"They are a tax fearing people": Deterrent Effect – Penalties, Audit and Corruption in a Developing Country

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Abstract

A critical part of a country's tax revenue base is taxpayer compliance, which can be acute for developing nations as they attempt to establish a tax system, including the tax mix and enforcement agencies. Allingham and Sandmo (1972) model of tax compliance predicts that if detection is likely and penalties are severe, people will be more compliant. Non-compliance decisions have been found to be indirectly related to the threat of penalties; larger fines are a more effective deterrent than are frequent audits (Friedland, Maital, & Rutenberg, 1978). However, empirically the deterrent effect of the enforcement factors appears to be questionable. Some studies even suggest that an increase of penalties can have unintended undesirable effects, resulting in more tax evasion (Andreoni et al., 1998; Fischer, Warwick, & Mark, 1992; Frey, 2003). The fiscal psychology approach combines both the economic deterrence and the social psychology approaches, and views tax enforcement as a behavioural problem, one that can be resolved by co-operation between taxpayers and tax collectors (Loo, McKerchar, & Hansford, 2009). The more positive the taxpayer's attitude towards paying tax is, the greater the level of co-operation with the tax authority and the greater the willingness to pay tax.

The mixed evidence about the deterrence effect has been attributed to such things as penalties for non-compliance being too low (Polinsky & Shavell, 1988, 1989), or corruption undermining the enforcement system (IFC, 2008). Given the importance of a value added tax (VAT) as part of the tax mix for developing nations, this study explores to what extent are deterrent effects effective to improve compliance with VAT Law in a developing country. This paper will report the findings from focus groups and a survey of 240 small and medium businesses (SME) in Bangladesh with participants identified with a compliant or non-compliant history.

The results indicate that there is greater potential for deterrent effect SME taxpayers who have a compliant history compared to non-compliant taxpayers. These results are consistent over a number of measures of deterrence, including the likelihood of audits and penalties; and the promotion of successful audit prosecutions. Part of the reason for the reduced

deterrence for non-compliant SME taxpayers appears to be related to the potential corruption of Tax Officers with audits, as officers can be 'managed' through bribes. Also, there was a perception of corruption at a number of levels including the government and 'big business' which influenced compliance behaviour. The results suggest that the reduction of corruption could have a positive impact on the compliance behaviour of both compliant and (importantly) non-compliant SME taxpayers. These findings of this research are important as they demonstrate that in a developing country, such as Bangladesh, for a deterrent effect through audits and penalties to lead to greater compliance it is essential that corruption within the system be addressed. Otherwise, the 'fear' of audits and penalties will not be effective in improving tax compliance and thereby the revenue collected. Without this tax revenue base government spending for development will be restricted

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1. Introduction

While the specific reasons for adopting a Value Added Tax (VAT) may differ from one country to another, the main argument is that a properly designed VAT raises more revenue than other broad-based taxes. Keen and Lockwood (2006) have demonstrated that VAT raised about 18 trillion USD in 2007, representing 20 percent of the world's tax revenue and affecting approximately 4 billion people. Senior economists of the International Monetary Fund (IMF) regard VAT as 'probably the most important tax development in the latter part of the twentieth century' (IMF, 2011). For developing nations the introduction of a broad-based consumption tax like a VAT is seen by supranational organisations such as the Organisation for Economic Cooperation and Development (OECD) and the World Bank as being a critical element in providing a sufficient tax revenue base for public spending by governments (Bird, 2013).

Compliance issues for small and medium enterprises (SME) are particularly important for developing and transition economies, as they typically account for more than 95% of all firms outside the primary agriculture sector; constituting a major source of employment and generating significant domestic and export earnings (Smulders, Stiglingh, Franzsen, & Fletcher 2012; OECD, 2015). For developing economies such as Bangladesh, improving tax compliance for SMEs can contribute to the economic and social development (World Bank Group (WBG), 2005).

Policy makers around the world see VAT as a useful tool to collect at least some taxes from SMEs (IFC, 2007). However, the VAT collected can be adversely affected by non-compliance and evasion. In the United Kingdom (UK), VAT revenue losses through evasion increased sharply in 2005-06, reaching £12.4 billion, 14% of potential VAT revenue (Smith, 2007). In Italy the size of VAT evasion in 1977 was estimated to be as high as 40% of VAT revenue (OECD, 2007).

Developing and underdeveloped countries are also losing substantial tax revenues due to intentional tax non-compliance or tax evasion. A study by the Global Financial Integrity demonstrates that, due to tax evasion and corruption, India has lost USD 213 billion in the period 1948-2008 due to tax evasion and corruption, which is almost 18% of India's 2008 GDP (KPMG, 2011). Bangladesh is no exception, as Transparency International Bangladesh (TIB) estimated that an amount of BDT 210 billion (USD 2.8 Billion) in taxes was evaded or defalcated in the 2009-10 financial year (FY). This represents 2.8% of Bangladesh's national income, which is equivalent to one-third of tax revenues collected during that year. The TIB noted that the NBR would have collected 34% more revenue if this evasion had not

occurred. TIB also identified tax evasion as a major reason for the country's poor tax to GDP ratio. The problem of taxpayer non-compliance is seen to be much more severe in developing countries (Andreoni, Erard, & Feinstein, 1998), where there may be an absence of tax culture, a large informal sector, corruption of tax officials and a lack of effective enforcement and monitoring of the tax enforcing agencies.

Also, in Bangladesh, SMEs appear to be under-represented in terms of their registration for VAT and their contribution to the VAT revenue collected. This is despite the introduction of various policy and administrative measures to encourage SMEs to register for VAT (Faridy et al., 2014; Centre for Policy Dialogue, 2014).

For VAT to be effective in assisting a developing nation there needs to be, apparent from other things, effective compliance. However, our understanding of VAT compliance in developing nations, in particular deterrence, is scant. As a developing nation Bangladesh has had a VAT for over 24 years and it has contributed on average some 37% to total tax revenue over the last 15 years (Saleheen, 2012; National Board of Revenue, 2014). Despite this many SME[1] taxpayers do not comply with the VAT legislation, not only failing to register for VAT but also failing to pay the VAT (Faridy et al., 2014; The Centre for Policy Dialogue, 2014).

Saleheen, (2013c) has conjectured that SME non-compliance could be due to ineffective or under-enforcement of the VAT legislation by the Bangladeshi tax authorities (Saleheen, 2013c). Indeed, Allingham and Sandmo (1972) model of tax compliance predicts that if detection is likely and penalties are severe, people will be more compliant. Non-compliance decisions have been found to be indirectly related to the threat of penalties; larger fines are a more effective deterrent than are frequent audits (Friedland, Maital & Rutenberg, 1978). Some studies even suggest that an increase of penalties can have unintended undesirable effects, resulting in more tax evasion (Andreoni et al., 1998; Fischer, Warwick, & Mark, 1992; Frey, 2003). The mixed evidence about the deterrence effect has been attributed to such things as penalties for non-compliance being too low (Polinsky & Shavell, 1988, 1989), or corruption undermining the enforcement system (IFC, 2008). Indeed, it appears that corruption does exist in Bangladesh and adds to the VAT compliance costs, with bribe (speed payments) accounting for approximately 10% of compliance cost for SMEs (Faridy et al., 2014).

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[1] Using the measures adopted by the NBR (the administrating body for VAT in Bangladesh) an SME is an enterprise with an annual turnover equal or greater than 8 million BDT (0.11 million USD), but with an annual VAT payment less than 50 million BDT (0.67 million USD). Note 8 million BDT is the VAT registration threshold, and the 50 million BDT and greater is used by the NBR to signify large taxpayers.

This paper seeks to address the current research gap about the deterrence effects of government enforcement activities in developing countries. In doing this, the study considers and compares the perceptions of compliant and non-compliant SME taxpayers in Bangladesh. In particular this article considers to what extent are the deterrent measures effective to ensure compliance with VAT Law in Bangladesh. The findings highlight that for compliant taxpayers the deterrent effect of penalties and audits appear to increase compliance, whereas non-compliant taxpayers reported that they are unlikely to reduce their non-compliance with the VAT legislation.

The reminder of the paper is organised as follows. The next section provides an overview of VAT in Bangladesh. Section three briefly reviews the literature regarding the non-compliance theories including economic deterrence models, social psychology models. This discussion is then followed by the outline of the methods used in this study comprising of focus groups and a survey. Next the findings of the study for both methods are provided. The subsequent section provides a general discussion of the overall findings. The final section concludes the paper and provides suggestions for future research.

2. Overview of VAT in Bangladesh

Since being introduced in Blangadesh in 1991, the VAT has become the largest source of revenue for the Bangladesh government ranging from between 32% to 39%: Table 1. However, the tax/ Gross Domestic Product (GDP) ratio is very low in Bangladesh compared with other developing nations. Table 2 illustrates that for Bangladesh, the tax/GDP ratio was less than 10% in Bangladesh in 2005-06, and 11% in 2011-12 (Bangladesh Economic Review, 2012). In comparison, in 2005, the average tax/GDP ratio in the developed world was approximately 35%. In developing countries it was 15%, and in the poorest of these countries (the low income countries) tax revenue was 12% of GDP (Fuest & Riedel, 2009). This low percentage is of concern as Nicholas Kaldor (1963) argue that for a country to be considered 'developed' and moving away from a 'developing' status, collected taxes need to account for 25% to 30% of GDP (cited in Bird, 2013, p.3).

Table 1: Contribution of the different taxes as percentage of Total Tax Revenue

Financial Years	Income Tax (%)	VAT (%)	Customs Duty (%)	SD (%)	Excise Duty (%)	Others Taxes (%)	Total (%)
2000-01	18.70	33.90	26.94	18.12	1.47	0.87	100
2001-02	19.80	33.33	25.60	18.57	1.40	1.30	100
2002-03	20.21	33.61	24.47	18.48	1.30	1.93	100
2003-04	19.51	31.70	26.98	20.07	0.62	1.12	100
2004-05	19.18	34.77	26.22	18.36	0.49	1.37	100
2005-06	20.23	35.48	23.90	18.55	0.47	1.37	100
2006-07	23.86	36.50	22.08	16.26	0.49	0.81	100
2007-08	23.47	37.00	20.23	17.33	0.46	1.51	100
2008-09	25.54	37.95	18.02	17.20	0.55	0.74	100
2009-10	27.59	38.84	15.13	17.22	0.56	0.66	100
2010-11	28.89	37.78	14.44	17.08	0.61	0.52	100
2011-12	29.92	37.54	14.12	17.72	0.70	0.53	100
2012-13	31.44	36.13	12.92	17.78	0.88	0.85	100
2013-14	35.49	36.75	10.75	15.32	0.96	0.73	100

Source: Bangladesh Economic Review (2014), Note: SD = Supplementary Duty. The Financial Year in Bangladesh commences from 1st July each year and ends at 30th June of the following year.

The IMF (2013) credits this relatively low revenue to GDP ratio due to inherent weakness in Bangladesh's taxation system, which could be attributed to weaknesses in tax policy as well as revenue administration (Bird and Zolt, 2008). Also, Keen (2007) argues that citizens and businesses are discouraged to comply with tax obligations due to the absence of a well-designed tax system, the large informal business sector and the corrupt tax administration.

Table 2: Bangladesh's Tax Revenue as a % of GDP

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15 Projections
Total Revenue	10.9	11.7	12.4	13.2	13.6	14.2
Tax Revenue	9.0	10.0	10.4	10.9	11.3	12.2
NBR Tax Collection	8.5	9.6	10.0	10.5	10.7	11.8
Of which: *VAT and SD*	4.9	5.4	5.5	5.5	5.6	6.4
Customs and Excise Duties	1.3	1.4	1.4	1.5	1.4	1.5
Taxes on income and profit	2.3	2.8	3.1	3.5	3.7	3.9

Source: NBR (2014)

It has been estimated that in terms of VAT productivity, for each point of the standard VAT rate, Bangladesh generates only 0.22 percent of GDP in revenue compared to 0.34 percent of GDP in other low income countries (IMF, 2011). If Bangladesh could raise its VAT productivity by 0.12 percent of GDP to the average level of other low income countries, then with everything being equal, VAT could increase government revenues by 1.8 percent of GDP (NBR, 2014). It is estimated that the informal economy in Bangladesh accounts for approximately 39% of GDP (TIB, 2012), which can have a negative impact on the macroeconomic stability (Heintz, 2012; Shome, 2004).

This low VAT collection may be due to a lack of effective monitoring or enforcement on the part of authorities (Kirchler, 2007) such as the National Board of Revenue (NBR), which responsibilities include tax collection, administration and policy design.[2] In economic terms, any lack of effective monitoring or enforcement on the NBR's part could imply that the expected costs to the NBR of better monitoring and better enforcement of the VAT Law exceed the perceived benefits,[3] including those arising from any deterrent effects that enhanced monitoring and enforcement might have on taxpayers. In this context, deterrent effects arise if VAT taxpayers generally comply more with the VAT Law because they see other (typically high profile) taxpayers being successfully prosecuted or penalised for non-compliance, and are thereby themselves deterred from non-compliance (Polinski & Shavell, 1998, 1999; Posner, 2000; Palmer, 1977; Benson, Kim, & Rasmussen, 1994).

Since the NBR is government-funded, the costs of enhanced monitoring and enforcement is ultimately borne by all Bangladeshi taxpayers and any public financiers such as the World Bank, the Asian Development Bank (ADB), the Islamic Development Bank (IDB), or the Japan International Cooperation Agency (JICA). While government-funded taxpayer audits may go some way toward discouraging taxpayer non-compliance (Weck-Hannemann & Pommerehne, 1996), it may be administratively more efficient for the NBR to seek to discourage intentional non-compliance through increased penalties for non-compliance or other measures.

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[2] Under section 2 of the *VAT Law*, the NBR has a legal duty to monitor and investigate taxpayer activities in respect to VAT, and enforce the legislation.

[3] Some data also suggest considerable inefficiencies in the administration of the Bangladeshi VAT. For example, there are over 18,000 pending court cases related to VAT and Customs in the Bangladeshi High Court, representing – according to the taxation authorities – about 30 billion taka in potential VAT collections outstanding (Mustafiz, 2012). Having said this, any investigation into the efficiency or otherwise of the administration of the Bangladeshi VAT is beyond the scope of this thesis.

2.1 VAT rate

To appreciate the potential deterrence effect, it is useful to have a broad understanding of Bangladesh's VAT, and its penalty and audit system.

Although the standard statutory rate is 15%, the Bangladeshi VAT also has exemptions and zero-rating (Bickely, 2003).[4] However, the reality is that there are some other rates in practice (4%, 4.5%, 5%, and 9%) that have emerged due to different methods of calculation[5] of the VAT (GOB, 2013). For example, for those firms at the wholesale and retail levels which do not declare any input tax credits, a deemed 4% VAT is imposed on the total value of the goods or services sold in lieu of the standard 15% VAT. This is known as the 'trade VAT'. In addition, small business 'consumers' (that is, purchasers) at the wholesale and retail level pay a fixed annual dollar amount of VAT,[6] known as 'package VAT', based on the geographic location of their business.

Another variation is that, for some taxable products listed in the NBR's 'special regulatory orders', if the NBR determines that market prices have increased too much, the NBR can determine and set a lower so-called 'tariff value' so that relevant market prices (and the VAT payable) are artificially reduced (Saleheen, 2012).[7] Furthermore, VAT is generally imposed on the invoiced price; where invoices are unavailable, a so-called 'fixed value addition' on a

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[4] Zero rating means that the goods and services are taxable but the rate of VAT applied to them is 0%. Khadka (2003) states that when some goods and services are required to be kept completely free from VAT, then zero-rated tax should be applied. For example, a rate of 0% applies to all goods and services to be exported and deemed 'exported' from the country.

[5] Though in the standard practices of VAT, the amount of VAT is calculated by applying the VAT rate to the difference between sales and purchases, the Bangladesh VAT contains a number of assessment methods applicable to different groups of businesses. Section 5 of the VAT Act stipulates methods of valuation for the purpose of determining the amount of VAT charged at different stages of business transaction. At the importation stage, the value on which VAT is charged is the value which is arrived at by adding all duties and charges to the assessable value ascertained/ determined under section 25 or 25a of the *Customs Act, 1969.*

[6] Again, subject to the 'cottage industry' exception discussed below.

[7] Products in this category include powdered milk, refined soybean oil, machine-made biscuits, tomato paste, fruit juice, hand-made cigarettes, liquefied petroleum gas, petroleum bitumen imported in bulk (primarily for road building), various types of paper, bricks, cold-rolled corrugated iron sheeting, mild steel products produced from re-roll able scrap metal, and electrical transformers. Businesses which pay VAT on the basis of this tariff value are not entitled to claim input tax credits. Saleheen (2012) points out that, under the same legislative provisions, the NBR also has the power to determine and set a higher tariff value if it considers that market prices have fallen too much, so that the VAT payable is artificially increased for some taxpayers.

'truncated base'[8] is used to assess the appropriate VAT. One of the greatest deviations from the standard practice is the value declaration of Bangladesh VAT system.[9]

2.2 Offences and Penalties

There are a number of offences and penalties for persons failing to comply with the VAT law,[10] including failing to register or to submit a VAT return by the specified time; failing to inform a VAT officer about any change of information in relation to registration. The penalties for breaching these range from 10,000 BDT (133 USD) to a maximum penalty of 25,000 BDT (333 USD). Any taxpayer who, after two written notifications from their local NBR branch office, unintentionally fails to give a tax invoice in a timely way, or who fails to pay VAT or supplementary duty on goods or services supplied, is liable to pay a minimum penalty of 10,000 BDT (133 USD) and a maximum penalty of 100,000 BDT (1,333 USD) for their failure to comply.

In contrast, any taxpayer who intentionally provides a fake invoice or submits a VAT return that is false in important respects is liable to pay, as a minimum penalty, the amount of the tax evaded; and, as a maximum penalty, 2.5 times the amount of VAT that should have been paid. Most occurrences of intentional non-compliance include attempting to evade VAT by supplying goods without recording information in current-account books (*Mushak-18*)[11] or in

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[8] Truncated value is a notional value based on value addition. This is a kind of truncated value for some listed goods and services suppliers which are not entitled to claim input tax credit. But for a number of services the VAT authority has fixed a notional base commonly known as the truncated base. The RRC Report (Government of Bangladesh, 2003) illustrated the truncated base in the following manner: 'VAT @ 15% is not calculated on its whole value; instead a certain percentage of the whole base (30, 15 and 10) is taken for calculation of VAT. For example, VAT on the construction service is calculated on 30% of the base. Hence VAT rate for this sector is (30*15%) =4.5% of the whole base.' The difference between the imposition of VAT on a truncated base and that on a tariff value is that while the former is optional the latter is mandatory. These two methods of VAT assessment are presumptive methods which pervade the Bangladesh VAT.

[9] In Bangladesh, VAT rules provide for a declaration and subsequent approval from the VAT Authority of the value of the product by a supplier on which VAT will be assessed. The supplier is required to provide information about the input-output co-efficient of the product, that is, the quantity of raw materials, the packaging materials used for each unit of the goods, the percentage of wastage and the components of value addition. The VAT Act empowers the authority to determine the value of the relevant good for imposition of VAT.

[10] Sections 37 and 37A of the *VAT Act 1991*.

[11] In Bangladesh VAT is known as Mushak.

sales-account books (*Mushak-17)* and evading or attempting to evade VAT by submitting counterfeit or false documents to a VAT Officer.[12]

2.3 Taxation Audits and Appeals

The Bangladesh VAT has specific provisions for the carrying out of audits on business transactions. To this effect, the NBR issued a number of general orders detailing the audit mechanism and an Audit Manual in 2006. According to this audit manual, each VAT registrant is supposed to be audited at least once every three years. However, given that a reassessment of VAT registered business can be done within five years from the date of certain business transactions, at least one audit should be done once every five years.[13]

The main role of the VAT Audit and Investigation Department, located in the Bangladeshi capital Dhaka, is to conduct audits of VAT units, collect taxpayers' information, and conduct investigations. Any discrepancies are referred to the VAT Commissionerate for enforcement action. In addition, regular taxpayer audits are also conducted by the VAT Commissionerate itself, which has branch offices throughout the country. According to NBR statistics, in the 2011-12 FY, a total of 140 million BDT (1.8 million USD) was collected through the auditing of 410 VAT-paying businesses. However, the revenue (140 million BDT or 1.8 million USD) collected from auditing is very negligible in comparison to the amount (26,090 million BDT or 347 million USD) detected by the Audit Directorate (NBR, 2014).

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[12] Other examples include intentionally failing to retain required documents (invoices and receipts) or destroying relevant documentation, without the permission of the local VAT office; and intentionally making a false statement or declaration. Also considered as intentional non-compliance are the following: the intentionally obstruction or prevention of a VAT officer in the course of their duty; intentionally being involved in receiving, taking possession of, or carrying goods in respect of which VAT or supplementary duty has been evaded; and claiming an input tax credit through a false or counterfeit VAT invoice.

[13] The NBR has a Central Audit Directorate headed by a Director General. In addition, each VAT Commissionerate has an Audit Wing headed by a Joint Commissioner. In addition to the existing organizational set-up for conducting audits in VAT, the NBR constituted a Central Audit Cell in 2006 to facilitate integrated audits through the exchange of information among the VAT, Income Tax and Customs Divisions. Taxpayer audits are commissioned by the VAT Commissionerate or by any Officer of the Commissionerate with the rank of Joint Commissioner of VAT or above. In the VAT Commissionerate, there are two relevant levels of executive officer above the Joint Commissioner of VAT. These are the Commissioner of VAT himself, and the Additional Commissioner of VAT. Section 26*ka* of the *VAT Act 1991* provides: "A value added tax officer, not below the rank of a Joint Commissioner, may order the auditing of tax and tax related activities of a registered or registrable firm for a specified period and the officer or officers ordered for the purpose shall, after completion of the audit on the basis of orders issued by the Board and the audit manual including the provisions of this Act and the rules made thereunder, within the specified time, submit a report to the ordering officer (Government of Bangladesh, 1991)."

The VAT Law provides for a number of taxpayer rights. According to the *VAT Act* and Rules, taxpayers enjoy the right of appeal against any decision of a VAT Officer and taxpayers have the opportunity of being personally heard.[14] Any aggrieved taxpayer intending to appeal against a decision or order relating to a demand of VAT payable on any goods or service or to a fine imposed under the *VAT Act 1991* has to pay 10% of the fine imposed or VAT demanded to the Commissioner Appeal.[15]

2.4 VAT Administration and Enforcement

Among the enforcement issues in Bangladeshi VAT are the quasi-judicial powers of the VAT Officers, the preventive surveillance, the supervisory clearance of goods and the use of stamp and banderol.[16] In dealing with tax enforcement, Bangladesh VAT offers a unique approach. For offences committed under the VAT law, all VAT Officers (from Revenue Officer up to Commissioner) have quasi-judicial powers of adjudication based on their rank and jurisdiction. The VAT Officers therefore act as both prosecutors and adjudicators. As such, the VAT Officers have the power to seize any goods liable for confiscation. For example, a preventive team in each VAT Commissionerate monitors transport movement to ensure that no goods are transported or transferred without the payment of VAT. Bangladeshi VAT Officers are more active in seizing rather than in auditing, as there a higher number of seizure cases than audits.[17]

There is a provision of supervisory clearance in Bangladeshi VAT Law which can be made applicable to any goods if the VAT Commissioner thinks large tax evasion by a particular firm is occurring. Presently this supervision is applied to cigarettes which account for the

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[14] Taxpayers who are aggrieved with any decision or order of a VAT Officer can appeal directly to the Commissioner (Appeal) of VAT and then to the Customs, Excise and VAT Appellate Tribunal. If the taxpayers are not satisfied with the decision of the above two, they can further appeal to the single Judge of the High Court Division of the Supreme Court of Bangladesh and then to the Appellate Division (Full Bench) of the Supreme Court of Bangladesh.

[15] In the case of an appeal to the Appellate Tribunal against an order given by the Commissioner or by any other value added tax officer of equivalent rank, taxpayers have to pay 25% of VAT demanded or fine imposed. Additionally, in the case of an appeal preferred to the Appellate Tribunal against an order of the Commissioner (Appeal), taxpayers have to pay 15% of the tax demanded or fine imposed.

[16] Section 6 (4ka) of the VAT Act'1991 has empowered the NBR to direct the use of stamp or banderol or special sign or mark of specified size and design for the purpose of realizing VAT or SD. Currently stamps and banderols are used in cigarettes, cold drinks and mineral water, toiletries and some other packaging items. It is claimed by NBR that uses of stamps and banderols are effective to control VAT evasion and to collect revenue.

[17] In 2009-2010, the number of seizures was 638 involving an amount of revenue of BDT 158 million, while far fewer audits (176) unearthed an evasion/avoidance of BDT 1719 million.

highest amount of domestically collected VAT and Supplementary Duty. Another unique feature of enforcement in Bangladesh VAT is the use of a stamp or banderol for some evasion prone items. Currently, cigarettes (both machine-made and handmade), toiletries, cold drinks and mineral water, are some of the items for which the packages are required to be stamped or banderol before being supplied from the place of production.

With this understanding of Bangladesh's VAT system, the theories about deterrence and non-compliance will be canvassed.

3. Theories

Of relevance to this study are the theories of deterrence, economic deterrence and social psychology, which are discussed below.

3.1 Deterrent Effects of VAT

Deterrence effects occur if VAT taxpayers generally comply more with the VAT Law because they see other taxpayers being successfully prosecuted or penalised for non-compliance, and if they are aware of the potential penalties for non-compliance. Deterrence effects, where they exist, are a form of positive externality. Thus deterrence effects of successfully prosecuting or penalising non-compliant taxpayers are a form of positive externality, provided the benefits to the community as a whole, exceed the costs to the community of doing so (Pindyck & Rubinfeld, 2009). For example, other taxpayers (who may be more numerous and, together, of more value, in terms of potential revenue collected) perceive that they too will be prosecuted or penalised if they do not comply with the VAT Law.

According to deterrence theory, the level of legislative compliance is positively related to the level of enforcement and punishment, including penalties (McKerchar, 2003). The theory specifies that the level of compliance is determined by the level of enforcement and punishment (Loo, 2006). Penalty and punishment by a legal system will communicate to the individual that the legal system takes intentional tax non-compliance as a crime. For some taxpayers, the penalties must be demonstrated in concrete sentences that are relevant to their own life situation. The imposition of fines and punishments is a demonstration to the society that the legal system is serious in its attempt to prohibit illegal behaviour such as tax evasion. Therefore, even increasing the penalty or fine may improve the deterrent effect. Similarly, the threat of punishment (higher penalty rate) is considered a positive strategy for

influencing behaviour, as the Australian Taxation Office (ATO) has a deterrent effect upon taxpayers through the issuing of tax rulings and media releases about the enforcement of tax laws (Devos, 2007).

Conversely, the enforcement and punishment for non-compliance with tax legislation can add to the cost of non-compliance, not only to taxpayers who are caught, but to others who are non-compliant but not yet caught. Not only do punishment and the imposition of fine demonstrate to society that the legal system takes illegal or non-compliant behaviour seriously; but public disclosure of a non-compliant taxpayer's identity and their punishment can affect their reputation (Levi, 2010). The media also has the incentive to report non-compliance with taxation legislation, since such stories can generate public attention (Devos, 2007).

Some taxpayers can be more sensitive than others to such threats and punishments. According to deterrence theory, those (generally more numerous) taxpayers who are deterred from non-compliance with tax legislation will be in this category. However, at least some of those non-compliant (often high-profile) taxpayers who are successfully prosecuted and penalised will be less sensitive to the threat and level of punishment (Polinsky & Shavell, 1988, 1989).

Deterrence by punishment has been described as a method of retrospective interference, by holding out threats that whenever a wrong is committed the wrongdoer will incur punishment (Kenny, 1929). Deterrence aims to discourage potential offenders by demonstrating the punishment of convicted offenders (Walker, 1965). The threat of punishment (fines, penalties and imprisonment) may improve taxpayer behaviour, habits of obeying the tax law and excluding the criminal alternative. The New Zealand case of *R v Radich* (cited in Devos, 2007) is useful to illustrate the purpose of punishment:

One of the main purposes of punishment… is to protect the public from the commission of such crimes by making it clear to the offender and to other persons with similar impulses that, if they yield to them, they will meet with severe punishment. In all civilised countries, in all ages, that has been the main purpose of punishment and still continues so. (p. 201)

However, the empirical evidence relating to the effectiveness of a deterrence effect is mixed, from at least the developed economies, with the observed effects being at best weaker than expected, and at worst inconclusive or non-existent (Devos 2009; Frey, 2003; Ali et al., 2001; Andreoni et al., 1998; Fischer et al., 1992). Some of these weak results may be because the penalties for non-compliance with the law are too low (Polinsky & Shavell, 1988, 1989). Corruption undermines penalties: with some taxpayers in South Africa believing

that their tax officials can be managed relatively easily with the use of side-payments or bribes (IFC, 2008). In a developing country like Bangladesh, where there can be corruption among the tax authorities and the policy makers (Monir, 2012) this could reduce the effectiveness of this deterrent effect.

3.2 Economic Deterrence Models

The neoclassical economic approach to tax behaviour starts from the assumption that individuals and groups are rational agents trying to maximise their outcome by evading taxes. Becker (1968) argues that people become criminals not because their motivations are different from others, but because their cost and benefits differ. When this is applied to the tax situation, it treats people as rational amoral decision makers whose aim, in this as in all other areas, is simply to maximize utility. Enforcement measures, such as audits, or sanctions to detect and control evasion, is perceived to be the dominant instruments that ensure the taxpayer's co-operative behaviour. The likelihood of audits and sanctions allows a taxpayer to take the tax system as a game in which they choose between (a) a sure loss, namely the taxes due, or (b) a probable gain via evasion and non-detection, or (c) a probable major loss resulting from evasion, detection and punishment. Bernasconi (1998) stated that evading taxes is like gambling: there are gains if the evasion is successful and costs if not.

In early tax compliance literature deterrence theory is considered as an influential factor in tax compliance decisions (Allingham & Sandmo, 1972). The classical models (Allingham & Sandmo, 1972; Cowell, 1985) assume that behaviour is influenced by factors such as the tax rate (which determines the benefits of evasion), the penalties for fraud and the probability of detection (which determines the cost). Individuals have a choice of how much income to declare and how much not. However, the main objective is to maximize the utility of the taxpayer. The Allingham and Sandmo (A-S) model predicts that both the probability of detection and the severity of penalties will affect tax evasion: if detection is likely and penalties are severe, people will be more compliant. The A-S model suggests that evasion increases with gross income, while the effect on the fraction of income evaded depends on relative risk aversion; that is, if relative risk aversion is constant, the fraction of income evaded will be constant. In advancing their model, Allingham and Sandmo (1972) argued that tax authority can control evasion by two substitute enforcement strategies: increasing either the penalty rate or the probability of being detected.

In addition to the A-S model, other early models included the works of Srinivasan (1973), Kolm (1973) and Yitzhaki (1974). McKerchar (2003) argues that these earlier models are very much similar to the underlying principles of the Allingham and Sandmo economic deterrence model. The A-S model was further extended by relaxing some of the basic assumptions and by incorporating agents (such as the tax authority and tax practitioners) playing key roles in the tax compliance decision-making process, in such models as these developed by Cowell (1985); Graetz, Reinganum, and Wilde (1986); and Scotchmer and Slemrod (1989). However, the A-S model has limitations: it is simplistic (as acknowledged by Allingham and Sandmo) in that it ignores other factors relevant to the compliance decision. It reduces human behaviour into a mathematical formula, which could be changed by manipulating the variables of interest. The deterrence model also attempts to explain the change in compliance behaviour rather than in the level of compliance (Cuccia, 1994). Among other things, the model does not incorporate the impact of compliance costs on tax compliance decisions; it focuses only on direct tax non-compliance. Braithwaite (2009) described deterrence as a double-edged sword. Not only can it enhance voluntary compliance because it includes what is the right thing to do; it can also make taxpayers resistant to complying with tax laws because of feelings of oppression.

Non-compliance decisions have been found to be indirectly related to the threat of penalties; larger fines are a more effective deterrent than are frequent audits (Friedland, Maital, & Rutenberg, 1978). Empirically, the deterrent effect of the enforcement factors appears to be questionable. The observed effects were weaker than expected, and some studies even suggest that an increase of penalties can have unintended undesirable effects, resulting in more tax evasion (Andreoni et al., 1998; Fischer, Warwick, & Mark, 1992; Frey, 2003). Silvani and Baer (1977) found that threats of future enforcement actions, including penalties, have little impact on the compliance behaviour of taxpayers in countries where non-compliance is high. In the United States of America (USA), the penalty rate on tax evasion between 1980 and 1995 increased from 5% to 30%. Ali, Cecil, and Knoblett (2001) analysed the compliance behaviour of American personal income taxpayers during that period and found that increasing the penalties appeared to have no deterrence effect. Friedland (1982) reports that audit rates affected compliance more than the amount of the fines. Alm et al. (1995) pointed out that fines are effective only with high audit rates. In an experiment by Park and Hyun (2003), voluntary compliance was more negatively affected by the amount of fines than by audit probabilities. That is, taxpayers were likely to comply when they had a possibility of frequent audits. However, audits need to be free of corruption to be effective. For example, in South Africa informal businesses thought tax officials could be managed with bribes while auditing (IFC, 2008). Long and Burnham (1990) argued that it was difficult

to determine the effect of tax audit and the varying probabilities of detection on taxpayer compliance as other possibly influential factors (including other enforcement strategies) generally did not remain constant.

The economic deterrence models generally assume that all taxpayers seek to maximise utility by responding in an identical and predictable manner when exposed to a change in any variable, as the sole purpose of a tax system is seen to be collect revenue (McKerchar, 2003). Taking into account the empirical evidence, and the experimental studies on economic deterrence models seems to be less effective as it appears that taxpayer non-compliance is not only influenced by economic factors. Consequently, it is important to consider compliance in the context of non-economic factors such as social-psychological models.

3.3 Social-Psychological Models

Social psychology models are concerned with the prediction and understanding of human behaviour and how people make decisions (McKerchar & Evans, 2009). The purpose of social psychology models is to develop an understanding of human behaviour and attitudes, whereas fiscal psychology models consider the psychological background of financial activities. It has been argued that social and psychological insights are very important to understand the observed level of tax compliance (Alm, McClelland, & Schulze, 1999; Cullis & Lewis, 1982; McKerchar, 2002). In these models, taxpayer's actions are influenced by many factors, including their outlook towards public institutions, the perceived fairness of the taxes and their prevailing social norms. Similarly, tax compliance is influenced by a range of factors including attitudes, perceptions, beliefs, personality traits and interactions among the actors. Specifically, fiscal psychological models view tax enforcement as a behavioural problem that can be resolved by the co-operation between taxpayers and tax collectors. To obtain this co-operation, the role of the tax system to provide a positive stimulus is emphasised, for example, by lowering the tax rates or decreasing the penalties. These actions in turn are expected to generate a better taxpayer attitude, which then affect their compliance decisions (McKercher, 2002).

In social psychology models, distributive justice, retributive justice and procedural justice are considered to have vital roles in influencing tax evasion behaviour (Wenzel, 2003).[18]

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[18] Distributive justice refers to the give-and-take of resources, both benefits and costs. Retributive justice is concerned with the perceived appropriateness of sanctions in case of norms breaking (Tyler, 2006), and are closely related to the interaction between tax authorities and taxpayers. Procedural

Taxpayers will evade less if they believe that government is spending tax revenue on public goods that they value and use (Kirchler, 1997). However, Wallschutzky's (1984) study about Australian personal income taxpayers found that people born outside Australia had little belief in distributive justice, as they had a higher tax evasion rates and had little influence on the government services they received.

If tax authorities treat taxpayers fairly, in a respectful and reasonable way, co-operation and trust in the institution are likely to increase at the individual, group and societal levels (Feld & Fray, 2002). Similarly, if taxpayers perceive the formula used to distribute resources (benefits and costs) as fair, then procedural fairness is high (Murphy, 2003, 2004; Braithwaite, 2003; James, 1998). However, Porcano (1998) did not find any significant effect of procedural justice on the compliant intentions of income taxpayers in the UK. Irrational and intrusive audits and unfair penalties lead to negative attitudes toward the tax office and taxes (Spicer & Lundstedt, 1976; Hasseldine & Kaplan, 1992). Consequently, it appears that procedural justice and retributive justice may be important factors for tax evasion, but these have rarely been investigated in the field of tax non-compliance and tax evasion, especially in Bangladesh.

Another important factor for tax non-compliance is the perception of what others are doing. If taxpayers are convinced that their co-citizens are paying their right share of taxes, they might be more willing to contribute. Using Swedish individual survey data to understand Swedish people's perceptions about tax evasion, Hammer, Jagers, and Nordblom (2009) demonstrated that distrust of fellow citizens and political distrust are very important determinants of perceived tax evasion.

The fiscal psychology approach combines both the economic deterrence and the social psychology approaches, and views tax enforcement as a behavioural problem, one that can be resolved by co-operation between taxpayers and tax collectors (Loo, McKerchar, & Hansford, 2009). This approach is based on taxpayer's attitude; tax mentality; feelings of tax tension and tax morale. The more positive the taxpayer's attitude towards paying tax is, the greater the level of co-operation with the tax authority and the greater the willingness to pay tax. Kirchler's 'slippery slope' approach is based on the interaction between taxpayers and tax authorities, and distinguishes between enforcement and voluntary compliance (Kirchler, Hoelzl, & Wahl, 2008). The framework suggests that the tax climate in a society depends on

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justice refers to the quality of treatment in interaction between taxpayers and tax authorities, the quality of information provided by tax authorities, the compliance and administrative costs as well as the dynamic of allocation of revenue (Carnes & Cuccia, 1996). The efficiency of interaction between taxpayers and tax authorities, the satisfaction with enforcement process and the audit treatment determine the perceptions of procedural justice (Wallschutzky, 1984).

both the antagonistic climate and the synergistic climate. The former is based on a 'cops and robbers' attitude towards tax authority and taxpayers. According to Braithwaite (2003), tax authorities perceive the taxpayers as 'robbers', who always try to evade tax, while taxpayers consider tax authorities as 'cops' and feel it is right to hide income. In such a climate, both the social distance and the intentional non-compliance are likely to increase between the two groups. In comparison, with in a synergistic climate, tax authorities consider taxpayers as 'clients' and they provide 'service' to the taxpayers (service and client attitude). The tax authority's supportive treatment to taxpayers helps to improve the voluntary compliance level. Under this model, the power of tax authorities (to detect illegal tax evasion; to conduct frequent and thorough tax audits; to punish tax evaders) and the trust of taxpayers towards tax authority are important for voluntary compliance or intentional non-compliance (Kirchler, Hoelzl, & Wahl, 2008).

Based on prior literature, Kirchler (2007) and Loo (2006) identified factors that are likely to influence tax evasion and tax compliance: tax rates; tax enforcement (audits); complexity; simplicity of the tax forms and returns; the attitude and efficiency of the tax authority; perceptions of fairness and ethics; perceptions of government spending with taxpayers' money; and socio-demographic characteristics (age, income level, education and gender). As many of these factors are not constant, it is to be expected that compliance behaviour can change over time and a compliant taxpayer one year may be non-compliant the next (Loo, McKerchar, & Hansford, 2009). The next part reflects upon what impact corruption may have on tax compliance.

3.4 Corruption in Taxation

Perceptions of fairness and corruption have also been identified in the tax compliance literature as a crucial factor (Torgler, 2004; Wenzel, 2003). Feld and Frey (2002) noted that taxpayers show more willingness to comply with the tax law when governments are seen to be fair, not corrupt, and to treat taxpayers respectfully. This willingness to comply with the tax authorities also refers to the degree of satisfaction with public services (Alm, Cherry, Jones, & Mckee, 2010). Kirchler (2007) conveyed the idea that mutual respect and trust between tax authorities and taxpayers have an important role in voluntary compliance. Trust also appears to be related to perceptions of corruption. In 2012 a survey of the European Commission revealed that 57% of Europeans believed that corruption is a major problem in Europe and that bribery and the abuse of power for personal gains were widespread among politicians. Corruption and tax evasion (intentional non-compliance) are two major problems globally, as these two obstruct socio-economic progress in developing countries and erode

the welfare programmes of developed countries (Julius, 2006). These two economic delinquencies sometimes occur together and sometimes substitute for one another, depending on the situation and the economic condition of a country. Corruption and taxpayer non-compliance are significantly interrelated and reinforce each other in causing negative effects on government finances, growth and wealth distribution (Litina & Palivos, 2011). The prior literature of developing countries shows that half or more of the taxes that could be or should be collected remain untraced by government treasuries due to corruption and tax evasion (Krugman, Alm, Collins, & Remolina, 1992; Bird 1992; Alm, Bahl, & Murray, 1991).

Taxation and corruption have been widely discussed in the public finance literature. It has been empirically established in a number of studies that the countries with a high level of corruption tend to have a lower collection of tax revenue as a percentage of GDP (Tanzi & Davoodi, 2000). Le (2007) points out, that corruption and tax evasion reduce voluntary compliance with tax laws and regulations, demoralise honest taxpayers, and create an atmosphere of distrust. Corruption by tax officials has been advanced as a vital reason of non-compliance in most developing countries (Thuronyi, 2003). The Transparency International of Bangladesh (TIB) report of 2011 stated that the NBR lost USD 3 billion in a year and failed to generate optimum revenue due to the tax officials' involvement in corrupt practices, a high rate of indirect tax and people's unwillingness to pay taxes due to apparently complex procedures (Saleheen, 2013a).

Flatters and Macleod (1995) have identified three agents in developing countries which can be involved in corruption: the Minister of Finance (or government or president) who sets the revenue target; the collector who collects the revenue for the Ministry of Finance; and the taxpayer who pays the tax to the collector. The first agent might take part in corruption by the formulation of complex tax law and policies and the last two agents might be directly involved in corruption and tax evasion. In the case of most developing countries, tax officials can be lowly paid, the monitoring system inefficient, and the taxation system complex. The tax system can be manually operated and the tax collectors might overlook various types of intentional non-compliance activities through bribes from taxpayers. Obid (2004), who has examined the effect of corrupt tax administration on tax compliance, points out that the poorly paid and low morality tax official might tend to maximise personal benefit by colluding with the taxpayers in utilising the complexities of the tax system and the inadequate resources of the tax administration. She further argues that corruption negatively affects the equity and fairness of the tax system, as well as the efficiency of the tax administration. Despite the importance of this topic, very little empirical research has been conducted to date on corruption and taxpayers' non-compliance in Bangladesh. Monir (2012) identified influential driving forces for income tax non-compliance, being the absence of a tax culture

among income earners, the inadequate taxpayer service, the complexities and unfairness with the income tax estimation, the weak enforcement and the negative image of the income tax department. The empirical findings of that study also revealed that corruption is facilitated by inappropriate relationships between self-interested policy makers and rent-seeking income tax officials, and between self-utility maximiser taxpayers and their intermediaries and income tax agents (Monir, 2012). As her study was limited to income tax evasion in the socio-economic and administrative context of Bangladesh, generalising the findings regarding VAT non-compliance by SMEs is problematic.

Over the last 40 years, two widely accepted findings have emerged from the considerable body of literature which has developed in the area of taxpayer compliance (Alm, 2012; McKerchar & Evans, 2009). Firstly, taxpayer non-compliance is a continual and growing global problem that is not adequately addressed in many countries. Secondly, despite a great deal of research originating from a wide variety of disciplines, there is not a great deal of consensus about why people do, or do not, pay their taxes or otherwise comply with their tax obligations. Most of the literature about taxpayer non-compliance has been concerned mainly with direct taxes and has focused on developed countries. The analysis of indirect tax non-compliance is largely ignored (Alm, 2012; Sandmo, 2005). Indeed, VAT is seen as a neglected area in the compliance behaviour and tax evasion research (Alm, 2012). A reason for the absence of VAT from evasion studies may be due to common belief that VAT has a self-policing mechanism: buyers of intermediate goods have opposing interests to the sellers, thus reducing the scope for VAT evasion (Keen & Smith, 2007). However, in practice, VAT in several countries has not achieved its objective of raising the projected revenue, as VAT, like any other tax, is open to fraud and evasion (Keen, 2007). For these reasons, Hemming and Kay (1981) questioned the 'self-enforcing' power of VAT, as both seller and buyer can gain by intentional non-compliance where tax administrations have poor control and auditing (cited in Barbone, Bird, & Vázquez- Caro , 2012, p. 42).

Although there is some research into compliance with consumption taxes in developed economies (such as the UK, OECD Countries, and European Union member countries), there is a lack of research into VAT compliance in developing countries in general, and particularly in Bangladesh. This article seeks to address this.

4. Methodology

The overarching research problem which underlies this study is to explore to what extent are deterrent measures effective to ensure SME compliance with VAT law in Bangladesh.

A mixed methods approach was adopted utilising quantitative and qualitative methods. This type of mixed methods approach is most likely to maximize, as far as is practically possible, the internal and external validity of the results.[19] While much of the earlier empirical literature on tax non-compliance utilised quantitative research methods, more recent studies have used a combination of quantitative and qualitative methods.[20]

Permission was obtained from the NBR to obtain lists of SMEs taxpayers that filed monthly VAT returns in the 2011-12 FY. Participants were divided into three groups:

1. The SMEs taxpayers who have no non-compliance history and registered with VAT for at least three years (Referred to as Compliant VAT payers, and abbreviated to CT);[21]

2. SMEs taxpayers who have a completed and decided VAT non-compliance cases against them and have already paid the fines and penalties imposed on them (Referred to as Non-Compliant VAT payers, and abbreviated to NCT);[22] and

3. NBR's VAT Officials from field level to policy level and who have been working with the NBR at least for eight years (Referred to as VAT Officials, and abbreviated to VO).

The study relevant to this article was conducted in two stages. Stage 1 involved focus group discussions (FGD) with VAT payers of the SME sector (both CTs and NCTs) and VAT

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[19] Huck, S.W., W.H. Cormier and W.G. Bounds (1974), *Reading Statistics and Research*, Harper & Row, New York.

[20] Tran-Nam, B. and J. Glover (2002), "Estimating the Transitional Compliance Costs of the GST in Australia: a Case Study Approach*", Australian Tax Forum*, 17(4): 499- 536; Glover, J. and B. Tran-Nam (2005), "The GST recurrent compliance costs/benefits of small business in Australia: a case study approach" *Journal of Australasian Tax Teachers Association*, 1(2): 237-258; McKerchar, M. (2003), "*The Impact of Complexity upon Tax Compliance: A Study of Australian Personal Taxpayers*", Research Study 39, Australian Tax Research Foundation, Sydney; Loo, E.C. (2006), "Tax knowledge, tax structure and compliance: A report on a quasi-experiment", *New Zealand Journal of Taxation Law and Policy*, 12(2): 117–140; Yesegat, W.A. (2009), *Value added tax in Ethiopia: A study of operating costs and compliance*, PhD Thesis, University of New South Wales.

[21] Compliant taxpayers (CT) were those who had paid VAT to the NBR and who had no dispute in respect of their VAT payments; or taxpayers who had had a dispute with the NBR but had subsequently been vindicated by the NBR, the Tribunals, or the Courts.

[22] Non-compliant taxpayers (NCT) were those who had either not paid the correct amount of VAT to the NBR (as assessed by NBR's VAT Inspectors) and who had had a dispute in respect of their VAT payment but who ultimately lost their appeals through the NBR, the Tribunals, or the Courts. For ethical reasons, taxpayers who were still engaged in ongoing dispute with the NBR in respect of their VAT payment were excluded from the study.

Officials. After completing the focus group discussions, a survey was designed through three stages: first drafting of the survey; pilot testing and revision of the initial draft. Finally the content of the survey was submitted to independent readers for checking before commencing the actual survey. Stage 2 involved the mailing of a survey, seeking qualitative and quantitative data, from both complying and non-complying SMEs taxpayers. Participation was voluntary and no financial incentives were given for their time. As this study used human subjects, it was necessary to ensure that ethics approval was received before commencement of each stage.

4.1 Focus group discussions

The focus groups were conducted in Dhaka, the capital city of Bangladesh because of the respondents' location. A total of 45 participants participated in the FGD consisting of 15 from CTs (11 were business owners and 4 were Director VAT of the enterprises), 15 from the NCTs (12 were business owners and 3 were VAT consultants from the selected enterprises) and 15 from VAT Officials (9 were Joint Commissioners of VAT and 6 were Second Secretaries of VAT from the NBR). Because very few participants were fluent in English, the discussions were conducted mainly in Bangla the common language especially among SMEs. The discussions were recorded for transcription and any identifying names or references were removed from the transcription. The confidentiality and anonymity of the recorded data was confirmed by coding the participant and not using the participants' names. The findings of the focus groups are presented later in this article.

4.2 Survey development

In Stage 2 a survey was mailed to compliant and non-compliant SME taxpayers, with a view to gathering both quantitative and qualitative information on factors affecting VAT compliance. The questionnaire was designed using mainly closed-ended questions in order to gather numerical data, in the form of information which could be verified against documentation (such as, the value of fees paid to professional advisers); in categorical form (such as, tax rates applicable to different product categories); or in integer format (such as, taxpayers' ratings of their perceptions on a 1-6 Likert scale).

After the pilot test and refinement of the survey instrument, a total of 500 questionnaires were distributed to SMEs VAT payers from June 2013 to September 2013. The SME VAT payers were selected based on purposive sampling from NBR's taxpayers list. Out of this

total, 200 questionnaires were distributed to NCTs group and remaining 300 questionnaires were distributed to CTs. Two reminders were sent to the taxpayers to improve the response rate. Finally the usable responses were 240 (152 from CTs and 88 from NCTs). Giving an overall response rate was 48%, representing 51% response rate from CT and 44% response rate from NCT.

Since VAT extends to the whole of Bangladesh, mail survey data was collected from the target population resident in the business regions of city corporation area, district town and Upazilla area. A summary of the participants' characteristics is shown in Table 3. Most of the respondents of mail survey were well qualified in terms of academic qualifications, 35% holding a Masters and 38% holding a bachelor degree. 50% of the respondents were from manufacturing business unit and approximately 45% conducted their business as a sole proprietorship. Regarding the manner of keeping accounting records, 43.1% from compliant group and 34.1% from non-compliant group indicated that their systems were fully manual. The rest noted that either their accounting systems were fully or partially computerised or their external accountants or tax advisors kept their accounting records.

Table 3: Summary of Stage 2 Participants' Characteristics

Characteristics	Compliant (N=152) n (%)	Non-Compliant (N=88) n (%)
Location of business / enterprise		
City corporation area (Dhaka)	33 (21.7)	35 (39.8)
City corporation area (Other)	60 (39.5)	26 (29.6)
District town	33 (21.7)	15 (17.1)
Upazilla area	26 (17.1)	12 (13.6)
Primary business / enterprise		
Manufacturing	75 (49.3)	44 (50.0)
Construction Units	16 (10.6)	12 (13.6)
Service Rendering Units	36 (23.7)	16 (18.2)
Traders (local, importers, exporters, commercial importers)	25(16.4)	16(18.2)
VAT related record keeping practice		
A manual / paper system	65 (43.1)	30 (34.1)
A partially computerized system	58 (38.41)	39 (44.3)
A fully computerized system	18 (11.9)	18 (20.5)
Tax adviser / external accountant	10 (6.6)	1 (1.1)
Average monthly VAT paid in FY 2011-12 (in BDT)		
Under 400,000 (Under USD 5172)	45(29.6)	28(31.8)
400,001 to 600,000(USD5173 to USD 7759)	27(17.8)	11(12.5)
600,001 to 800,000(USD7760 to USD10,345)	12(7.9)	10(11.4)
800,001 to 10,00,000 (USD 10,346 to USD 12,930)	19(12.5)	10(11.4)
More than 10,00,001 (More than USD 12,930)	49(32.2)	29 (33.0)
Education level		
Below SSC	0	1 (1.14)
HSC	19 (12.5)	14 (15.90)
Certificate	2 (1.32)	3 (3.41)
Diploma	11 (7.24)	7 (7.95)
Bachelor degree	58 (38.15)	33 (37.50)
Master's degree or above	60 (39.47)	24 (27.27)
Others (CA, LLB, MBA, PHD)	2 (1.32)	5 (5.68)

5. Findings

To explore the issue of VAT compliance and deterrence effects, the findings for the focus groups (Stage 1), and the survey (Stage 2) are presented below.

5.1 Focus Groups

Reason for complying

In the focus groups, for compliant taxpayers the most common response about VAT compliance was that participants saw civic duty as motivating people to comply with the VAT law. In contrast, the most common influence for complying with the VAT by the non-compliant taxpayers was that VAT was seen as a mandatory obligation for businesses and to avoid conflict with VAT Officials. Three enterprise owners asserted that most business persons want to run their business according to the law and to avoid any interference and obstruction from VAT Officials. This was especially the case if a large percentage of their wealth was invested in the business, so it may be very costly if they are subjected to any penalties:

> I don't want any conflict with my local VAT offices and also I want to avoid any sort of legal trouble with the NBR which may be very costly for me. So I try to pay my VAT timely. (NCT 13)

> I firstly understand my duty when any kind of tax is mentioned. Paying VAT and abiding by the VAT Law cannot be enjoyable for people but if I can calculate my VAT correctly, paying the rightful amount of the taxes is a good job actually. I feel secure if I maintain a good relationship with the VAT offices. I think some SMEs taxpayers comply with the VAT law to maintain a good relationship with VAT offices and to get co-operation from them. (NCT 9)

The views from the VAT Officials were consistent with Aaron and Slemrod (2004), as they asserted better enforcement and monitoring by the revenue authority to be the most influencing factor to improve VAT compliance:

> Civic duty or contributions to The State are not the main factors. The most important things are strong monitoring and enforcement. They are tax fearing people; they are not tax loving people. (VO 3)

> In my 15 years of service life with the VAT department, I have never seen a taxpayer want to deposit the right share of VAT. Most of the times they want to avoid our requests to pay VAT. Finally when they are given threat by the VAT Officials about

audit, surprise visit or 26 dhara (Section 26)[23] of the VAT Law, they got careful and pay VAT. But in most cases, they pay a little more than before, not the right amount. (VO 5)

Audit, penalties and sanctions play a vital role in changing their attitude towards paying tax. It also serves as a deterrent for them. So better enforcement and monitoring through more auditing, penalties and sanctions from our part can encourage taxpayers' of being compliant. (VO1)

Allingham and Sandmo (1972) stated that an increase in the probability of detection will lead to larger incomes being declared. Consistent with this literature, the likelihood of audits, penalties and sanctions appears to affect compliance rates for some taxpayers, especially CTs:

I think, NBR's effective steps regarding better enforcement of VAT law, strong monitoring and vigilance of local VAT offices and finally the likelihood of audits, penalties and sanctions are very important to make us more compliant. (CT 10)

When I saw the possibility of visits of VAT Officials to my business premises and got information that my business can be audited, I become more careful to any dealings with VAT. (CT 14)

However, the focus groups suggest this may not be the case for NCTs:

I don't think the enforcement and monitoring of NBR is sufficient to prevent the taxpayers from non-compliance. The frequency of audit is very low in Bangladesh, then why the taxpayers' will be afraid of audit? (NCT 2)

This implies that the frequency and adequacy of the audits in Bangladesh may be deficient. Indeed, the NBR statistics (NBR, 2014) less than 1% (0.07%) of VAT registered businesses were audited in FY 2011-2012.[24]

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[23] Section 26 of the *VAT Law'1991* provides: "Any value added tax officer not below the rank of an Assistant Commissioner or any value added tax officer authorized by him in this behalf (a) shall have the right to enter a place of production, supply, rendering of service or trading or other related houses or premises belonging to a registered or registrable person; (b) may inspect production process; and goods in stock, service and inputs and examine related accounts of a registered or registrable person; and (c) may at any time, examine all trading documents including books, files and commercial documents related to value added tax of any registered or registrable person, direct to submit or detain them or to do any other thing necessary for this purpose.

[24] Only 410 audits (0.07%) were done in FY 2011-12 against a total of 534,991 VAT registered units. Of these 410 businesses which were audited, 257 were manufacturing industries, and 167 were others including service rendering units.

Reasons for non-complying

In exploring the reasons for non-complying the most common theme was that corruption emerged as an influential reason for non-compliance by SMEs in Bangladesh:

> If I saw less corruption of the VAT officials, I would comply more with the VAT Law and pay more VAT. (NCT 12)

> Some of the tax officials are so rich and corrupted that is beyond our imagination. You will never believe, a revenue officer gave me the proposal to give him money personally each month and I need not to take the VAT registration as he will manage the VAT office. (NCT 3)

> We actually don't have any options except to give them bribe. I think, if I not give him some money this time, next time he will not do my work and will not co-operate with me. So we compromise with them, pay less VAT than the actual amount. (CT 5)

The VAT Officials acknowledged that corruption does exist, although some of the taxpayers informed that young VAT Officials are less corrupt:

> Our taxpayers always love to talk about corruption by the revenue department. They will never agree that they gave 1 BDT to the officials and take the opportunity of more than 100 BDT. Actually they inspired the revenue officials to be corrupted so that they can evade taxes. (VO 13)

> I don't think all the VAT Officials are corrupted. Some of them may be, but not all of them. Comparatively the young officers are helpful and cordial to me. I received remarkable support every time I needed. I can't say I am not listened to and I am not heard. (CT 3)

Deterrence Effects

The final question in the discussion guide for focus groups was designed to gain specific responses about the possible deterrent effects with non-compliance. From the discussion, the most common themes emerging from this question, in order, were connection with NBR and political parties, lengthy judiciary processes, and ineffective audits.

The first theme which participants recognised in relation to the deterrent effect was the association of business owners with the NBR and political parties. In Bangladesh, politics is dominated by 'big money' (mostly unaccounted for), 'goons' and people with little background and training in formal politics (Khan, 2003). It has been reported that the party that has the greatest business support can influence the general elections by the distribution of illegal money among the poor voters (Meisburger, 2015). Buying political influence and buying votes are common manifestations of political corruption in many countries including

Bangladesh (Ahmed, 2003). Given that money is a requirement for being active in politics and participating in elections, businesses are invited to join the mainstream of politics, which gives rise to the notion of 'Businessman Politicians' (Me'ny, 1996), which is also the case in Bangladesh. Tasnim (2007) demonstrates that the percentage of business professions among the members of parliament has increased from 24% in 1971 to 61% in 1991 and was still 60% in 2001. This concentrated representation can lead to benefits being provided to the rich. Similarly, civil service employees view public service as an opportunity for self-enrichment, particularly with side payments to public sector officials who are poorly paid (Khan, 2003). Moreover, a civil servant may engage in corrupt activities in an effort to meet personal obligations to members of his immediate and extended family (Alm, 1989; Gould & Mukendi, 1989). In Bangladesh, the extended family places significant pressure on the civil servants, which may lead them to engage in corrupt and nepotic practices. Bureaucrats are believed to exploit their public positions to generate benefits for themselves, their families, and their ethnic or social cleavage (*cf*. UDAMA, 2013).

There can also be interaction with corrupt officials and entrepreneurs, which promotes the strengthening of organized crime (Levin & Satarov, 2000). For instance, a business person who evades VAT is at the mercy of a VAT inspector and becomes an easy target for demands for bribes in exchange for promises of protection. Official corruption, particularly through bribery, reduces the likelihood of punishment and consequently the effectiveness of punishment as a deterrent (Moscos, 1998). Comments from participants highlight this interaction:

> How can you say a deterrent effect exists in Bangladesh? Political connection and corruption by civil servants allow inefficient producers remain in business. This business group motivates government to pursue perverse tax policies and provide opportunities to civil servants and politicians to enrich themselves through extorting bribes. (NCT 12)

> Some businessmen maintain political affiliation to keep a monopoly in the business sector. They take extra benefit during the annual budget. The payment of bribes to the right Ministers and Officials can help them to mitigate their unsolved issues very quickly. (NCT 9)

> Civil service employees view public service as an opportunity for self-enrichment. Civil service positions should not be used as a reward for businesses' illegal support, political support or negotiated for bribes. Incompetent, unqualified and unprofessional politicians and civil servants are significantly responsible for insubstantial deterrent effect. (CT 10)

The Global Competitiveness Report (GCR) 2014-2015, which surveyed 77 Bangladeshi business executives, found that the key factors hampering the country's business

competitiveness was a politically ineffective parliament, political corruption, burdensome government procedures, and improper government and business relationships. The report argued that for this to change, accountability and ethical standards for politicians are needed.

During the focus group discussions, some taxpayer participants indicated that in the early stages of business registration, expenses are considerably higher in Bangladesh. They described how creating a business requires permission from about 50 officials of several departments. Such expenses included bribes to the government officials. When government regulation imposes significant costs and time on a business, the entrepreneur may try to minimize these costs and time by paying bribes to the right politicians and members of the enforcement community. The bribe is expected either to exempt the business from the laws and regulations or to have the individual's enterprise taxed at a lower rate by special orders from NBR. Political and bureaucratic corruption can be seen as primarily rent-seeking behaviour, which is directly related to the level and extent of government activity in the economy (Mbaku, 2008):

> I think, to extract extra income a corrupt bureaucrat always helps private entrepreneurs. With the help of corrupted bureaucracy and affiliation with political parties, some businesses are able to capture and maintain monopoly position in the economy. (CT 1)

> The habitual bias of the NBR Officials towards some businessmen makes us insecure. Not having found enough co-operation and legal protection from NBR, we are obliged to seek special arrangement by buying unlawful services from NBR officials. (NCT 9)

However, not all the government officials were blamed by participants during the focus group discussions. Some participants stated that pressure exerted by politicians of the ruling parties is sometimes unavoidable for civil servants:

> I think we should not only blame the government officials. Use of a public officer for one's (businessmen politicians) private interest is a common practice in Bangladesh now. This conflict of interest exists when a member of the Parliament or a member of his family or a friend or a partner or a contributor to his/her election expenses does have a business. (CT 5)

> Why do we talk only about the civil servants? Political inference everywhere in civil service creates a lack of confidence in public officials at different levels. In the absence of guarantees for posting and promotions, the officials become more susceptible to the temptations of bribe taking. They take the motto that as long as they have opportunities to earn extra money, they will earn. Who can say, what will happen tomorrow? (NCT 2)

From these comments and discussions it is evident that the deterrent effect appears to be adversely affected by corrupt politicians and civil servants. For example, if a civil servant accepts money from a business person to give some favour, it is unlikely they will be aggressive or take lawful action against that business. However, some of the VAT Officials stated that the deterrent effect was apparent during the military backed caretaker government in 2007-2008 FY:

> During the caretaker government there was tremendous pressure from the higher authority to the tax officials to collect as much revenue as they can and to taxpayers' to deposit more income tax and VAT without looking at the actual rules and regulations. At that time media also played a vital role. In Chittagong Customs House and some other land customs station, army people set up their office to look after the revenue matters. Some of the big shot businessmen were caught and was send to jail for tax evasion. The general taxpayers were very afraid at that period. I think there was strong deterrent effect during that military-backed army government. (VO 9)

A number of focus group taxpayers also confessed that they paid more income tax and VAT during the 2007-2008 FY due to tremendous pressure from the NBR. This was re-enforced by watching media of high wealthy business owners being victimised by the army-backed government:

> We have seen in TV and newspapers that some of the civil officials are openly assaulted by the army officers. As they (army person) can be so rude with the civil servant, then they can go to any extent with the general taxpayers. Naturally, I was afraid and deposited more VAT than before though I had loss in my business at that time. (NCT 8)

> There is a set of law everywhere and in every sector in Bangladesh. But what is absent is its enforcement. During the caretaker government, enforcement was strong and monitoring was very intensive and close. Even, the government officials were closely monitored at that time. So we all tried to comply with the VAT law. But things went to back to square one with the end of that regime. (CT 5)

One NBR Official acknowledged that it was not only the taxpayers, as tax officers were also under extreme pressure at that time. The revenue collection scenario under the caretaker government and some of their initiatives, such as the Citizen Charter of the NBR, has been acknowledged by Saleheen (2013b), in terms of improving good governance and VAT collection in Bangladesh. The discussions and comments made by the respondents during the focus groups indicated that the deterrent effect could be more visible and effective if there was better and more honest enforcement by the revenue administration.

The second theme that emerged relating to the deterrent effect was the corruption and lengthy judiciary system. In Bangladesh successful implementation of the taxation policy depends primarily on NBR, the judiciary and the press (Ahmed, 2003). It would be hoped that those agencies, are appropriately constrained by the law, proactive and free of corruption. However, in Bangladesh, the political system, the judiciary and the revenue department appear to be embroiled in high levels of corruption. The TIB report (2014) found that 76% of the respondents thought corruption in the public sector was the major problem, while 40% thought personal relationships were more important in getting public service. The report also revealed that 93% of Bangladeshi interviewees thought that the police were the most prone to bribery, followed by the judiciary (63%) and land services (44%). On the other hand, the TIB report (2011) noted that citizens perceive political parties (62%) and the Parliament (40%) as some of the most corrupt institutions in Bangladesh. Given this, it is difficult for the taxation system, which is backed by these agencies, to be effective in Bangladesh. The comments about the judiciary shed some light on this situation:

> I think, the most judiciary systems, revenue officers and police forces in our country are not properly controlled by the Law and that most civil servants (including some Judges and revenue officers) are themselves corrupt. So we can't expect deterrent effect in Bangladesh. (NCT 9)

> Our company lawyer sometimes gives luxury gifts to the persons related to legal service. I am not unhappy for that as this helps us to save a lot of money by delaying the court decision. (CT 6)

These findings are consistent with the literature (Mbaku, 2000), which illustrates for example that most of the citizens in Africa are not afraid of the enforcing agencies, as the politicians, civil servants and the legal system are mostly corrupted. Brennan and Buchanan (1985) argue that any existing rules and regulations of a country will be ineffective if citizens perceive that politician and bureaucrats are corrupt. Therefore the entrepreneurs or the taxpayers who bribe politicians and civil servants are never afraid of the enforcement agencies and there will be minimal deterrent effect among the taxpayers. One of the respondents commented:

> Corruption infiltrates courts also. Our lawyers can use bribes as an effective tool for the defence of their clients. (NCT 13)

Moreover, court decisions are often not implemented in a timely manner. For tax matters, the low effectiveness of courts relating to tax matters results in long case processing delays, which can have a paralysing effect on economic activity. This is made worse by the shortage

of skilled and knowledgeable personnel at the NBR to meet the requirements of the court cases (Monir, 2012). Therefore, the judiciary has become largely unapproachable for VAT Officials, resulting in an apparent loss of tax revenue and reduced confidence in the tax system as a whole.

A lack of effective audits was also considered by the participants as an important theme relating to the deterrent effect. As in other developing countries that have adopted VAT, audits are yet to evolve as an effective instrument in the organizational culture of Bangladeshi VAT. Bangladesh has not been able to achieve a satisfactory level of audit performance, compared to the number of businesses registered for VAT, turnover taxes and cottage industries. The number of audits currently is below 1% when compared to the number of larger taxpayers, such as manufacturers (NBR, 2014). Therefore, whereas audits have become the major tool of tackling non-compliance in most developed countries, in Bangladesh this has largely not occurred. In the words of a compliant respondent:

> Before starting business, the word audit strikes a fear in my mind. But my business has not been audited by VAT department for last 4 years. I am continuing a very good relation with the local VAT office. I hope they will inform me before starting any audit, so that I can get enough time to arrange everything. (CT 3)

According to the respondents from the taxpayers' group, auditing has yet to take professional shape in Bangladesh. Everyone agreed audits should be one of the most important issues of the NBR. However, ironically, a posting in the audit division of the NBR or the Audit Directorate is considered as a 'punishment posting' for staff in Bangladesh (Saleheen & Siddiquee, 2013). In addition, comparatively inefficient inspectors and superintendents are posted to this division, due to the lack of status of the job. Taxpayers are informed that the audit division has a low social image and that the officers are not as efficient and knowledgeable as they should be. As a result, taxpayers do not take VAT auditing as an effective deterrent tool:

> My enterprise was audited last year. The problem was from the beginning of the audit: the team started their attitude that they came to catch a thief. At the beginning I was very worried. Even I needed to visit a psychiatric. But sorry to say, when I understood that two of the members of that team had minimum knowledge about VAT law, I became relaxed. My VAT consultant helped them to write the report. I realised from then, we should not be afraid of a VAT audit. (NCT 6)

VAT Officials confirm this:

> It is fact that there have always been some meritorious detection of irregularities, but many of the objections were ill-conceived, without adequate understanding of rules and regulations of VAT. So for most of the cases we can't establish our claims. So taxpayers are not very much concerned about VAT audits. (VO 9)

Saleheen (2013c) in his thesis about 'VAT and Good Governance in Bangladesh' quoted one taxpayer: 'unless you are in hands of a few officers who are very skilled, honest, many of whom are arrogant and discourteous as well, audit is a matter of involving some additional cost' (p. 233). Therefore, an audit would appear as more effective when the auditor is skilled, honest.

The VAT Officials stated that the taxpayers who have political connections or who are both politicians and businessmen are very reluctant to discuss about VAT auditing. Their political influence may have made them confident about the consequences of VAT auditing, although the Officials did not deny the strength of auditing:

> Auditing is an effective tool of deterrent, when the findings from audit are really genuine. Even the influential and politically connected business owners became fully in our control when we identified their VAT evasion through audit. (VO 5)

The relationship between the auditor and the auditee, especially the level of trust between the two parties, is very important to make the auditing process effective (Saleheen, 2012). In response to the question of how effective the audit was, some of the participants from SME taxpayers perceived that audit as not being effective at all:

> Most of the time, the auditors raised very silly objections. Sometimes maybe the objections are genuine but when we can understand our fault, we generally try our best to manage them by offering bribes. I think, we are successful about in 75% cases. Otherwise we go to court to object. I think audit is not an effective tool to make me compliant. (CT 2)

> An aggrieved taxpayer has the forum to file an appeal. Then why will I be afraid of VAT Audit? I have very good relation with our local VAT offices and NBR. So I believe, I will get sufficient help and lawful suggestions from them. I know, if I have any fault, they will give me enough time to rectify myself. (NCT 3)

Overall, it appears through the focus groups that any potential deterrent effect of VAT audits and penalties is undermined in Bangladesh due to corruption and inadequacies at many levels.

5.2 Findings: Survey

To explore empirically the initial findings of the focus groups the survey sought to measure the effectiveness of the deterrence effect for complying and non-complying taxpayers.

Reasons for complying

One of the key findings of this study relates to the perceptions of fines and penalties with compliance behaviour. Allingham and Sandmo (1972) predict that if detection is likely and penalties are severe people will be more compliant. However, this positive relationship between penalties and sanctions with compliance appears not to hold with the non-compliant VAT payers in Bangladesh. Only 32% of non-compliant VAT payers strongly agreed or agreed that the likelihood of penalties and sanctions would encourage them to comply with the VAT law: Table 4. In comparison, 73% of compliant VAT payers considered the likelihood of penalties and sanctions would increase their compliance behaviour. This may be due to the fact that NCTs tend to be risk-takers in making compliance decisions. Alternatively, it may be because non-compliant VAT payers do not think there is a great risk of detection by the NBR, as less than 28% thought the likelihood of audits would encourage compliance.

Table 4: Reasons for Compliance with VAT Law in Bangladesh

Reasons for Compliance	Not Sure (%)	Strongly Disagree (%)	Disagree (%)	Neutral (%)	Agree (%)	Strongly Agree (%)
Paying the correct amount of VAT is our civic duty						
CT	0.65	0	0	1.97	59.21	38.15
NCT	3.41	0	60.23	12.50	23.86	0
The likelihood of audits encourage me to comply with the VAT law						
CT	5.92	1.32	5.27	17.10	46.71	23.68
NCT	6.82	25.00	30.65	9.09	22.73	5.68
The likelihood of penalties and sanctions encourage me to comply with the VAT law						
CT	1.97	1.32	7.24	15.79	51.32	22.36
NCT	6.82	21.59	26.14	13.64	27.27	4.54

The ANOVA[25] results (Table 5) demonstrate that the three statements yielded significant results between the two groups in terms of reasons for compliance: civic duty, likelihood of audit and the likelihood of fines and penalties. It appears for CTs that the major reasons for their compliant behaviour relate to their sense of civic duty and fear of audits and penalties. These three reasons affect CTs more than NCTs.

Table 5: Reasons for compliance: ANOVA Table (one tailed and between groups)

Reasons of compliance	Sum of Squares	df	Mean Square	F	Sig.
Paying the correct amount of VAT is your civic duty	13.812	1	13.812	9.046	0.003**
The likelihood of audits encourage me to comply with the VAT law	12.463	1	12.463	10.746	0.001**
The likelihood of penalties and sanctions encourage me to comply with the VAT law	13.14	1	13.14	4.964	0.027*

R= 0.568, R Square= 0.322, Adjusted R Squared= 0.198.
Std. Error of the estimate= 0.429
*$p < 0.05$; **$p < 0.005$

Reason for non-compliance

More than 70% of the respondents considered that the non-compliance increases due to higher fines and penalty rates: Table 6. It should be recalled that the penalty rate for intentional non-compliance is up to 250% in Bangladesh. By having higher penalties and fines, SMEs may be encouraged to stay within the cash economy and not register for VAT. Moreover, when the NCTs had to pay higher penalties for their evasion, they may have considered the imposition of such penalties to be nearly harassment. Literature suggests that when the fines and penalties are too high the tax system can be perceived as unjust and unfair, leading taxpayers to avoid their tax payment (Devos, 2009). The findings also indicate that NCTs tended to consider the VAT system to be unfair, as approximately 46% of NCTs agreed or strongly agreed, whereas only 16% of CTs did so.

It appears that NCTs have the perception that by becoming VAT registered, businesses are more likely to come to the attention of the NBR, compared to if they stay outside of the VAT system altogether and operated in the 'cash economy'. Kirchler (2007) states that if a

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[25] The ANOVA is an important test because it enables us to see the comparison of two different types of treatment. The *F*-ratio tells the researcher how big of a difference there is between the conditions. ANOVA tests assume: the population sample must be normal; and the observations must be independent in each sample.

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taxpayer finds the burden of taxes as unfair and that a non-compliant taxpayer is in a better position than a compliant taxpayer, then taxpayers may be discouraged to comply.

Table 6: Reasons for non-compliance with VAT Law

SMEs do not comply with the VAT Law because	Not Sure (%)	Strongly Disagree (%)	Disagree (%)	Neutral (%)	Agree (%)	Strongly Agree (%)
The fine and penalty rates are very high						
CT	0	3.30	20.40	5.90	52.60	17.80
NCT	1.10	3.40	10.20	9.10	58.00	18.20
The VAT system is unfair						
CT	2.6	9.2	59.2	13.2	9.9	5.9
NCT	3.4	9.1	27.3	14.8	26.1	19.3
VAT Officials are corrupt						
CT	1.32	8.55	28.29	21.05	30.26	10.52
NCT	6.84	1.15	15.91	9.09	28.41	38.69
Discretionary and judicial power of NBR						
CT	11.84	1.32	10.55	7.24	44.07	25.00
NCT	11.36	7.95	9.09	12.50	28.41	30.68
Audit and inspections of NBR for VAT registered businesses						
CT	7.24	2.63	31.58	3.29	38.81	16.45
NCT	4.55	1.13	4.55	4.55	37.50	47.72

The discretionary and judicial powers of the VAT Authority appear to be important factors for non-compliance as 69% of CTs and 59% of NCTs agreed or strongly agreed that the discretionary and judicial power of VAT Authority discourages them to comply with the VAT law. Saleheen (2013a) demonstrates that the presence of excessive discretionary powers with Bangladeshi's VAT law creates lack of trust between taxpayers and tax officials. Excessive discretionary power may encourage corruption, especially in the case of price declarations and the determination of tariff values or truncated base.

Table 7: Reasons for non-compliance: ANOVA Table (One tailed and Between Groups)

Reasons of Non-compliance	Sum of Squares	df	Mean Square	F	Sig.*
The fines and penalty rates are very high	0.226	1	0.226	0.192	0.661
VAT system is unfair	12.846	1	12.846	8.465	0.004**
VAT officials are corrupt	25.618	1	25.618	10.162	0.002**
The discretionary and judicial power of VAT Authority discourages me to pay VAT	0.015	1	0.015	0.008	0.927
Audit and inspections of NBR for VAT registered businesses	22.22	1	22.22	11.069	0.001**

R= 0.649, R Square= 0.421, Adjusted R Squared= 0.268.
Std. Error of the estimate= 0.429
*$p < 0.05$; **$p < 0.005$

The ANOVA results demonstrate (Table 7) that among the selected reasons for non-compliance, only three statements yielded significant differences between compliant and non-compliant taxpayers. The areas of significant differences included the unfair VAT system, the corruption of VAT Officials, and the possibility of audits and inspections for VAT registered businesses. Among these reasons, NCTs emphasised the possibility of audits and inspections for VAT registered businesses (85%), and the corruption of the VAT Officials (67%). Consequently for NCTs the big issues for non-compliance appear to include audits and inspections and corruption. However, for both sample groups (CTs and NCTs) the higher fines and penalty rates; and the discretionary and judicial power of the VAT Officials can contribute non-compliance.

Deterrence and VAT Compliance

Table 8 reports the findings of taxpayers' perception about the deterrent effect on taxpayer compliance. There was differing opinions about the deterrent effects of significant promotion of the NBR prosecutions regarding compliance decisions. For example, 72% of the CTs strongly agreed or agreed that significant promotion of NBR prosecutions of non-compliant taxpayers would increase compliance among other SME taxpayers, while only 36% of NCTs thought so. Similarly, 43% of NCTs did not agree that greater enforcement by the NBR would increase compliance, whereas only 5% of CTs disagreed with this. This would indicate that there is a greater deterrent effect for CTs than for NCTs. This is re-enforced by the findings in Table 4, which indicate the likelihood of audits and penalties having greater

impact on CTs compared to NCTs. The findings demonstrate how deterrence attributes can have different impact on compliant and non-compliant SME VAT payers..

Table 8: Deterrent Effect

Statement about Deterrent Effect (CT=152, NCT=88)	Not Sure (%)	Strongly Disagree (%)	Disagree (%)	Neutral (%)	Agree (%)	Strongly Agree (%)
Taxpayers would pay the correct amount of VAT if there was greater enforcement by VAT Authority						
CT	6.58	5.92	9.87	9.21	46.71	21.71
NCT	6.82	22.73	22.73	9.09	26.13	12.50
Significant promotion of NBR prosecutions of non-compliant taxpayers would increase compliance among other SME taxpayers						
CT	4.61	0.66	4.61	17.76	42.76	29.61
NCT	6.82	25.00	18.18	13.64	27.27	9.09

The present enforcement by NBR may be another reason for the lower deterrent effect by NCTs. For example, in 2012 a mere 15,873 (out of 460,092) businesses received a show-cause letter from the VAT Commissionerates for not submitting the monthly VAT returns; of them, only 1,659 businesses were penalised for these non-compliance activities (NBR, 2014). It may be that taxpayers are well acquainted with the NBR's administrative inefficiency and they feel it is extremely unlikely that their non-compliance will be detected and penalised. Indeed, it may be the ineffectiveness of the audits and the potential corruption that reduce the deterrent effects of audits.

Corruption and Compliance

The discussions and comments made by the respondents during focus group discussions demonstrated that there could be multiple reasons for non-compliance beyond complexity and VAT compliance costs, including corrupt politicians and civil servants. Some of the VAT Officials also identified corruption as a potentially influential factor for non-compliance. To tease out perceptions of corruption and VAT compliance, a number of questions were asked in the survey (Table 9 and Table 10).

Table 9: Corruption and Voluntary Compliance

Statement about Corruption (CT=152, NCT=88)	Not Sure (%)	Strongly Disagree (%)	Disagree (%)	Neutral (%)	Agree (%)	Strongly Agree (%)
If I saw less corruption by Bangladesh big business I would be willing to pay the correct amount of VAT						
CT	0	2.6	7.9	11.8	58.6	19.1
NCT	3.4	4.5	22.7	17.0	37.5	14.8
If I saw less corruption by government officials I would be willing to pay the correct amount of VAT						
CT	0	7.00	2.6	11.2	69.1	16.4
NCT	13.6	3.4	12.5	14.8	34.1	21.8
If I saw less corruption by VAT Officials I would be willing to pay the correct amount of VAT						
CT	7.00	7.00	5.3	8.6	65.8	19.1
NCT	6.8	3.4	5.7	14.8	47.7	21.6
If I saw less corruption by Bangladeshi politicians I would be willing to pay the correct amount of VAT						
CT	0	7.00	6.6	7.2	66.4	17.1
NCT	11.4	3.4	23.9	12.5	33.0	15.9

It appears that the reduction of corruption would have the biggest positive influence for CTs, although it would still have some positive impact for NCTs. Particularly, less corruption by VAT Officials could have the largest influence for both CT (85%) and NCT (69%), followed by government officials. It is interesting that more than 20% of the NCTs are in the position of 'not sure' or 'neutral' about the statements relating to corruption, whereas only 10% of the CTs are in this position. This may be because a larger portion of NCTs did not want to comment about the corruption of the VAT Officials or the politicians, as they have taken part in the corruption process to gain favour. Only 11% of CTs and 20% of NCTs disagreed or strongly disagreed that less corruption by politicians, civil servants (government officials and VAT officials) and big businesses would increase voluntary compliance among the taxpayers. The ANOVA results (Table 10) do not show significant difference between groups in terms of less corruption by politicians and big businesses. The findings that the corrupt practice of politicians, government officials, VAT Officials, and big businesses encourage VAT non-compliance are consistent with prior literature based on income tax corruption in Bangladesh (Monir, 2012).

Table 10: Role of Corruption in Voluntary Compliance: ANOVA Table (Between Groups)

Voluntary Compliance	Sum of Squares	df	Mean Square	F	Sig.
Less corruption by Govt Officials	16.116	1	16.116	16.261	.000**
Less corruption by VAT Officials	6.253	1	6.253	5.731	.017*
Less corruption by big businesses	3.881	1	3.881	3.246	.073
Less corruption by Bangladeshi politicians	3.652	1	3.652	2.557	.111

R= 0.710, R Square= 0.504, Adjusted R Squared= 0.277.
Std. Error of the estimate= 0.426
*$p < 0.05$; **$p < 0.005$

Overall

The comments from the focus groups were that VAT Officials viewed significant deterrent effects from NBR prosecutions of non-compliant taxpayers would increase voluntary compliance among taxpayers. However, the survey found that for non-compliant taxpayers such prosecutions appear to have little impact on them. For example, 36% of the NCTs disagreed or strongly disagreed that significant promotion of NBR prosecutions of non-compliant taxpayers would increase compliance among other SME taxpayers. However, the deterrent effect appears to influence CTs as 72% of compliant VAT payers thought significant promotion of NBR prosecutions would be effective to increase compliance. Legislators often try to increase the deterrent effect by successful prosecution against non-compliance taxpayers. However, Bangladeshi non-compliant taxpayers do not think heavier fines and penalties or prosecution actually improve compliance. This may be because of the fact that NCTs tend to be risk-takers in making compliance decisions, and so penalties and fines imposed by the VAT authority are seen as risks worth taking. Alternatively, it may be because NCTs do not take the deterrent effect seriously as the tax administration is seen as weak, inefficient, and corrupt in Bangladesh. The findings suggest that perceived corruption by VAT Officers, politicians and other government officials reduces the effectiveness of audits and fines and penalties and decrease the level of voluntary compliance.

6. Recommendations

Through the research findings a number of recommendations are posit to enhance VAT compliance by SMEs in Bangladesh.

6.1 Reduce Corruption

This study has highlighted how corruption is undermining various aspects of the VAT system, including the audit process. Indeed, one of the most interesting results of this research is that non-compliant taxpayers appear not to be too concerned about fines and penalties, or audit procedures, apparently because of the possibility of bribing NBR officials. In order to enhance revenue collection and voluntary compliance, policy makers need to take steps to reduce corruption at all levels. One area of concern relates to the discretionary powers of the VAT Officials. Measures could include introducing a hot line for taxpayers to report corrupt VAT Officials, disciplinary proceedings by an independent body, and better employment conditions for NBR Officials. It is important that disciplinary proceedings are made transparent to the public, to improve public perception of the integrity of the NBR and its staff. However, it needs to be noted that corruption at all levels, such as big business, other government officials, and politicians also needs to be addressed.

To lessen the temptation for corruption, one possible reform could be to improve the wages and conditions for NBR Officers. Increasing the wages of tax officials, however, will not reduce corruption unless and until an extensive and effective monitoring of corrupt VAT Officials is implemented (Fjeldstad, 2006). Accordingly, any increase in wages would need to be accompanied by the prosecution of corrupt VAT officials. Special service rules and regulations for NBR officials also need to be reinforced to ensure the provision of punishment for any corruption by public officials.

6.2 Effective Enforcement

Effective enforcement is required by local VAT offices and the NBR to ensure that all businesses required to register for VAT are in fact, and to establish a level playing field for compliant SMEs. This includes improving the speed of the VAT registration process and stopping the culture of unauthorised payments during registration. The NBR must ensure the proper enforcement of rules and regulations in relation to non-compliant taxpayers, in order to stop them taking advantage of weaknesses in the VAT system. Increased media reporting about the prosecution of non-compliant taxpayers could increase the deterrent effect. The government should also consider introducing a general anti-avoidance rule for VAT, rather than making annual 'band aid'-style changes to try to address loopholes.

6.3 Decrease Discretionary Power

As reflected in the research findings, it is important that the discretionary powers of VAT officials be reduced. These discretionary appear to lead to opportunities for corruption (whether real or perceived). This recommendation is supported by the IMF, which suggests that the power for the NBR to set tariff values for VAT concentrates too much power in the hands of the NBR and its officials (IMF, 2007). Without other legislative checks and balances, this aspect of Bangladesh's VAT system is vulnerable to political and bureaucratic opportunism (IMF, 2007). This recommendation is also supported by the country's apex business association, the Federation of Bangladesh Chambers of Commerce and Industry (FBCCI), which has proposed reduced discretionary powers for VAT Officials in a bid to improve business conditions (Financial Express, 2012).

Under the new VAT Law introduced to commence in 2016, some of the existing discretionary power will be eliminated. For example, the price declaration provision, the truncated base for assessment of VAT, and the power of determination of turnover taxes will be removed. However, discretions around the provision of tariff values and the use of stamp and banderol, the input-output coefficient for manufacturers will continue. Also under the new VAT Law, the NBR will have vested additional powers to recover VAT, including freezing a tax debtor's bank accounts, placing a lien on the tax debtor's property, and holding company directors liable for paying unpaid taxes. While the removal of some discretion is constructive, there continues the possibility of misusing this additional power and perpetuating the alleged corruption of VAT officials. It is therefore recommended that there be greater checks and balances around these discretionary powers, including taxpayer rights to appeal NBR decisions. In addition, a corruption hotline and more stringent disciplinary procedures for corrupt VAT officials could be introduced.

6.4 Improve Communication/Media

The NBR should consider treating compliant and non-compliant taxpayers differently. Compliant taxpayers should be given more assistance from NBR and local VAT offices. This could include the NBR being more understanding about inadvertent breaches, improving the audit process and increasing the frequency of constructive communications with taxpayers.

One of the most interesting results from the research is that non-compliant taxpayers appear not to be too concerned about fines and penalties, or audit procedures. VAT officials should be stricter with NCTs through regular audits, and the imposition of fines and penalties to increase pressure upon them to be compliant. However, this is only likely to be effective if

the audit process is free from corruption, since any corruption of VAT officials undermines the entire audit and penalty system.

6.5 Restructure Fines & Penalties

Allingham and Sandmo (1972) assume that if audit detection is likely and penalties are severe, the possibility of intentional non-compliance will decrease. In contrast, the results of this research suggest that higher fines and penalties would have minimal impact on compliance. As the penalty rate for intentional non-compliance is very high (250%) in Bangladesh and the probability of detection is very low, taxpayers could see evasion as a worthwhile gamble. Furthermore, the penalty for not registering VAT is not very high in the existing VAT law. As a result, businesses who do not register or comply with the VAT Law may not take the possibility of detection seriously. It is recommended that the NBR should focus on restructuring the fines and penalties for failing to register for VAT. On the other hand, the NBR could consider reducing penalties and fines for those taxpayers with a reasonable track record for compliance. For example, the NBR could take into account the track record of taxpayers in the audit process: for example if unintentional errors or mistakes arise, lower penalties could apply. Of course, this does provide for some discretion, so it is important that there are some checks and balances surrounding this to ensure corruption does not occur.

7. Limitations and Future Research

As with any research, the limitations of the analysis in this research must be acknowledged. First, the findings in relation to the focus groups are limited by the sample and demographic characteristics of the participants. The two main sample biases were that a larger percentage of SMEs came from city areas as opposed to country areas, and that these SMEs had typically attained higher education levels than the national average. These deficiencies could reduce the generalisation of some of the findings. A second weakness of this research could be a Type II error in the classification of the taxpayers as 'compliant' and 'non-compliant'. That is, it is possible that some compliant taxpayers were in fact non-compliant but had not yet been identified as such by the NBR. Indeed, in some of the comments made by compliant taxpayers would suggest that they have undertaken some activities which bring into question their compliance record. Also, given the sensitive nature of this topic matter (non-compliance) the self-reporting measures used may not be accurate.

Nevertheless, it is suggested that this research provides an important contributions to knowledge in terms of VAT compliance by SMEs in a developing nation, Bangladesh.

Future research could also estimate the enforcement and monitoring costs of VAT and test whether the findings of this research are corroborated. Research could also consider in more detail the 'gaming' that may be occurring when non-compliant taxpayers consider their activities in terms of likelihood of audits and the penalty regime. This research could add the notion of corruption and this influences the gaming decisions of taxpayers. Given the apparent importance of corruption to the effective audit process, research consider could explore exactly what are the circumstances more likely to lead to corruption and which measures are more effective to reduce it.

8. Conclusion

The VAT is generally acknowledged for its significant revenue-raising potential for financing government services and for the efficiency with which it can be imposed (Williams, 1996). Indeed, VAT has become one of the most important revenue-mobilising instruments in advanced industrialized countries as well as in developing countries (Bird, 2013; Eccleston, 2007). Since a robust and functioning VAT system is seen as important for a developing economy, the findings of this research are likely to be important not only for Bangladesh, but also for similar developing economies.

When a VAT system does not operate well this represents a substantial opportunity cost to the Government, since tax revenue otherwise collected could be spent on vital infrastructure development for Bangladesh. Moreover, to make the VAT system an effective tool for revenue-raising in a self-assessment environment, there needs to be trust and confidence in taxpayers, motivating them to pay the right share of VAT.

The findings of this research gave some clear directions to the NBR and other enforcement agencies to improve the efficiency, fairness and integrity of the whole taxation system. It is likely that these directions are relevant to the tax administrations in other developing countries and perhaps to other types of taxpayer (large taxpayers of VAT, personal income taxpayers and corporate income taxpayers in Bangladesh).

Without an effective audit and penalty regime free of corruption, it is unlikely the deterrence effect will be fully realised. Particularly, the existence of corruption means that taxpayers, especially non-compliant taxpayers, are unlikely to be a 'tax fearing people' and instead see

that tax officials can be 'managed' through bribes. This means that their economic costs in terms of increased VAT compliance costs and lost tax revenues.

For a VAT to assist developing nations to raise sufficient revenue it is critical that the presence of corruption at various levels be addressed. While the framework of legislation, audits and penalties of a VAT is important, how it is implemented and enforce is also critical. Without this, developed nations will struggle to raise sufficient tax revenues for their public expenditure programs to assist with their progress.