Short Research Article

Corruption Risks in Differential Taxation on Goods: An Analysis of Impacts on Revenue, Market Distortions, and Governance – Insights from Bhutan Trade Statistics and Case Examples

Abstract:
Differential taxation on goods, while often implemented to achieve social or economic objectives, may inadvertently create opportunities for corruption. This paper examines the inherent vulnerabilities of such systems, exploring the various ways in which they can be exploited for personal gain. With a comprehensive methodology that includes the literature review, real-world case examples, and information analysis from various sources, the paper aims to provide a nuanced understanding of the corruption risks inherent in tax systems characterized by varying rates on different goods. The paper concludes by proposing measures to mitigate these risks offering valuable insights for policymakers and practitioners.

Keywords: Corruption; differential taxation; goods; case examples; mitigation measures

Introduction

Differential tax rates refer to the practice of applying different tax rates to different goods based on their nature, classification, or other criteria. This approach is often adopted to shape consumer behavior, encourage certain industries, or discourage practices that may have negative social or environmental impacts. For instance, higher taxes on products like tobacco or alcohol aim to reduce consumption for health reasons, while lower taxes on green technologies might encourage their adoption for environmental benefits.

Taxation is the backbone of any economy, providing the necessary funds for the government. However, differential tax rates on goods, both within the country and between the neighboring countries, can create opportunities for corruption due to the potential for tax evasion, smuggling, deflection of goods, and money laundering. When there are varying tax rates for different goods, it incentivizes individuals or businesses to exploit the differences for their benefit. This can result in a loss of tax revenue for the government, as well as distortions in the market and unfair competition for businesses. In addition, corruption in tax collection undermines the effectiveness of the tax system and erodes public trust. In this paper, we will delve into the issues of corruption risks associated with the differential tax rates on goods with an analysis of the literature review, case examples from around the world, information collected from various sources, and Bhutan Trade Statistics.

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Literature Review

Existing research has identified several key areas where corruption risks can manifest in differential taxation systems. Discretionary powers granted to tax officials, such as classifying goods or determining exemptions, offer opportunities for corruption. Additionally, loopholes in regulations and systems can be manipulated for private benefit. Studies have also explored the role of political influence and vested interests in shaping differential taxation policies, potentially skewing them toward certain groups or industries.

The historical context plays a fundamental role in understanding the complexities surrounding corruption risks in differential taxation on goods. One of the earliest instances of differentiated taxation can be traced back to ancient Rome. The Roman Empire implemented a complex system of taxation on goods, with various rates and exemptions depending on their nature. However, as power was centralized, corruption and bribery seeped into the administration of taxes, leading to widespread malpractice. Adam Smith, the renowned Scottish economist, provided profound insights into the implications of differential taxation. His seminal work, "The Wealth of Nations," published in 1776, emphasizes the importance of a fair and transparent tax system to uphold the principles of justice. Smith argued that levying different tax rates on goods could lead to distorted market incentives and create opportunities for corruption. Economists such as Joseph Stiglitz brought further attention to the corruption risks associated with differential taxation. Stiglitz's work on information asymmetry and market failures shed light on the potential for rent-seeking behavior and corruption in tax systems that do not treat goods equally. Keen and Lockwood (2010) discuss how tax differentiation is often employed to correct market failures or promote socially beneficial behaviors. Studies on regulatory capture, such as those by Stigler (1971) and Shleifer and Vishny (1994), emphasize the risk of interest groups influencing regulations for their benefit. In the context of taxation, regulatory capture can manifest when industries lobby for favorable tax differentials, creating opportunities for corruption. Mauro (1995) explores the relationship between corruption and the size of the informal economy, revealing how corruption tends to be more prevalent in economies where the informal sector is substantial.

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Case Examples

Differential taxation on goods can have significant impacts on revenue generation for governments. High tax rates on certain goods may incentivize tax evasion and smuggling, leading to revenue leakages through corrupt practices as highlighted in the case examples below:

India: Differential tax rates on certain commodities like tobacco and alcohol have contributed to the growth of illegal trade and tax evasion, resulting in substantial revenue losses (Mangu, 2017). Another example is the widespread practice of "pan masala" taxation in India. This product, often consumed for its psychoactive properties, was subject to varying tax rates depending on its classification. However, the ambiguity around these classifications led to corruption, with officials able to manipulate them to extract bribes from producers and traders (Khan et al., 2003).

China: The case of China's Value-Added Tax system illustrates how differential taxation can be manipulated. The complex VAT structure allowed for fraudulent invoicing and false reporting, leading to tax evasion and corruption (Wei, 2017).

European Union: The European Union's experience with VAT fraud highlights the challenges associated with differential taxation across member states. The EU faced issues of carousel fraud, where goods were repeatedly traded to exploit tax differentials, resulting in significant revenue losses (Gibbs et al., 2012).

Brazil: Differential tax rates on fuel were linked to environmental concerns. However, loopholes in the system allowed for importing cheaper, environmentally damaging fuel that was misclassified as cleaner, creating financial benefits for specific players through corruption (Silva et al., 2012).

Kenya: Preferential tax treatment for imported agricultural equipment was intended to boost the sector. However, lax oversight and inadequate verification mechanisms enabled importers to misclassify non-agricultural equipment as agricultural, leading to significant revenue losses and enriching individuals through tax evasion (Waithaka, 2010).

To combat revenue leakages, governments need to ensure transparency and accountability in the tax system. Implementing effective tracking mechanisms and employing modern technological solutions such as e-filing and data analytics can help minimize corruption risks associated with differential taxation (OECD, 2019). And harmonizing tax rates and exemptions across different

sectors can help minimize distortions caused by differential taxation (Rouillon & Zhang, 2018). Further, robust oversight mechanisms, such as independent auditing bodies and anti-corruption agencies, can help deter corruption and ensure accountability (Kaufmann & Vicente, 2011). Investing in the professional development of tax officials and increasing their remuneration can also reduce the incentives for corrupt practices.

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Methods

This paper's methodology takes a thorough, multi-method approach to examining the connection between the use of differential taxation on goods and corruption. The paper combines both qualitative and quantitative analysis by referencing case examples, material analyzed from a variety of sources, existing literature, and statistical measures to provide a thorough understanding of the topic.

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Results and Discussion

Differential tax rates can inadvertently create loopholes or opportunities for exploitation. As such, corruption risks often stem from the potential for misuse or manipulation, misuse of power by public officials in the implementation, and unequal treatment. Accordingly, some of the issues and challenges are discussed below.

Fraudulent import and deflection of goods

The deflection of goods, also known as trade diversion, occurs when goods are imported into a country through a third country to avoid higher taxes or tariffs. This is a common practice in countries with high tax rates, where individuals and businesses seek to reduce their tax burden by importing goods through a neighboring country with lower tax rates. The deflection of goods not only deprives the importing country of tax revenue but also distorts the market and creates unfair competition for businesses. For example, in Table 1 below, Bhutan has imported smartphones (top ten imports in 2022) worth Nu. 1.93 billion which is a zero-tax item in Bhutan. A review by the Economic and Finance Committee (EFC) of the National Assembly of Bhutan found that while mobile phones worth billions are being imported into Bhutan a large chunk of it, particularly iPhones, is suspected to be deflected to India (Lamsang, 2022). This is because the GST (Goods and Services Tax) rate on mobile phones in India is currently 18%. So, it is suspected that Indian businesses operating in border town Jaigoan, working with their Bhutanese counterparts, have profited from the 18% tax differential between Bhutan and India. As per the findings of EFC, Bhutan imported 122,136 mobile phones from June 2021- June 2022, and there was a huge mismatch between the number of phones imported and those recorded as currently being used in Bhutan (Rabten, 2022). It is also suspected that the deflection of iPhones to the border town Jaigoan was used to convert the Bhutanese currency held in Jaigoan to INR which is money laundering. Due to the importation of iPhones from countries other than India, it has had an impact on the Bhutanese economy in two ways: first, it has led to the depletion of foreign reserves, and second, it may have established fronting businesses in Bhutan.

Figure 1 shows the import of mobile phones (in value) from countries other than India (COTI) from 2018 to 2022. There is a sudden upsurge in imports from 2020 (11,846.90% increase from 2019 to 2020). It is mainly iPhones because other brands like Samsung are cheaper in India than in other countries. As per the data from the Department of Trade (from 2020 to 2022), 60 business licenses related to mobile phones were issued in Thimphu alone out of which some are exclusively for iPhones. So, looking at the drastic increase in the import of mobile phones vis a vis the number of users (especially iPhone users considering its affordability) and as per the review of the EFC, it is suspected that the deflection of iPhones to India might have happened. GST in India was implemented on 01 July 2017.

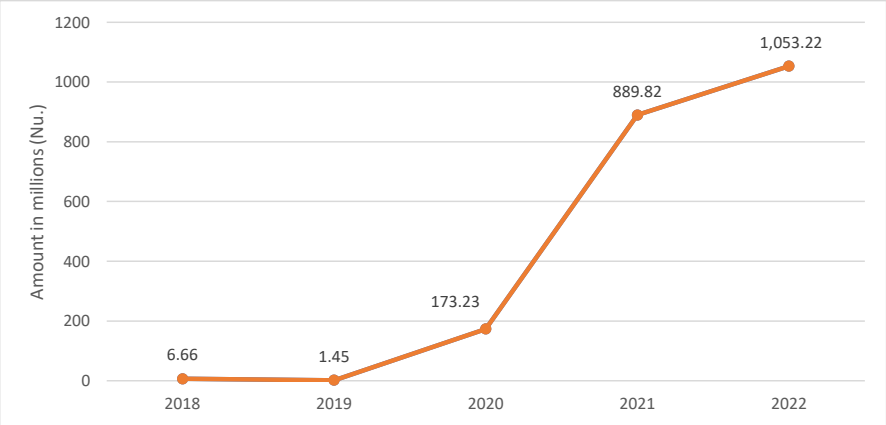

Figure 1. Import of mobile phones (BTC Code 8715.12.00, 8715.13.00 & 8715.14.00) from countries other than India (COTI) from 2018 to 2022 (*Source: Bhutan Trade Statistics)*

In one instance, as per the news covered by BBS on 29 August 2012, the Revenue and Customs office in Phuentsholing had confiscated a consignment worth about Nu. 2,60,000.00 from an Indian merchant who was trying to deflect the consignment to Jaigaon from Bhutan. The consignment was 191 boxes of grocery items like butter and noodles.

The Anti-Corruption Commission (ACC) of Bhutan in its annual report 2015 has also pointed out that from 2011 to 2015 there was a sudden upsurge in the import of zero-tax commodities like Rice, Maida (flour), and Sugar (ACC, 2015). It strongly indicated that zero-tax commodities in Bhutan were used as the means to obtain INR through fake imports by the businesses engaged in fronting. The commodities were either deflected across the border or were not imported at all. The ACC, while looking into the deflection of third-country imports and deflection of zero-tax items, has reportedly found that more than INR 1.4 billion (B) were repatriated through potential fake imports of zero-tax food items and construction materials over three years (Wangchuk, 2015). The ACC also stated that fronting businesses engendered a breeding ground for many fraudulent and corrupt activities. The common ones are commercial bribery, bribery of public officials, deflection of goods across the border, forgery of invoices and Customs Declaration Forms, and trade-based money laundering.

Figure 2 below shows the country's rice imports trend from 2015 to 2022. After the ACC investigated fronting businesses in Phuentsholing in 2015, the rice imports from 2016 to 2019 decreased, indicating that fake imports were controlled. However, with the onset of the COVID-19 pandemic in 2020, rice imports have spiked again, possibly due to stockpiling for emergency supplies. As shown in Table 1, rice is one of the top 10 imported commodities in 2022.

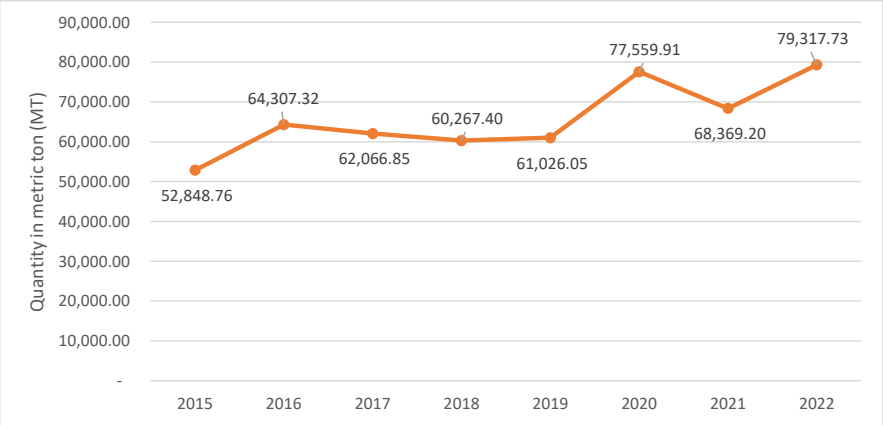

Figure 2. Quantity of Rice (BTC Code 1006.30.00) imported into the country from India (*Source: Bhutan Trade Statistics)*

Similarly, in the Special Audit Report on the Import and Distribution of LPG and superior kerosene oil (SKO) in the Country dated 2015, the Royal Audit Authority of Bhutan stated that, from 2008 to 2013, SKO worth Nu. 230.21 million were deflected to Indian border towns by Bhutanese individuals. Table 1 below shows the top 10 commodities imported into the country in 2022.

Table 1. Top 10 commodities – imported in 2022 (*Source: Bhutan Trade Statistics 2022*)

Sl. No.	Commodity description	Value in Nu.
1	Processing units other than those of subheading	11,909,703,712
2	Other light oils and preparations (HSD)	8,735,335,769
3	Coke and semi-coke	4,098,394,982
4	Other (Wood Charcoal)	3,479,086,318
5	Motor spirit (gasolene) including aviation spirit (petrol)	2,638,271,490
6	Semi-milled or wholly milled rice, whether or not polished or glazed	2,608,429,111
7	Ferrous products obtained by direct reduction of iron ore	2,488,000,887
8	Smartphones	1,933,943,946
9	Other (Soya bean oil)	1,597,380,611
19	Cigarettes containing tobacco	1,470,011,555

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Underreporting or Misreporting

Businesses might underreport the value or quantity of goods to pay lower taxes. They might also misclassify goods to take advantage of lower tax rates, leading to revenue losses for the government. For example, as shown in Figure 3, it indicates that tax evasion might have taken place through the misclassification of imports from higher-taxed tobacco commodities (100% tax) to lower-taxed pan masala (10% tax), in addition to underreporting the value of imports. During the Covid-19 pandemic, since the ban on Tobacco import in the country was lifted in July 2021 and the tax was reduced to zero percent, there have been more tobacco imports than pan masala indicating that pan masala might have been misclassified as tobacco or underreported. After the 100% tax on tobacco products in the country was reinstated after the Covid-19 pandemic in November 2022, there is more import of pan masala than tobacco which indicates that tobacco is

misclassified as pan masala to pay lower tax. It is reasonable to assume that this type of misclassification is easier for similar products.

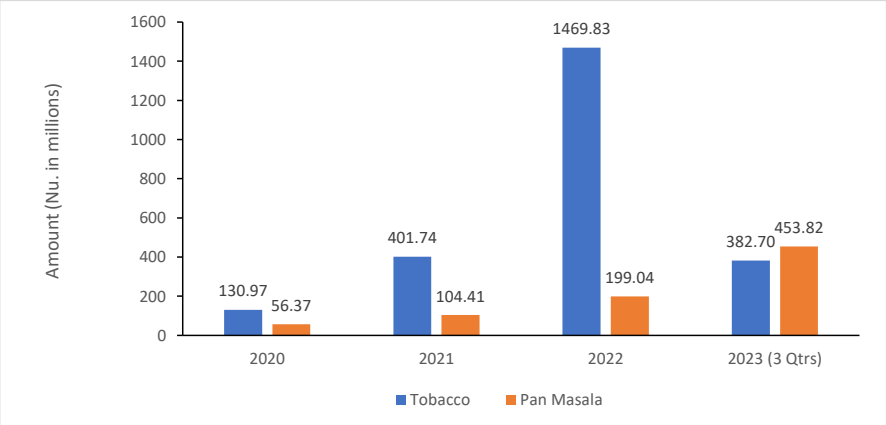

Figure 3: Tobacco and Pan Masala (BTC Code 2402.20.00 & 2106.10.10) imported into the country from India (*Source: Bhutan Trade Statistics)*

Likewise the import of betel leaves and betel nuts in 2022 when compared, the quantity of betel leaves (1,194,952 KGM) which has a 10% tax is much higher than the quantity of betel nuts (47,500 KGM) which has a 50% tax. The betel leaves and betel nuts are consumed together, and their quantities should have been about the same, therefore, there is every possibility that betel nuts are either misclassified as betel leaves or their quantity is underreported for tax evasion.

Mitigation Strategies

Addressing the corruption risks associated with differential taxation requires a multi-pronged approach as given below:

Transparency and standardization: Standardized processes and transparent, publicly accessible rules and guidelines for classification, exemptions, and assessments can decrease discretionary power and boost accountability.

Technology and automation: Procedures can be made more efficient and manipulation chances can be decreased by using technology to automate tasks and minimize human interventions. Analyzing trade statistics is also possible to identify irregularities in trade activities.

Strengthening law enforcement: Tax authorities must enhance their law enforcement functions and also collaborate with other law enforcement agencies in monitoring illegal trade activities.

Public awareness and engagement: Educating the public about differential taxation systems and potential risks can foster vigilance and strengthen community oversight.

Conclusion

In conclusion, goods tax differences within the country and between two countries significantly impact the deflection of goods, money laundering, and corruption. The analysis of Bhutan Trade Statistics, case examples, and literature review show how these differences create an incentive for

individuals and businesses to engage in illicit or corrupt activities, resulting in a loss of tax revenue, distortion of the market, and hindrance to economic growth. Therefore, the government needs to address these discrepancies in tax rates, strengthen enforcement mechanisms and tax collection systems, and work towards tax cooperation with neighboring countries to combat these issues effectively.

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