

Black money and investment

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AT a time when the government is engaged in the difficult task of drafting the budget for what is looming as a recession year, a contentious debate is raging in the public domain about allowing black money to be whitened or legalised. Even the business leaders are evenly divided on the issue. Those who support the legalisation of black money are arguing that this would allow the money to be invested in productive sectors, and help the government effort to tide over the recession. Other business leaders are against such legalisation as being morally repugnant, conducive to tax evasion, and inherently unfair to honest taxpaying business people. The Finance Minister has publicly stated as much, but conceded that he might have to yield to the demand for whitening. Interestingly, most of the economists are also neatly divided along these same lines. One group is strongly opposed to the whitening of the black money for ethical and/or moral hazard reasons, while the other group supports it in the belief that it would raise productive investment. No rigorous economic argument for or against is offered, nor is it demonstrated how whitening black money could raise investment. This note analyses these issues in an objective manner and demonstrates that the arguments made in support of the whitening have no real merit.

Black money may be defined as the accumulated savings from legally or illegally earned income that was not declared to the taxman. When the undeclared income was earned, all of it was part of the nation's gross domestic product; thereafter the unconsumed part of it was added to the nation's financial or real wealth. It is important to understand that investment in the current year is done with current saving; past savings cannot be translated into current investment except in a special case explained below. To demonstrate this more clearly it may be noted that black money may be held in the form of (a) financial or real assets in the country and/or (b) financial or real assets overseas. When the black money is held in the country in the form of any real assets, the money is de facto already invested in the domestic economy. Legalisation of undisclosed real assets, such as real estate, would simply enable the holders to re-register the assets in their own names, or publicly claim ownership. This might help the black money holders sleep better, but it would not have any direct positive impact either on investment or on the economy. As regards black money held in the form of domestic financial assets, some business people argue that legalisation will bring this money into circulation, and allow them to invest in new industries. In addition, the government will also earn some revenue. When the economy is heading towards a slowdown and government revenue is shrinking, the additional investment due to the whitening will help stimulate the economy, increase revenue and raise employment. This argument seems to have fairly wide acceptance, and oft repeated in the media. However, a careful analysis would reveal that this is an apocryphal argument. Financial assets in which the black money could be held are either stocks and bonds or bank deposits (i.e.

money). If the undisclosed assets are held (perhaps 'benami') in stocks and bonds, the holders are in reality part owners of some real capital, i.e. the money is already invested in the real economy and contributing to economic activity. Legalising the black money in this case simply gives legal ownership to the stocks and bonds, nothing new happens. If the holders of black money cash out once the amnesty is announced and invest the amount in new plants and machinery, it might seem that some new investment would take place. However, this is illusory; in reality it would only be a substitution of one form of productive assets by another since the purchasers of the stocks would have reduced investable funds by an equal amount. Hence, there would be no new addition to the capital stock of the economy. No new asset on a net basis would be created as a result of the tax amnesty.

If the black money is held in bank deposits, it is already contributing to domestic economic activity through financial intermediation by the banking system. Banks generally extend loans to investors against these deposits, thereby contributing to domestic economic activity. The legalisation of black money does not increase the volume of bank deposits or the flow of credit, and therefore, does not increase business activity. What appears to be new investment by black money holders is offset by withdrawal of deposits/credit, or reduction of investment elsewhere.

If the black money is parked overseas, and it is liquidated and brought home as a result of an amnesty for black money, there will be a real resource transfer from overseas to Bangladesh. When the black money was taken overseas there was a real resource transfer to overseas; now the same is being repatriated. This would be very similar to a transfer of resources from overseas through foreign investment or aid, with the

added advantage that there would be no associated profit or interest payments obligations. If this really happens, a tax amnesty would indeed add to current resources, and thereby raise current investment in the domestic economy. However, the probability of this happening is slim. If the holders of black money have successfully taken the money out of the country and parked it in some foreign financial institutions, or bought real assets, there is not much risk that it would be detected by the home government. Presumably the money was invested overseas under the laws of those countries and hence, it is unlikely that the foreign governments would penalize them. With the money securely parked overseas, there is little reason why the money would be brought home simply because of a tax amnesty. In any case if somebody really wants to bring back assets held abroad, he does not need any tax amnesty, there are other ways of doing that.

Thus, the argument that legalising black money raises investment at a macro level would appear to be based on faulty logic. However, such legalisation does cause real damage to the economy although it is not immediately evident.

From an economic point of view, the essential difference between black and white money is that the latter is earned after paying taxes while the former evades taxation altogether. The profitability of a business enterprise that pays tax will obviously be less than that which evades taxation. The taxpaying business enterprises become less competitive compared with the non-tax paying business enterprises. The former may be then obliged to evade taxes in order to compete and survive. In the event they do not resort to such illegal practices, many of

them would be forced out of business due to the unfair competitive pressures. This will result in the economy having more non-taxpaying business enterprises and fewer tax-paying ones in the longer term. To paraphrase a famous saying: 'bad business will drive good business out of circulation'. The tax base of the government will decline, leading to a secular decline in tax revenue collection. The process may be already at work as indicated by the poor revenue collection, which is one of the lowest in the world.

If the government permits the holders of black money to legalise it at minimal cost repeatedly, it creates serious moral hazard for the law abiding taxpayers. Why should anyone pay high taxes when they know that they can later escape with their undeclared income by paying only a nominal penalty? Empirical analyses done globally demonstrate that much more revenue is lost due to the disincentives created through repeated tax amnesties than the amount actually collected as pecuniary fines under amnesty programmes. Every year Bangladesh government loses thousands of crores of taka due to a lack of proper enforcement of lax laws, and wrong incentives engendered through expectations of future amnesty programmes.

Several governments during the last decades have legalised black money through some form of tax amnesty. The most recent one was in 2007 under the caretaker government. As always, at that time it was also announced to be the last opportunity to come clean. An ultimatum was served that after the expiration of the tax amnesty there would be a crackdown on the holders of undisclosed assets. Before the ink on the document containing the ultimatum has dried, there is fresh demand for further tax amnesty. Such demand simply validates the wellknown empirical observation that this game is never ending.

The right thing to do for the popularly elected government is to bring this game to a close by enforcing the

existing tax laws. If there is to be any relaxation, that should apply to all by reforming the tax policy and tax administration. Such a determined approach would be both economically efficient and morally right. It will encourage the expansion of honest business and also realise more revenue for the government.

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