

## Chapter - V : Privatization - A Fatal Remedy

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While this is not basically a study of ‘unanticipated consequences of purposive action’ [Merton, 1936], it does, however, examine the mechanism through which Bangladesh’s efforts at privatizing the customs process met with ironical results. According to Sieber [1981], one of the reasons behind unintended outcome of social policy is *overload* which occurs when a key ‘requirement’ is imposed on the target system that remains unsatisfied [p. 73]. Overload is caused and a regressive outcome is precipitated despite correct diagnosis of the problem because the remedy is built upon fallacious presumption.

In the Bangladesh case, it is the fallacy of presuming pre-shipment inspection firms to be incorruptible that engendered catastrophic consequence. As estimated by NBR officials, it cost the public exchequer as much as Taka 5000 million (roughly US\$123 million) in evasion just in two years since 1995<sup>36</sup>. In fact, not only

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<sup>36</sup> Apart from the revenue loss to the government, the impact on the market was uneven. Honest and small importers who did not take advantage of the programme were thrown into a severely non-competitive situation. Similarly, domestic manufacturers also faced a difficult situation. Producers of artificial yarn, table fan, gas lighter, iron nuts and bolts, wood screw, shaving razor, electric lamp and glass sheets approached the NBR for withdrawing these items from the jurisdiction of the PSI programme.

that the PSI firms engaged in malpractice, they outlived the customs officials in that. As it turned out, Bangladesh's decision to privatize part of the tax system in a bid to overcome rampant corruption by the customs officials turned out to be a 'fatal remedy' [Sieber, 1981]<sup>37</sup>.

Perhaps the PSI firms were not essentially corrupt, but they were not incorruptible either. Why would the PSI firms collude with the tax-evading importers? There are at least three plausible reasons to suggest. First, they would have more 'clients' by providing a reliable service that would lessen the tax liability, thereby enhancing profitability. Second, collusion would mean personalized transaction of a nature that would develop a patron-client relationship and prevent client's (that is importer's) switching over to other agencies. Third, they could also have a share in the evaded amount and substantially raise their total income thereby. In this chapter, the unexpected involvement of the PSI firms in corruption leading to higher levels of evasion is analyzed in the light of the framework developed in Chapter III.

#### Severe underinvoicing

In colluding with the importers, the PSI firms appear to have preferred underinvoicing rather than misdeclaration of commodity description as the most suitable means for evasion. During 1996, twenty-six items were identified by the revenue authority as most vulnerable to underinvoicing under the PSI programme. They included among others: Peas, Dun-peas, Cinnamon, Tallow, Cloves, Cardamoms, Cement (Portland), Razor blades, Cumin seed, cigarettes, powdered milk, White cement, Soda ash, Caustic soda,

37 See the cost-benefit analysis carried out before introduction of PSI system in Bangladesh (Annexure-1). None of the benefits indicated therein realized. It was merely an exercise in post-decisional rationalization in order to inject legitimacy.

Portland Cement, PVC compounds, DOP, different kinds of Yarn, Glass sheet, Wood screws, Hack saw blades, Dry cell batteries, Fluorescent tubes, Air coolers, Iron sheet, Card board and various kinds of Paper including Newsprint.

It may be observed, however, that a particular category of items were being imported under the PSI system. These were high-duty products imported in large volume that constituted a sizeable proportion of the country's total import. The concerned importers found the new system convenient for reducing the cost of procurement by avoiding grater part of the tax burden. They were big importers who could presumably afford to fly abroad and negotiate deals with the concerned PSI agency. The demand for tax evasion shot up.

CDSO and CPO<sup>38</sup> are two such items imported regularly in huge quantities every year with very significant revenue contribution. While the prevailing price of CDSO from different origins ranged between US\$ 548 to 582 per metric tonne, as documented by the *Oil World*, PSI firms were certifying invoiced prices like US\$ 414. Similarly, while the prevailing price of CPO ranged between US\$ 530 and 577 per metric tonne, PSI firms were certifying prices as low as US\$ 414 per metric tonne<sup>39</sup>. Given the massive volume of import, this indicated an alarming rate of under-collection of revenue.

According to Bangladesh customs officials, PSI firms were resorting to outrageous rate of underinvoicing that would be inconceivable even for the most corrupt band of officials in the department. This claim is corroborated by the price differential of imports of nine items under the PSI and

38 CDSO is 'crude degummed soyabean oil' and CPO is 'crude palm oil'. These are basic raw material for the edible oil industry.

39 NBR's report to the Finance Minister, dated 19th of February 1997.

non-PSI (that is, the bureaucratic) mode of customs clearance as shown in Table-1<sup>40</sup>.

**Table-1 : Price differential of 'PSI' and normal imports**

Items	PSI Price		Normal customs price		
	Highest	Lowest	1997	1996	1993
Prices are in US \$ per metric tonne unless mentioned otherwise.					
Peas	275	170	400	340	250
Dun-peas	200	170	250	240	250
Cinnamon	1002	425	1500	2200	2600
Cloves	1200	428	2500	3000	3200
Cardamom	1700	825	3800	4200	4500
Tallow	390	200	450	425	370
Cement (Portland)	60	47	63	65	65
Paper(offset)	800	550	950	925	925
Razor blade: price per 100 pieces	1.00	0.75	3.00	n.a.	n.a.

Second-hand (reconditioned) cars imported from Japan are an item in point that would illustrate the extent of revenue loss under the private regime. During the first nine months of 1995, as many as 1,619 cars were imported into Bangladesh through the PSI programme and the total amount of revenue that was collected on account of them was Taka 151.70 million which is Taka 93,700 a car on average. During the same period, 4,150 cars were imported outside the PSI programme and were assessed to duty through the bureaucratic process of examination and appraisal. The amount of revenue collected from these was as high as Taka 767.7 million which is Taka 1,84,987 a car on average. Under-collection of import duties on account of the pre-shipment inspection programme was, on average, as high as Taka 91,287 a car.

<sup>40</sup> According to the knowledgeable customs source in Bangladesh, the differential would be greater because there was also a downward trend in the prices of non-PSI consignments: plummeting of 'PSI prices' helped fall in 'non-PSI prices' as now the 'non-PSI importers' could refer to the PSI prices and claim their lower prices to be authentic.

### Efficiency of the market in corruption

As already noted, it is unrealistic to assume in a pervasive moral hazard situation that private firms will maintain integrity and remain incorruptible merely because they belong to the private sector. However when the revenue system is privatized and private firms replace the tax-officials, the critical question is in which way would the level of corruption be affected? As borne out by the PSI firms in Bangladesh, not only that the private firms will resort to corruption but they will probably outdo the tax-officials at that.

Such an unfortunate outcome will result since the efficiency of the market in corruption will go up and facilitate more corrupt transactions to take place. The market in corruption will be more efficient in a privatized regime because the constraints operating will be now relaxed than under a bureaucratic regime. The constraints are such that they restrict an individual much more than an organization facing an opportunity to engage in corruption. So the supply of corruption will shoot up in response to a rise in the demand for corruption. In effect, a private firm has a greater propensity to participate in corruption than tax bureaucracy. Consequently, the level of corruption will be significantly higher in a privatized regime.

In a more efficient market, not only will corruption be facilitated, but also there will be now built-in incentives towards more corruption. The level of corruption will now be effectively determined by higher levels of both demand and supply. Higher levels of corruption will end up in higher levels of tax evasion. How the corruption market in Bangladesh's customs administration was affected with the introduction of pre-shipment inspection programme may be analyzed in the light of these constraints on efficiency in the corruption-market framework developed in Chapter-III.

### The Problem of accountability management

For the PSI firms, the problem of ‘accountability management’ was reduced relative to individual customs officials not because that they were not accountable for their action, but because accountability could not be enforced in their case due to information asymmetry. For want of knowledge of facts and data, the government was not able to establish its suspicion of malfeasance by the PSI firms.

In relation to appraisalment of the assessable value, the task of the tax-officials was basically judgmental in nature, based on precedence from the past. So, any significant deviation from precedence could be called into question leading to disciplinary action if there was no satisfactory explanation.

On the other hand, verification of the declared value by the private firms was supposed to be based on primary information or even observation of the transaction *per se*. So while, operating in the vicinity of the place of transaction, the PSI firms were in a position to claim their action to be authentic, government was constrained to disprove this claim being away from the place of transaction<sup>41</sup>. In fact, according to the arrangements, information supplied by them was *supposed* to be more authentic than that available to government from any other source. So when there was an offer for collusion, the PSI firms were not constrained like a customs official by the need of an ‘accountability cover’. However, in Bangladesh the situation was worse since, in absence of any meaningful regulatory framework, the PSI firms were not actually obliged to account for their action. Through the amendment of the Customs Act of 1969 [GOB, 1985], as noted in the foregoing chapter, they were actually rendered immune from any official challenge or investigation.

<sup>41</sup> Even in countries where the Government has an Embassy, it is very difficult for the Commercial Counsellor to verify a price.

### The problem of uncertainty

In the bureaucratic regime, there was always the chance that the customs official could turn down the proposal to connive and abort the attempt at evasion entailing a dead-weight loss to the importers on account of the efforts already made. This uncertainty was totally gone in the private regime. With the PSI firms, it was rather a matter of collusion than accountability conspiracy since the importer could negotiate the deal and obtain pre-commitment well before effecting the importation. As is evident from the economics of the situation, the importers would not require their service in substitution of the customs department if the PSI firms declined to authenticate ‘misdeclaration’ or ‘underinvoicing’. In reality, cost-conscious importers would attempt at evasion only if the PSI agency pre-committed to collude.

Under a bureaucratic regime, achieving pre-commitment from tax-officials was cumbersome because of hierarchical and divisionalized structure of the Customs department. As for example, a tax file travels through many desks before assessment is finally done and tax may be deposited<sup>42</sup>. Pre-commitment would require a lengthy chain of negotiation that was simply impracticable.

On the other hand, it became a matter of one-stop-shopping in the private regime. While with bureaucracy negotiation was necessary on case-by-case, under the private regime, the importer just required to register himself for once with the concerned PSI agency as a permanent customer for evasion. In reality, the unscrupulous importers took a flight to the source of importation, negotiated a deal with the PSI agency and opened letter of credit on return<sup>43</sup>.

<sup>42</sup> In Chittagong Custom House, an import clearance application, known as the Bill of Entry, has to travel through more than a dozen of desks, including those of at least six officers.

<sup>43</sup> In this connection it is interesting to note that such deals rewarded only the PSI offices abroad and nothing accrued to their counterpart offices in Bangladesh. So, at one stage, the Bangladesh offices of the PSI agencies approached the National Board of Revenue with the proposal of issuing the CRF from their Dhaka office based on reports received from their office at the source of shipment. It was argued that this would facilitate the PSI process.

### Social costs

For a firm, organizational goodwill is the social cost of engaging in corruption. However, in engaging in corruption, a PSI firm faces the cost not as a commercial firm serving the importers as clients but as an agency serving its principal, the government. A firm may lose future or even present contract if it proves to be unloyal and unreliable.

However, the importance of goodwill will depend on the nature of the market. In a competitive market, organizational goodwill will be more important than in a monopolistic situation.

In operating in Bangladesh, the PSI firms do not appear to have incurred much of any 'social' cost in engaging in corruption. These firms have been in existence in business all over the world for a long period of time. The global market is monopolistic in nature with only a few firms effectively operating since entry-investment is prohibitively high. PSI firms are required to have sizeable offices with expert personnel and testing facilities in a large number of countries and ports of shipment.

Moreover, the total volume of the services as PSI agency in a particular country is not very substantial compared with their total businesses as inspection and survey firm. A Swiss inspection firm SGS operates in 140 countries but in only 30 it serves as a customs-substituting PSI agency. Understandably, business in Bangladesh formed only a very insignificant part of its total turnover.

However, in reality, the fear of social cost was very low since the government was constrained to establish a case of malfeasance and take action against the PSI firms in absence of an adequate regulatory framework. Consequently, neither they lost their contract nor their goodwill was damaged through negative publicity.

This is borne out by the fact that while the PSI regime was causing huge evasion, the news media in Bangladesh held NBR responsible for introducing 'a faulty system' instead of blaming the

PSI firms for their collusion with the importers and helping out in evasion.

### Cost of negotiation

With the private regime, the cost of negotiating a corrupt deal was greatly reduced as proposing and accepting a deal in evasion now looked like a commercial deal to both the parties and no longer posed a moral-psychological problem. In absence of any legal fear, negotiation in evasion lost legitimacy. The problems of secrecy and privacy required for negotiation and transfer of bribe money did not exist anymore. Negotiations took place in the office of the PSI firms. It became as easy as a one-stop shopping. In other words, under the private regime, the market in corruption was more physical than virtual and in effect, the scope of corruption was now institutionalized.

To be true, the importers now faced almost no cost for negotiating a deal in evasion. As the cost of negotiation was reduced almost to nil, the demand for evasion shot up beyond proportions. As a result, more opportunities and greater extent of evasion were discussed and utilized causing substantial rise in the scale and level of evasion, as already shown in Table-1 above.

In this regard it may be noted that escalation in underinvoicing took place in phases, as evidenced by the case of Cardamom. Its invoiced price, certified by the PSI agencies gradually fell from US\$ 4500 per metric to US\$ 825 over a period of only 18 months. This implies that as the legal unchallengeability of the CRFs issued by the PSI agencies became more and more established, the two parties, namely the importer and the PSI agency, dared negotiate for excessive evasion and the result was an outrageous underinvoicing boom. The PSI firms were acting as loyal agents of the unscrupulous importers.

### Discounting future

For the individual tax official future was very important and they discounted future at a low rate. On the contrary, commercial firms discounted future at a much higher rate. The PSI firms were operating on a short-term contract. They could not be sure about the continuation of the contract beyond that period. The situation was actually more uncertain since many governments (like Indonesia) had already discontinued the programme or were in the process of withdrawing it (like Pakistan). Probability of re-nationalization made it only rational for the PSI firms to maximize current income by maximizing gain through evasion.

The rationale was reinforced by the absence of an effective accountability framework that rendered the opportunity cost of current behaviour very low. As it turned out, the PSI firm engaged in profit maximizing behaviour flouting their responsibility as government's agent. The result was involvement in outrageous level of evasion.

However, the high discount rate for future contracts may be attributed to the procedure of appointment of a PSI agency. The bidding process does not disqualify any firm for its track record. So despite blatant failure in performing its role in a fair way and despite proven involvement in tax evasion, there was no blockade in participating in future bids and secure a contract in future by responding to the essential tender conditions.

### A Fatal Remedy

In sum, the impact of the constraints that operate in the market in corruption around revenue administration was much lower on the PSI firms relative to their bureaucratic counterparts, that is, the customs officials. For the importers, there was effectively very little transaction cost other than the share of evasion (bribe or kick-back)

payable to the PSI firms. The market regime facilitated negotiation and perpetration of all sorts of opportunities of evasion and that almost on any scale. The demand for evasion and corruption shot up beyond proportions. Plots of evasion received consideration irrespective of severity and scale.

So when it came to underinvoicing, there seemed to exist almost no bottom line as may be understood from the case of Cardamom already outlined above. According to sources at the Chittagong Customs House, while the international market price was prevailing around US \$ 4500 per metric tonne, a consignment priced US\$ 4541 per metric tonne was authenticated by a PSI agency on 2.3.1995. Only three months later, on 6.6.1995, a consignment priced only US\$ 2415 per metric tonne was authenticated. The story got more shocking: in less than three weeks time, a consignment unbelievably priced at US\$ 1015 only per metric tonne was authenticated. The Customs authorities were aware that at that time the ruling international price of Cardamom was in the range of US\$ 4500 to US\$ 5000. Nevertheless, under the existing law and practice, the customs authority were obliged to accept all these prices as 'genuine' because of PSI certification (CRF) and assess customs duty accordingly.

PSI agencies could reduce evasion of customs duty by stopping underinvoicing attempted by the unscrupulous importers. However, institution of PSI agencies in Bangladesh as parallel customs functionary turned out to be a fatal remedy. PSI agencies helped in evasion much more than that the tax officials could think of.