a more substantive way in the tax enforcement process. The Bangladesh case shows how the concept of privatization may be applied on a broader scale if *transaction* is considered the unit of analysis instead of organization [Commons, 1934]. Private firms were involved in the collection of customs duties, which is a major source of revenue for the country[21].

The customs department or any of its wings was not abolished but two of its important functions, namely, *identification of taxable activity* and *appraisement* (i.e. determination of taxable value) were privatized. In the contemporary jargon, these two activities were 'franchised' out to the private sector.

The Bangladesh case

Before contracting out and outsourcing became a popular strategy of simultaneously downsizing government and improving its performance under the New Public Management (NPM)

21 The annual tax revenue collection was about Taka 111.9 billion for the fiscal year 1995-96, of which about 40 percent came from customs sources.

movement, Bangladesh privatized government functions as fundamental as revenue collection[22]. It was effectively a non-monopoly franchisee system without the willing firms having to enter into any formal contract with the government. Firms were merely required to be approved by government to enable them to function in relation to imports to Bangladesh[23]. In addition, the government did not have any direct financial obligation to the firms: it is the importers (taxpayers) who paid directly to the firms for the customs services they rendered[24]. In this system, the PSI firms worked as 'agents' of the importers, rather than agents of the government.

Another characteristic of the system is a private-public mix in which the public sector also continued to perform as well as the private firms. The responsibility of the firms so appointed was to examine the import cargo and verify declarations as to the description, quality, quantity and price made in the trade documents at the port of

22 Indonesia pioneered in this way and involved the private sector in the customs process as early as 1985. Other countries with comparable programme include the Philippines, Pakistan, Benin, Cameroon, Peru, Ghana, Côte d'Ivoire, Central African Republic, Mali, Tanzania, Uganda and Zambia. However, such privatization did not occur in pursuance of any privatization programme or under the label of privatization. The main objective was proper tax enforcement and trade facilitation. Bangladesh joined the league in 1992. But the Bangladesh case is altogether different since here, like in Indonesia, the private firms operated independently, effectively as a parallel customs authority in certain areas. Their report on verification of cargo description and value, known as CRF, was acceptable as a legal customs document, in suppression of all other reports or information, for the purpose of assessment of leviable duty.

23 As for example, by a notification No. 8/Cus/97, dated 2.2.1997, Government of Bangladesh authorized *four* private firms namely (a) Bureau Veritas, (b) Inchcape Testing Service, (c) Inspectorate Griffith Limited and (d) Societe General de Surveillance, to work for *one* year as its pre-Shipment Inspection agents. No formal contract was signed.

24 In a similar system, government of Pakistan required the private firms to enter with government into formal contract. It is the government who paid the private firms for their services. Government recouped the money by levying an *ad valorem* service charge at the rate of two percent of the import value.

shipment. In Bangladesh, as also in some other countries, the system came to be simply known as *pre-shipment inspection* (PSI)[25].

It must be emphasized that pre-shipment inspection has been in existence for a long time [de Mowbray, 1988, p.34]. However, the purpose of the new programme was to increase the efficiency of the customs administration by reducing evasion in two ways: first, through establishing better control over import-related transactions effected abroad; and second, by eradicating evasion through corruption by the customs officials by replacing them in crucial areas like 'identification of commodity' and 'appraisement of assessable value'. It appears that the World Bank insisted on the use of PSI programme for controlling overinvoicing that was causing misuse of donor funds [Low, 1995].

Evidence is there that pre-shipment inspection firms had also great potential in preventing customs evasion through underinvoicing and misdeclaration of commodity description. As for example, in Zambia, during the first nine months of 1993, the customs authority collected only 54 percent of all duties as they ignored the PSI reports [Low, 1995, p.112]. Theoretically, too, the PSI firms could be more efficient than the customs officials since, beng stationed at the source of importation, they were not constrained by information asymmetry as is the case often faced by customs officials in ascertaining if there is an attempt at evasion.

An attempt at evasion requires either fake commodity description to qualify for a lower rate of duty, commonly referred to as 'misdeclaration', or under-reporting of unit price and total value, usually known as 'underinvoicing', so that the base of assessment of duty is reduced[26]. This is captured by the following evasion equation [Chowdhury, 1992]:

$$E = (V - v)t + (T - t)v$$

25 However, in Pakistan, it was named Comprehensive Import Supervision Scheme (CISS).

26 Over-invoicing is also resorted to, usually for smuggling foreign currency out of the country. Cost-padding in international procurement often leads to overinvoicing.

Where, **E** = amount of evasion; **V** = actual value of the import consignment; **v** = declared value of the consignment; **T** = legally applicable rate of duty; and finally, **t** = wrongly applied rate of duty. In case of evasion through underinvoicing and misclassification, obviously, **V** > **v** and **T** > **t**.

Away from the place of transaction, stationed at the port of importation, customs officials suffer from information asymmetry and are greatly constrained to reliably verify importers' declaration as to the commodity-description and value of the consignment. Obviously, operating at the place of export, the PSI firms do not face this problem having the direct scope of obtaining information necessary for the verification of importer's trade declarations. So, they could be far more efficient than the customs officials.

In the traditional system, the customs officials carry out physical examination of the cargo, examine auxiliary trade documents and consult literature for ascertaining true commodity description, correct tariff classification and appropriate rate of duty. However, they are constrained in performing the task because of a number of reasons. Since unpacking and re-packing is troublesome and costly, only a small portion of the whole consignment may be physically verified. At the port shed or wharf, packets that are placed in the inner part of a stack largely remain unexamined. For the same reason, it is difficult to verify the contents of full-load containers; consequently only those at the periphery can be examined. Physical examination becomes all the more difficult in absence of technical literature and for want of competent testing facilities.

As to valuation, being away from the export market, customs officials are obliged to depend on the previous record of prices for verifying the price declaration. However, a serious problem arises if there is no comparable price record of contemporary period. Then they undertake appraisement of the consignment in accordance with the appropriate procedure and try to estimate the free market

unbiased price, known as the 'normal value'[27]. In effect, the declared value is frequently *loaded* at the discretion of the appraising official to arrive at the appropriate assessable value. However, a complicated situation arises if the importer insists on acceptance of the declared price claiming it to be genuine despite obvious underinvoicing. The point is, while easy to suspect, it is all very difficult for customs officials to establish underinvoicing.

The problems faced by the customs officials do not usually occur in respect of private firms since, under the PSI programme, not only the private firms replaced the customs authority, but also the customs functions were now being performed right at the market for export. First of all, the consignments can be thoroughly inspected and examined at the pre-shipment stage without much inconvenience. Since it is examined at the exporter's place the problems of accessibility and unpacking do not arise. Secondly, the complex problem of valuation is reduced because of the presence of the PSI firms in the vicinity of the place of transaction. They can ascertain the value by consulting the exporter and in case of doubt, they can readily observe the price trend in the prevailing export market. Thus, under the PSI system, a private tax firm does not, in effect, suffer from incompetence due to information asymmetry. This renders them capable of fighting attempts at underinvoicing and misdeclaration.

The way it started

According to Murray Horn, legislators make a very deliberate choice in setting the boundary between public and private ownership [Horn, 1995, p.134]. However, Bangladesh's decision in 1992 to involve the private sector in the customs process came about without any parliamentary knowledge at all. It was entirely an

27 This is known as the Brussels definition of 'value'. Also, see Section 25 of *Customs Act, 1969* [GOB, 1985].

executive process through which the new regime came into place. Apart from the fact that the Bangladesh case illustrates how weak parliaments are sidelined in policy making, it is interesting to know how the idea developed and was eventually materialized.

While it remains undocumented exactly under what circumstances and under whose initiatives the policy of introducing pre-shipment inspection programme was really instigated as a component of the revenue administration of the country, the formal initiative, however, came from the President of Bangladesh himself. On the 19th March 1990, a letter was sent from the President's secretariat to the Secretary of the Internal Resources Division (IRD), who was also the *ex officio* chairman of the National Board of Revenue (NBR), stating that the President was eager to *implemen*t the 'Proposal to the National Board of Revenue of Bangladesh for an import verification Programme'. It was stated that the proposal should be examined properly and, if necessary, the opinion of the other concerned ministries should be obtained, and concrete proposals in this regard should be sent within 10(ten) days for consideration and *approval* of the President [Alam, 1999].

In this connection it should be noted that engaging private firms in the customs process was also a World Bank condition of ISAC-II credit agreement at the same time[28]. However, it seems that it is one of the PSI companies rather than the World Bank that directly approached the president of the country with the 'Proposal to the National Board of Revenue of Bangladesh for an import verification Programme'. Had it been the World Bank, the proposal would have been received directly by the NBR [Alam, 1999].

28 World Bank has been identified as a mega force behind privatization in developing countries : "... the policy shift of powerful financial and economic forces, such as the World Bank which, for loans to less developed countries, now often requires a privatisation programme whereas it used to look for a five-year plan" [Wiltshire, 1996, p.191].

Instructed by the President, the NBR started working on the Proposal, and prepared a working paper on the issue within a very short time. Having been processed through a chain of bureaucratic formalities, the proposed 'pre-shipment inspection programme' was introduced in Bangladesh through a government notification with effect from 12th of February 1992, albeit on an 'optional' basis. As many as twenty-nine international firms were authorized by the NBR to work as pre-shipment inspection agency almost without any string of regulatory framework. However, for years, the response of the trade community was poor. There was lack of interest among the traders of the country about the new procedure.

It is important to divide the operation of the pre-shipment inspection system in Bangladesh during 1990s into two regimes. During the first regime that stretches over nearly two years since the inception, the new system failed to prove attractive to the importers. The second regime started when, about two years later, NBR took a move to popularize the programme, and the existing Customs Act, 1969 [GOB, 1985] was amended accordingly to give the certification of the PSI firms a legal status[29]. According to the amendment, it was mandatory for the Customs authority of Bangladesh to accept, unconditionally and without question, all certification of the concerned PSI firm, as to the value and commodity description as the basis for the assessing tax liability of the concerned importers. Such certificates are knows as Clean Report of Finding (CRF) meaning that the concerned cargo has been examined and the invoiced price has been internationally verified and no anomaly has been found by the PSI agency.

It was an overriding amendment that stripped the customs department off the authority to scrutinize and accept a PSI certification at its discretion. Under the new regime the customs

29 *Vide* Statutory Regulatory Order (SRO) Notification No. 316 issued by Government of Bangladesh on the 3rd of November 1994.

authority was legally bound to carry out assessment of duty on the basis of CRF, without physical verification of cargo and scrutiny of the declared value. In sum, physical examination and price verification of the cargo was outsourced and the customs authority was merely left to calculate the duty amount.

Thus the programme was established as a parallel customs functionary very much in the Indonesian model of 1985, and almost immediately, it became vastly popular to the importers. By October 1995, the programme covered as much as fifteen percent of imports into the country[30]. Suddenly a section of the importers found the PSI system very useful for their purpose. The focus of this book is on the second regime when the private firms were effectively operating independently as a parallel customs authority.

Modus operandi

No officially produced document is available that comprehensively describes the operation of the system. Cotecna Inspection SA of Switzerland was one of the firms, which was contracted to carry out import verification programme on behalf of the government of Pakistan[31]. According to the contract, Cotecna would carry out comprehensive pre-shipment inspection including physical examination, price verification and tariff classification[32]. Cotecna produced an 'information brochure' which describes the mode of operation of the new system[33]. The Bangladesh system is by and

30 Report of *The Financial Express*, a daily published from Dhaka, dated the 9th November, 1995, quoting NBR officials.

31 Pakistan discontinued the programme (that is, CISS) in early 1997.

32 The tariff classification is known as Harmonized Systems Code or briefly HS Code. This is formulated by the Customs Co-operation Council (now WCO) based at Brussels, and is followed in a large number of countries in the world. For example, the HS Code of Caustic soda is 28.15.

33 The programme is carried out in accordance with the code of practice produced by the International Federation of Inspection Agencies (IFIA).

large similar to the system that was followed in Pakistan described in the Cotecna brochure.

According to this literature, an importer willing to have his import consignment examined by an inspection and survey firm (a PSI agency) will place an 'Inspection Order' with the firm along with the necessary trade documents such as the Letter of Credit and indent or proforma invoice. This will be received by the firm's office at the port of export. On receipt of the inspection order, the port of export office will contact the named exporter at the address provided in the inspection order using a format entitled 'Request For Information' (RFI) asking to supply all the relevant details needed to carry out comprehensive inspection and verification to the inspection firm. Then on a date mutually agreed, the goods are physically examined. An 'Inspection Report' is then produced and endorsed to the exporter. The declared price as shown in the invoice is verified in the light of commodity description reported in the inspection report and within the acceptable limits of the prevailing export market price in the country of supply. If everything is in order, a 'Clean Report of Finding' (CRF) is issued to the importer. The importer submits it to the customs authority of the importing country as a customs document. A CRF is accepted as the basis for assessment of the tax liability without any physical examination of the consignment or any further price verification.

Economics of the PSI programme

The sudden spurt in the popularity of the PSI firms in Bangladesh, as an alternative customs functionary, since late 1994, is intriguing. Compared with the first regime, the new regime clearly promised some *extra benefits* that now enabled it to attract a large section of the imports under the programme away from the bureaucratic system of customs clearance. Clue to the nature and source of such

benefits becomes apparent on examination of the economics of the programme.

The new system had a number of explicit and implicit cost components. First, there was the agency fee around one per cent of the value of the imports[34]. The second cost component was due to the increased paper work and correspondence involved in the whole process of arranging pre-shipment inspection. Over and above, there were a number of implicit trade-reducing costs constituting a welfare loss[35]. As to the benefits, however, the only official promise was the gain in welfare owing to trade facilitation, by way of quicker customs clearance. So, an importer's (net) welfare function was:

$$W_{NET} = W_{TF} - (C + W_{TR})$$

where,

W_{TF} = welfare gain from trade facilitation due to quicker customs clearance;

C = agency fees and costs of additional transactions, and

W_{TR} = welfare loss from trade reduction due to complex modalities of PSI.

A rational importer would have no reason to utilize the service of a PSI firm until $\mathbf{W}_{NET}$ was positive. So, the viability of the system would require the importer's welfare gain from trade-facilitation to

34 There was a minimum fee of US$ 500 that discouraged small value consignments from pre-shipment inspection.

35 It may be noted that the UNCTAD Trade Facilitation Programme had reported that pre-shipment inspection requirements were causing additional costs and delayed shipment of international cargo. Even businesses were frustrated sometimes causing loss of potential income. Then it caused escalation of import costs whereby the import capacity of the importing country was squeezed down. In all, the comprehensive pre-shipment inspection programme was effectively trade reducing rather than trade facilitating in nature. *Vide* "Report of the Working Party on Facilitation of International Trade Procedures", UNECE document No. Trade/WP.4/R.821, dated 14 January 1992.

outweigh the agency fees and costs plus the welfare loss due to trade-reduction. However that was unlikely because **C** was positive and concrete, and, as it turned out, welfare gain resulting from trade facilitation, net of welfare loss on account of trade-reduction, appeared to be rather negative [*vide* footnote-35]. However, granting that trade-reduction was just as much as trade-facilitation, the equation reduces to:

$$W_{NET} = -C$$

With net welfare gain in the negative, there was no reason for a rational importers to part with the traditional bureaucratic system and incline towards the new programme.

But the entire scenario would be changed if the programme allows evasion, contributing additional welfare gain for the importers. If the amount of evasion allowed by the PSI firms is **E**, then, ignoring for the sake of simplicity any share of the PSI firms in it, the welfare function becomes:

$$W_{NET} = (W_{TF} + E) - (W_{TR} + C)$$

Assuming as before that $\mathbf{W}_{TF}$ and $\mathbf{W}_{TR}$ are equal, the equation reduces to:

$$W_{NET} = E - C$$

So, the viability of the private system required that, at a minimum, tax liability be reduced enough through evasion, so as to cover the costs involved for using the private system. The larger the divergence between **E** and **C**, the greater would be the attraction of the private system.

Although the viability of the private system requires that **E > C**, but that it became suddenly popular for a certain class of importers indicates that the **(E – C)** differential, that is, the net gain from evasion, became greater under the private regime than under the bureaucratic regime.

In conclusion, in an optional regime, when the importers were not obliged under law to utilize the private system, the PSI firms could not viably operate without participation in evasion. That they thrived well and became increasingly popular implied that they allowed higher level of evasion, in terms of scale and severity, than what could be secured by the importers in connivance with the customs officials. As a consequence, the extent of evasion was destined to shoot up under the private regime.