

THE THEORY OF BLACK MONEY

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I. Introduction

On August 13, 2009, we published our first Exclusive Paper titled “Indefinite Corruption”. In that paper, besides discussing various dimensions of corruption, we also elaborated the Theory of Black Money. In this article, we are illustrating the theory once again to create more awareness about the issue, which we believe is very important in the current global scenario.

This paper is divided into various sections. In Section II, we have described different issues centering on Black Money to give the readership a firsthand idea about the concept before going deep into the matter. In Section III, we have outlined the Theory along with its overarching principles.

II. Basic Concept on “Black Money”

The Definition of Black Money

When anybody hides his/her income to the Government and does not report the actual income to evade taxes, the hidden income then becomes “Black Money”. There are many other sweeter terms to denote the same thing, such as, undisclosed income, unreported income, covered income, etc.

There are many ways how black money is created. The most common is through illegal professions, such as drug trafficking, prostitutions, and other activities that are deemed as criminal offences in the eyes of law. These incomes are not reported to the tax authorities and remain hidden.

Black money can also be created by corrupted individuals who have enormous power and who earn a substantial part of their income by abusing their power.

When a powerful person abuses his power to earn illegal income, his actual income becomes higher than his official income, and thus s/he wishes to avoid reporting those excess income to the tax authority because if tax officials ask them about the sources of such additional income, they would not have any satisfactory answer. That’s why powerful elites, such as politicians, bureaucrats, etc. have a tendency to earn Black Money in those countries where governance structure is pretty weak.

Black money is also created through evading taxes by businessmen, corporates, professionals and celebrities, etc. who have high income and they are not willing to pay taxes.

Causes of Creation of Black Money

Black money is the result of different kind of corruption and the causes behind corruption are also the causes of the creation of Black Money. If we look into the causes of corruption, we will see that there are only two causes that influence people to be corrupted, i.e., the greed for money and the need for money¹.

People love money and they have greed for money. That's why they involve themselves in illegal activities where income potentials are much higher.

Even when the profession is legal, people tend to hide their income and they tend to evade taxes just because they have greed for money.

This trait of "greed for money" is universal and is applicable for almost all the global citizens. When this greed is not checked through proper accountability mechanism, people tend to income more, and when they do not report such income, it results Black Money.

When corporates earn a lot of revenue and there is no proper supervision from the tax authority through regular intensive audits of checking the income, they tend to hide their true income and channel this additional income through illicit transfers elsewhere.

The same goes for celebrities, professionals and other wealthy individuals who have tendency to hide their true income from the Government authorities.

Sometimes creation of Black Money is also influenced from the fear of losing the income in the future. If people have a perception that the future of the country is gloomy, then they tend to transfer their cash to a safe place where they believe the cash would be stored safely and it can be withdrawn whenever there is a need. This behavior is also indirectly influenced by the greed for money because, the more the greed for money, the more risk averse a person is, and the more he would be afraid of losing his income in the future.

Black money can also be created due to the need for corruption. If the tax laws are discriminatory and people feel that it is discriminatory for them to pay such high taxes, then people would tend to hide their true income from the Government and create black money.

If the Government rules are too cumbersome and it is not easy for taking the cash out of the country for meeting some needs, people tend to transfer a portion of their income illegally to places abroad from where they can withdraw the cash balance whenever there is a need. These needs might arise from having children to study abroad, need for healthcare, or even the need for having a leisure lifestyle abroad outside the home country

¹ "Corruption in Civil Administration: Causes and Cures", written by Mabroor Mahmood; Published in Humanomics, Volume 21, Number 3/4, 2005.

where leisure living is not possible due to the absence of proper infrastructure and needed social culture.

When people become wealthy, they tend to show off their wealth to others through different means, such as buying expensive cars, yachts, private jets, etc. If a country does not have proper infrastructure, flexible rules and regulations and the required social culture to support such spending behavior, wealthy people tend to transfer a part of their income outside where such spending is easier.

Tax Avoidance and Tax Evasion

It is very important to understand the basic difference between Tax Avoidance and Tax Evasion in order to understand the causes of the creation of Black Money. Take a look at the following table:

Tax Avoidance	Tax Evasion
Tax Avoidance does not generate Black Money	Tax Evasion generates Black Money
Tax Avoidance is the mechanism of paying less tax through using various accounting techniques that make expenses higher and taxable income lower	Tax Evasion is the mechanism of hiding true taxable income either through improper recognition of expenses or lowering the revenues
Tax avoidance is legal and the reasons for lower tax liability is usually explained in the Notes to the Financial Statements of a corporate	Tax evasion is illegal and is a criminal offence
Since paying less taxes through Tax avoidance is legal, there is no need for hiding the additional income generated through Tax avoidance. Therefore, there is also no need for transferring such additional income outside the country illegally	Since paying less taxes through Tax Evasion is illegal, people tend to hide their additional income earned through tax evasion and transfer the cash outside the country where such cash balance can be kept safely

Let us explain the matter more clearly through the following example. Assume a corporate generates the following Income Statement in a given year:

Particulars	Type A	Type B
	Amount (USD)	Amount (USD)
Revenue	100,000	100,000
Cost of Goods Sold	60,000	60,000
Gross Profit	40,000	40,000
Salaries	5,000	5,000
Depreciation	1,000	1,500
Earnings Before Interest and Taxes	34,000	33,500
Financing Charges	0	0

Taxable Income	34,000	33,500
Income Taxes (20%)	6,800	6,700
Net Income	27,200	26,800

As you can see in the above table, the Taxable Income of the company becomes lower in Type B where the accountants applied a different technique for calculating the depreciation that results higher depreciation charges for Type B compared to the Type A. The technique used in this case will be disclosed in the Notes of the Financial Statements and thus, the reporting of less Taxable Income and paying less taxes of USD 100 is therefore legal in the eyes of law. This is Tax Avoidance and there is a no need for the business to channel this additional income of USD 100 illegally to another safe haven because the corporate is allowed to transfer such cash as dividends legally to any places.

On the other hand, the same corporate might be involved in Tax Evasion if the following occurs:

Particulars	Tax Avoidance	Tax Evasion
	Amount (USD)	Amount (USD)
Revenue	100,000	90,000
Cost of Goods Sold	60,000	60,000
Gross Profit	40,000	30,000
Salaries	5,000	5,000
Depreciation	1,500	1,500
Earnings Before Interest and Taxes	33,500	23,500
Financing Charges	0	0
Taxable Income	33,500	23,500
Income Taxes (20%)	6,700	4,700
Net Income	26,800	18,800

As one can see in the above table, the company hides USD 10,000 of revenue and thus generates a Taxable Income of USD 23,500, which is USD 10,000 lower than the previous example. Thus the company is in need of channeling this excess USD 10,000 elsewhere because this income was not reported to the concerned Government authority and is thus illegal.

Therefore, if you find somebody concealing his/her identity for showing some balances or transferring his income to another place where it is not supposed to be transferred, you can be sure that the cash balances were originated from Tax Evasion, not from Tax Avoidance.

Popular Tax Havens

It is widely perceived that Tax Havens are located only in Island states where there are less inhabitants and few banks dealing with such dirty money. But Tax Justice Network (TJN), a non-profit charitable UK based entity that conducts periodic research on Tax Havens thinks otherwise. They have recently formulated Financial Secrecy Index (FSI) that reveals most popular tax havens are not the Island states or relatively less known

countries in Latin American or in the Caribbean; according to the index, the most popular tax havens are the countries which are OECD members!

The full FSI Index 2015 can be accessed at <http://www.financialsecrecyindex.com/introduction/fsi-2015-results>

In the following table, we are illustrating the top 20 countries listed in FSI 2015 and we are comparing them with their corresponding ranks in the Transparency International's Corruption Perceptions Index (CPI) 2015. The countries having the most stringent secrecy laws are ranked higher in FSI 2015 and the countries perceived to be least corrupt are ranked higher in CPI 2015:

Country	FSI 2015 Rank	TI CPI 2015 Rank
Switzerland	1	7
Hong Kong	2	18
USA	3	16
Singapore	4	8
Cayman Islands	5	-
Luxembourg	6	10
Lebanon	7	123
Germany	8	10
Bahrain	9	50
UAE	10	23
Macao	11	-
Japan	12	18
Panama	13	72
Marshall Islands	14	-
UK	15	10
Jersey	16	-
Guernsey	17	-
Malaysia	18	54
Turkey	19	66
China	20	83

This is to note that FSI 2015 ranks a total of 92 countries in the world in terms of the degree of secrecy in their laws, while the CPI 2015 ranks a total of 167 countries in terms of the perception of corruptibility.

As evident from the above table, out of 20 countries having most secrecy in their financial laws, 8 countries rank very high in the CPI 2015 as well. This indicates that these 8 countries, although discouraging corruption within their boundaries, are actually encouraging corruption beyond their boundaries by providing incentives through financial secrecy laws that induce people abroad to evade taxes and store money within their territories.

Source of Wealth

If a person underreports his income and evades taxes, then there would be no effective avenue to guarantee that the wealth was created from legal sources. It is because those who are involved in illegal activities also have legal professions in front to justify their existence in the society.

Therefore, if a celebrity has a lot of hidden wealth and it is unearthed, then we can only assume that his wealth was created from his activities in the media, but we will never be sure of this. The same is applicable for businessmen, corporates and other wealthy individuals.

III. The Theory of Black Money

We developed the theory back in 2005, but made in public in 2009, when we published our first Exclusive Paper titled “Indefinite Corruption”. The paper was targeted for Bangladeshi audience and was written in Bangla language. The paper is available at <http://www.ideasfd.org/assets/Paper1.pdf>.

Overarching Principles

Our theory on Black Money is guided by a number of overarching principles as follows:

- It should be treated as an unjust behavior on an individual if s/he is punished severely through long jail terms because of evading taxes and generating black money when such behavior is rampant in his society;
- If this happens, then the Government would be compelled to punish few individuals through selecting them arbitrarily, while keeping a blind eye for similar crimes of others. It is because it is not possible to impose the same jail terms for a large number of people at the same time;
- If the Government does not allow citizens to legalize their black money through appropriate provisions, the only punishment left for the tax dodgers will be the jail terms. Legalizing black money through paying taxes acts as a financial penalty, which is also a form of punishment, although to a lesser degree in terms of severity;
- From international perspectives, we can say it would be unjust to impose sanctions or other forms of severe punishment to select countries or individuals when many developed countries encourage corruptibility outside their territories;
- Encouraging corruption and generating of black money through creating tax havens has been encouraged in front of the very eyes of the global leaders and the institutions. Switzerland, the country that ranks the top in the Financial Secrecy Index 2015, also houses almost all the head offices of large global institutions where global leaders frequently meet to discuss on governance, transparency, etc.

The Theory

Our theory on Black Money goes as follows:

“Legalizing black money through various tax measures has any economic significance when people would tend to use this particular provision for legalizing their illegal income. If they do not use the provision despite its presence, it means that such provision does not have any economic significance. Therefore, there is also no need to spend time on such provisions.

*This provision will have economic significance only when the provision is supported by a concurrent **effective** anti-corruption drive. An anti-corruption drive has many elements, such as anti-corruption publicity, developing the required institutions to check corruptibility, effective monitoring in the banking transactions, strengthening regulatory regime, etc.*

If such a concurrent anti-corruption drive continues successfully, people will have fear of their illegal income and they would tend to legalize their illegal income more. So the economic significance of this particular provision will also increase.

If all countries follow this for a considerable period of time, then time will arrive when there will be no black money available within and outside the country boundary. Only then such provisions for legalizing of black money can be abolished for good. ”

The Applicable Tax Rates

In order to encourage people to legalize their income quickly, the following measures can be adopted:

- a. For legalizing the cash black money, the tax rate to be applied should be higher than normal tax rates of income;
- b. If any individual or a corporate wishes to legalize the illegal income through investments, the applicable tax rate should be lower than above. This would encourage people to invest the sums in productive opportunities, which will benefit the people in the long run. Since there are risks in investments, there has to be proper incentives provided to encourage people to legalize their illegal wealth through direct investments. Governments can select priority sectors where such investments should be channeled;
- c. For countries where people have a general tendency of paying taxes regularly, this provision should apply higher taxes for legalizing illegal income compared to those countries where tax evasion is rampant;
- d. The individual or corporates should legalize their illegal wealth in the jurisdictions from where illegal wealth was generated;

- e. The Governments can encourage people to quickly legalize their illegal wealth by adjusting the tax rates upward gradually in the long run.

The End Note

It is important to note that allowing citizens to legalize their illegal hoarding is nothing new. According to a report titled “Update on Voluntary Disclosure Programmes: A Pathway to Tax Compliance” published by the OECD during August 2015 shows that out of 47 countries surveyed, 38 countries have “Voluntary Disclosure Programmes” under which tax payers are encouraged to disclose their hidden wealth through paying proper taxes.

The success of these Programmes, is however, debatable. In the United States, the Voluntary Disclosure Programs that started in 2009 helped more than 45,000 tax payers to report their undisclosed wealth, generating an excess tax revenue of USD 6.5 billion². Many academic papers have termed such collection of revenue as “success”, however, it needs to be determined how much percentage of undisclosed wealth of US citizens have truly been disclosed through these programs that ran since 2009.

In Bangladesh, between fiscal years 1971-72 to 2012-13, a total of Tk 138,080 million of illegal wealth has been legalized under various provisions offered by the National Board of Revenue (NBR) of the Government of Bangladesh. Of these amounts, almost Tk 96,830 million or 70% were legalized during 2007-08 fiscal years. During these entire periods, the Government collected an excess tax revenue of Tk 14,560 million³.

This is to note that during 2007-08 periods, the Government launched a massive crackdown over the politicians and businessmen who were perceived to be involved in grand corruption in various regimes. At the same time, the provisions for legalizing the illegal wealth was also kept open. Therefore, there was an exit route for the illegal money holders and they showed more tendency to legalize their illegal income in order to avoid any criminal proceedings against them. However, it can be argued to what extent such a crackdown was really an *effective* anti-corruption drive that would reduce corruption in the long run.

In order to implement the theory, it is important to design an effective anti-corruption drive that would be long lasting and beneficial for all the countries in terms of generating more employment and ensuring sustainable economic growth, and at the same time, keep the Voluntary Disclosure Programs open with appropriate penalty mechanisms.

² “IRS Announces Third Offshore Voluntary Disclosure Program”, written by Gideon Rothschild, JD, CPA.

³ “Why Black Should be White”, written by Chowdhury Md. Rakibul Kamal ACA; The Bangladesh Accountant; April-June, 2014; The Institute of Chartered Accountants of Bangladesh.

About the Author



Mabroor Mahmood is the Founder of IDEAS FOR DEVELOPMENT (IFD). He is based in Jeddah, Saudi Arabia and now serves a development organization. Mr Mahmood published numerous papers in various journals. He completed his graduation from the University of Dhaka, Bangladesh and later obtained an MS degree from the University of Maryland at College Park, USA. He is the Inventor and Founder of “Biniog Sathi” – a new generation banking model that resolves the problem of credit default in the banking industry. Its web address is www.biniog-sathi.com. He is also the Chief Coordinator of “United Against Alcohol” – a social campaign targeted to create general awareness against the drinking of alcohol. Its web address is www.facebook.com/UnitedAgainstAlcohol.



IDEAS FOR DEVELOPMENT (IFD)

IDEAS FOR DEVELOPMENT (IFD) is a virtual think-tank. This initiative was first conceptualized through an email on January 18, 2007. This think-tank does not have any office; its website and email address are its identity. Mr Mabroor Mahmood, an expatriate Bangladeshi national living in Saudi Arabia, is the founder of this think-tank. IFD is his brain child.

The prime objective of this think-tank is to ensure the welfare of the humanity through the exchange of development related ideas with the help of the Internet. This is the mission statement of this think-tank. This mission statement is also reflected in its logo. The logo comprises four colored blocks, denoting four dominant races in the world.

IFD believes that the persisting inequality amongst nations is the root of continuing global tension and absence of peace all over the world. So IFD believes that such tensions will be significantly reduced if this inequality can be resolved. But we need new development ideas to resolve such inequality. At present, the developed nations are consistently formulating new ideas with the help of research and moving forward through their successful implementation.

However, the less developed countries are lagging behind due to either the lack of resources or indiscriminate wastage of such resources. This phenomenon causes the gradual expansion of inequality between the developed and less developed nations, and as a result, poverty and exploitation are increasing all over the world.

IFD has been created with a noble aim to reduce this disparity amongst nations with the help of generating new ideas. IFD wants to be the platform for exchanging ideas of all thinkers and creative people of the world. We expect the thinkers all over the world would exchange their ideas through this platform.

A potential thinker will receive some specific benefits if he/she exchanges his/her ideas through the IFD.

First of all, the generation of an idea only is not sufficient to ensure development; in fact it is only the beginning of a long process. A thinker should not stop after generating an idea, rather he also needs to describe in detail the solution of the problem in the form of a model. This model has to be implementable as well. Otherwise, this idea won't have any value.

We actually don't have any shortage of people having new ideas. But we really lack people who can provide us a nicely presented idea, which is also worthy for implementation.

To resolve this problem, IFD would guide a potential thinker on how to present an idea in a logical fashion. IFD will also give necessary guidance in this respect, and provide the required assistance to make a potential yet immature idea presentable.

Secondly, one does not need any qualification to send an idea to IFD. Any person can send an idea to IFD from anywhere with the help of any medium.

Thirdly, although IFD is temporarily focused on exchanging economic ideas only, eventually its activity would also expand to cover other disciplines as well.

Fourthly, if an idea is publicized by the IFD, everybody would be ensured of its reliability and its power to change the society in the right direction. It will enhance the credibility of the idea itself.

It has to be highlighted that IFD will not publicize any idea that it will receive. The selection of an idea for publication would entirely depend on its ability to contribute to the welfare of the society.

And fifthly and the most important benefit is that, the potential thinkers won't have to spend any money for sending an idea to IFD, except for the charges for email or postage. He/she won't also have to give any money to IFD if the idea is eventually published in IFD website.

One might ask, if a potential thinker gives us a valuable idea, it might eventually be stolen. As a result the true inventor of the idea would lose his/her proper recognition. Then what is the protection for the owners of the idea?

In this connection, we assure you that we won't publish your idea anywhere else under a different name without your permission.

We strongly believe that an idea generator can be properly valued only by another idea generator. IFD believes that an idea is properly valued when it is implemented, either partially or completely, and benefits the people. IFD has a limitation from this perspective. It is because in order to implement an idea successfully, one needs assistance from Government bodies or other organizations.

Therefore, IFD cannot guarantee that the circulation of an idea through the IFD would ensure its successful implementation. IFD intends to act as a platform for circulating and publishing the ideas only. IFD will not be responsible for implementing these ideas.

But IFD's activity will not be limited only to generation and publication of an idea. In order to generate new ideas and ensure its successful implementation, we not only need prospective thinkers, but also need proper political leadership, strong Government apparatus, modern education system, and above all, a peaceful political and social climate.

Prospective thinkers will not be born unless proper environment is ensured, and their ideas will not be properly valued and implemented in an unstable social and political atmosphere.

So besides circulating development related ideas, IFD would also act to ensure an environment where the number of prospective thinkers will increase, they will be properly valued, and their ideas will be successfully implemented.

To serve this purpose, IFD will publish special articles highlighting various social issues.

At last, we want to say if you are confident on any prospective idea, and firmly believe that this idea, if implemented, would benefit the society to an extent, then we request you to send us this idea. You can primarily send us an email in our address. You can also visit our website to know more about us.

We believe such exchange of ideas would help to develop prospective thinkers all around us. Everybody would also be benefited if their ideas are eventually implemented successfully. So we need cooperation from all for moving forward. We thus welcome any cooperation in order to exchange these development related ideas through the IFD.

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