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Using direct taxation to boost revenue and tackle inequality: A political economy analysis

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Using Direct Taxation to Boost Revenue and Tackle Inequality: A Political Economy Analysis

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Executive summary

The majority of the government's revenue in Bangladesh comes from indirect sources. Different indirect taxations, such as Value Added Tax (VAT), import duties and tariffs, etc., generate about 65 per cent of tax revenue. In contrast, direct taxation, such as personal income taxation, corporate income taxation, wealth surcharge provides the rest of the 35 per cent. This study emphasises promoting direct taxation for boosting domestic resource mobilization in Bangladesh. Furthermore, it offers economic rationales for switching the tax regime from high dependence on indirect to direct taxes. The paper explains that direct taxation creates less burden to raise a certain amount of tax revenue and improves income distribution. Thus, direct taxation can help reduce income inequality with minimal efficiency loss. Recently, policymakers have shown a keen interest in using direct taxation to generate more revenue. The National Board of Revenue (NBR) set a target to increase the share of direct tax to 70 per cent of total revenue. However, switching the taxation paradigm to a more direct one is a complicated process and requires precise understanding of the tax ecosystem. This study contributes to enhancing the understanding of the current state of direct taxation, the tax ecosystem, and the contribution of direct tax on reducing the rising inequality in Bangladesh. It analyses the challenges of revenue mobilization from direct tax and provides pragmatic policy recommendations that can contribute to shaping the tax policies and administrative reforms for promoting direct taxation in Bangladesh.

Using the data from various secondary sources, the paper discusses the compositions of different types of direct tax revenues of the government of Bangladesh. Direct tax, which is imposed on the income, and profit of individuals and enterprises, reached Tk. 1 trillion in 2021-22, increasing from just TK. 4 billion in 2001-02. It is important to note that the direct tax to GDP ratio in Bangladesh is among the lowest of its international peers. The share of direct tax declined considerably to 2.3 per cent of GDP in 2019-20 before increasing to 2.6 per cent in 2021-22. The comparable figures are 6.6 per cent in Bhutan, 12 per cent in China, 9.2 per cent in Hong Kong, 5.5 per cent in India, 4.8 per cent in Indonesia, 4 per cent in the Maldives, and 5.3 per cent in Vietnam. The smaller share of direct tax revenue almost certainly contributes to the rising income inequality in the country. This is because direct taxation tends to be more progressive than indirect taxation, and because the low direct tax-to-GDP ratio limits government’s ability to invest in social and economic development spending, which tends to benefit lower income people.

The paper offers a concise discussion of Bangladesh's tax ecosystem comprising different interdependent political and economic interest groups. The responsibilities of formulating and changing a tax policy lie on the members of the Parliament of Bangladesh and bureaucrats in the Ministry of Finance and Planning, while the NBR shoulders the responsibility of implementing it. Officials at NBR enjoy a great deal of autonomy and exercise discretionary power and generally oppose any reform or modernisation of the tax system in Bangladesh. Other stakeholders are businesses, households, and various think tanks, which also attempt to influence the drafting and implementation of direct tax policies. The intricacies of a tax code are determined by the relative political and economic powers of these different stakeholders. This creates winners and losers and diminishes the effectiveness of direct taxation to lessen income inequality.

Based on the discussion of the current state of direct income taxation and the tax ecosystem in Bangladesh, the paper proposes to develop a time-bound roadmap and policy actions to achieve the new direct taxation target, which can also contribute to reduce income disparity. There is a need for a short-to-medium-to-long-term roadmap and implementation strategies.[1] Therefore, it is important to set out a series of step-by-step policy measures that will be necessary to achieve this target. One target could be increasing the share of direct tax by 5 percentage points within the 8th Five-Year Plan period (2024-25). In the short run, raising the tax eligibility floor and the rates for personal income tax, rationalising the corporate income tax, increasing the tax base, and encouraging individuals with TIN to submit income returns could significantly raise the revenue from direct taxation. In the medium term, automating and centralising the audit system and separating the tax policy and tax administration unit would increase the efficiency of the tax administration and potentially increase the revenue from direct taxation.

Short-term recommendations:

- i) Implement the requirement to submit returns for taxpayers to access public services
- ii) Increase the tax eligibility floor and the highest rate of personal income tax
- iii) Send notices to registered taxpayers to submit tax returns
- iv) Deduct calculable tax obligations at source and automate tax returns
- v) Automate and centralise the audit system

Medium- to long-term recommendations:

- vi) Increase the number of registered taxpayers
- vii) Adopt a universal registration approach for taxation
- viii) Rationalise corporate tax rate
- ix) Review and rationalise tax exemptions and incentives
- x) Deal with malpractices in tax administration through digitalisation and automation
- xi) Strengthen the capacity of NBR
- xii) Separate tax policy and tax administration
- xiii) Improve taxpayer services for increased tax compliance
- xiv) Design a proper wealth tax

[1] The intention of this paper is to form the basis for further work by government and agencies into practical policy options to increase the direct tax take in Bangladesh over time.

Using Direct Taxation to Boost Revenue and Tackle Inequality: A Political Economy Analysis

Mohammad A. Razzaque, Jillur Rahman, Rabiul Islam Rabi, Deen Islam and Abu Eusuf[2]

I. Introduction

Domestic revenue generation: context in Bangladesh

The domestic revenue generation in Bangladesh is historically low. The revenue generation to GDP ratio is around 9 per cent. Of these, direct tax comprises one-third of total revenue. This is far below the comparator countries and the average of lower-middle-income countries. Nevertheless, direct taxation is superior to indirect taxation in numerous ways. To begin with, direct taxation creates less burden to raise a certain amount of tax revenue, leading to the least allocative inefficiency. Next, direct taxation improves income distribution and helps reduce income inequality. In addition, policies and efforts undertaken to increase revenue from direct taxation shrink the size of the informal economy and are complementary to generate more revenues from indirect sources as well.

Recently, at a high-level public consultation (on 3 September 2022), the National Board of Revenue (NBR) set out its target to increase the share of direct tax to 70 per cent of the total revenue from the currently 35 per cent. It is a welcome initiative that should help achieve the objective of economic development with fairness. The government and policymakers acknowledge that direct tax can be an effective tool to reduce the. In addition, higher revenue will enable the government to fund infrastructure and public services necessary to stimulate growth.

Direct versus indirect taxes

Now, the question is if direct taxation has some advantages ahead of indirect taxation in terms of generating more revenue with the least amount of excess burden of taxation, why do governments in developing countries not rely on it? There are several issues in implementing a direct taxation scheme in a developing country like Bangladesh. First, a direct taxation system requires state-of- art technologies to collect taxes from numerous taxpayers and proper auditing to ensure minimal tax-evading attempts.

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Second, devising a direct taxation policy is a complicated political process involving many stakeholders with competing interests. As such, there are conflicts of interest; lawmakers responsible for formulating a direct taxation policy might be subject to this policy significantly. Third, the cost of raising revenues using direct taxation could be higher than indirect taxation if modern automated technologies were not used. In addition, direct taxation implemented with the traditional infrastructure could lead to more corruption and significant losses in revenue.

Yet for Bangladesh, it is high time to emphasis a greater weight on direct taxation to raise revenue as it has achieved commendable socio-economic development over the past decade. Moreover, compared to many other countries at a similar stage of development, it achieved faster progress in various social and human development indicators, such as health, education, poverty reduction, nutrition, demographic, and gender equality outcomes. However, despite significant growth in the per capita income, the overall tax effort in the country has remained relatively low (around 9 per cent) and much smaller than that of many other competing countries. While maintaining a low tax burden can help to stimulate growth by leaving more wealth to circulate around the economy in private hands, rising income inequality in the county has become a major concern. According to the latest Household Income and Expenditure Survey (HIES) 2016, the gini coefficient – a measure of inequality – stood at 0.48: an all-time high. The income shares of richer population increased significantly while the same declined for poorer households. Richer people tend to have a lower propensity to consume goods and services with their extra income than do those at the bottom of the income distribution, so there is both a 'growth case' and a 'fairness case' for a more equitable outcome from fiscal redistribution.

In the context of rising inequality and a low tax-GDP ratio, there is an opportunity for more strategic use of the direct tax system to boost domestic resource mobilisation. Direct taxation helps build a more equitable society as the burden of direct tax is shouldered by the citizens and businesses based on their earned incomes. In contrast, an emphasis on indirect tax shifts the burden to the consumers in general, most of whom are from poor or low-income households. Fortunately, policymakers signal a shift in the tax policy tilted towards direct taxation. This year's budget can provide a strong policy signal towards tackling the growing inequality problem by focusing on the direct taxation system and allocating more resources to health, education, and social protection.

The purpose of this study

Against this backdrop, this study presents a critical review of the current state of the tax system in Bangladesh using information from both primary and secondary sources. The primary data are in the form of key informants' interviews and stakeholder consultations. These interviews were conducted to understand the complexity of the tax system in Bangladesh, especially the issues related to direct taxation and its challenges and to guide the proper steps to make the tax system in Bangladesh more direct. Secondary data comes from many sources: Ministry of Finance (MoF), National Board of Revenue (NRB), Bangladesh Bureau of Statistics (BBS), and Government Revenue Dataset (GRD), and UNU-WIDER. Data collected from these sources are used to analyse four aspects of taxation in Bangladesh. First, we document the current state of direct taxation in Bangladesh. Next, as a major component of direct taxation, we investigate the state of income and corporate taxation in Bangladesh. We then focus on rising income inequality in Bangladesh and the cross-country evidence between direct taxation and income inequality. Third, based on the secondary literature and stakeholder interviews, the tax ecosystem in Bangladesh is described with the challenges to promoting direct taxation. Finally, based on the findings from secondary data and consultations with policymakers and experts, the study provides pragmatic policy recommendations to move toward direct taxation in Bangladesh.

The paper is organised as follows: after this brief introduction, Section 2 describes the current state of direct taxation in Bangladesh and sets the ground on the role of direct taxation to reduce income inequality. Section 3 explains the intricacies of the political economy of direct taxation in Bangladesh, along with the findings from stakeholder interviews. Finally, section 4 provides a set of pragmatic policy recommendations for switching to a direct taxation system.

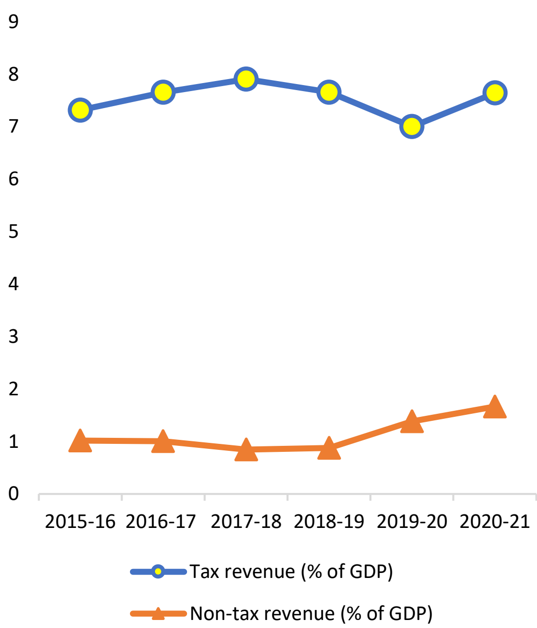
II. Direct taxation in Bangladesh

The current state of direct taxation in Bangladesh

Historically in Bangladesh, tax revenue is low and lags behind government expenditure. The revenue-GDP ratio stood at 9.3 per cent in 2020-21 – slightly increasing from 8.4 per cent in the previous year (Figure 1a). Total revenue comprises tax revenue and non-tax revenue. Tax revenue in the country was 7.6 per cent of GDP in 2020-21, while the non-tax revenue was 1.7 per cent. The tax-GDP ratio in Bangladesh remains one of the lowest among global economies (Figure 1b). The corresponding figure is 23.4 per cent in China, 17.3 per cent in India, 28.5 per cent in Japan, 26.4 per cent in the Republic of Korea, 19.6 per cent in the Maldives, 17.3 per cent in Thailand and 14.7 per cent in Vietnam.

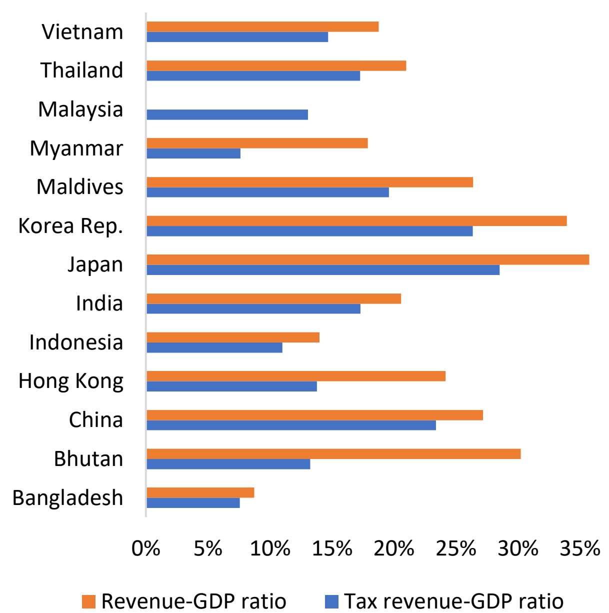
Figure 1: Tax revenue in Bangladesh remains one of the lowest in the world

(a) Revenue generation in Bangladesh (% of GDP)



Source: Authors' presentation using data from the Ministry of Finance, Bangladesh.

(b) Government Revenue in selected countries, 2016-2020 (% of GDP)



Source: Authors' presentation using data from the Government Revenue Dataset (GRD), UNU-WIDER.

The National Board of Revenue (NBR) is the main tax authority in Bangladesh. Taxes collected by the NBR constitute around 98 per cent of all tax revenue and 80 per cent of total revenue in 2020-21 (Figure 2).[3] Non-NBR tax is around 2 per cent of total revenue, while non-tax revenue is about 18 per cent. Since 2010-

[3] Taxes collected by NBR include income tax (IT), surcharge on wealth, value added tax (VAT), turnover tax (TT), supplementary duty (SD), customs duty (CD), regulatory duty (RD), excise duty (ED), income tax, foreign travel tax, and miscellaneous taxes. Non-NBR taxes narcotics duty (Collected by the Department of Narcotics Control, Ministry of Home Affairs), land revenue (collected at local Tahsil offices of the Ministry of Land), non-judicial stamp, registration fee (collected by the Registration Directorate of the Ministry of Law, Justice and Parliamentary Affairs), and motor vehicle tax (collected under the Ministry of Communication).

11, total NBR revenue grew at an annual average rate of 13 per cent to stand at TK. 3 trillion in 2021-22. It slightly declined in 2019-20 due to the Covid-19 economic slowdown and then rebounded quickly.

Figure 2: The National Board of Revenue collects around 80 percent of the total revenue in Bangladesh

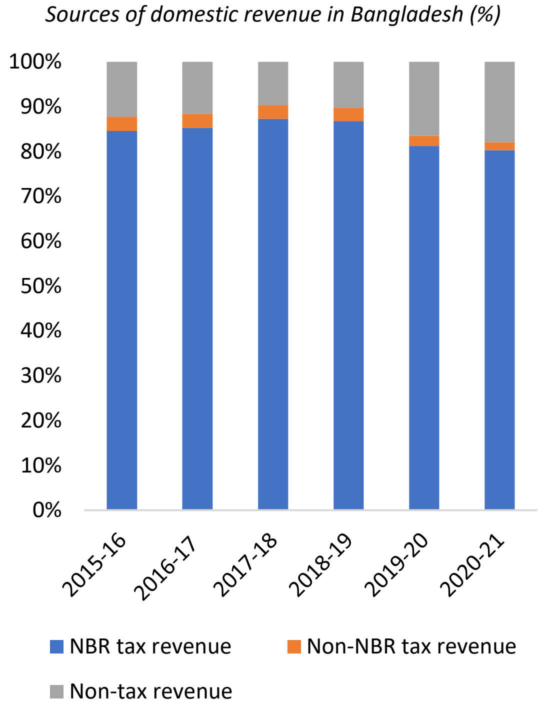
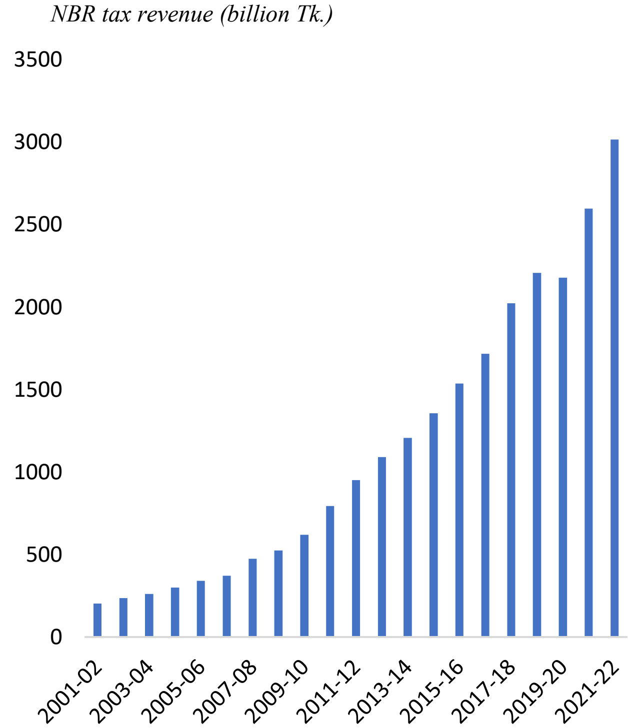


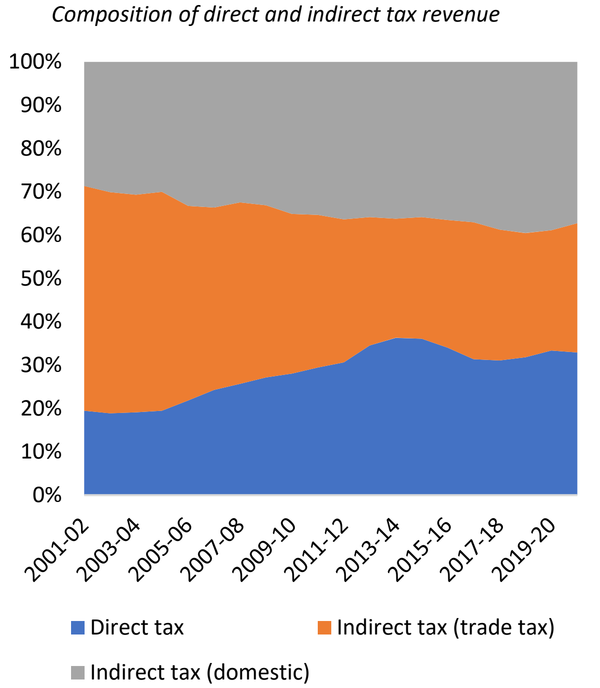
Figure 3: The NBR tax revenue reached at Tk. 3 trillion for the first time in 2021-22



Source: Ministry of Finance and National Board of Revenue (NBR), Bangladesh.

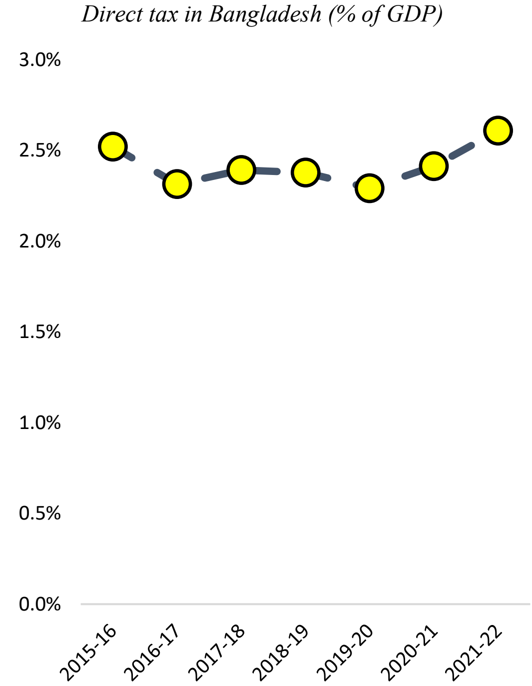
The structure of NBR tax revenue shows that Bangladesh is highly dependent on indirect taxation for revenue mobilisation. The share of direct tax remained around one-third of total tax revenue (Figure 4). Direct tax, which is imposed on the income, and profit of individuals and enterprises, reached Tk. 1 trillion in 2021-22, increasing from just TK. 4 billion in 2001-02. It is important to note that the direct tax to GDP ratio is among the lowest in Bangladesh. The share of direct tax declined considerably to 2.3 per cent of GDP in 2019-20 before increasing to 2.6 per cent in 2021-22 (Figure 5). The comparable figures are 6.6 per cent in Bhutan, 12 per cent in China, 9.2 per cent in Hong Kong, 5.5 per cent in India, 4.8 per cent in Indonesia, 4 per cent in the Maldives, and 5.3 per cent in Vietnam.

Figure 4: Direct tax comprises around one-third of total tax revenue



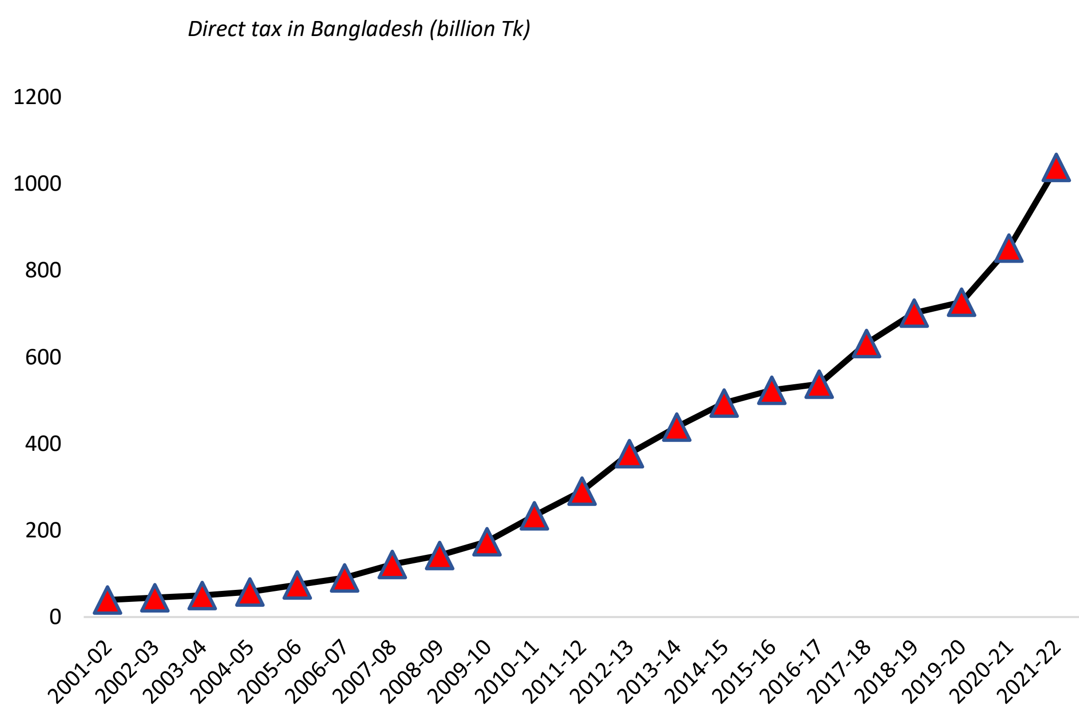
Source: Authors' presentation using data from the NBR.

Figure 5: Direct tax stood at 2.6 per cent of GDP



Source: Author's estimate based on NBR and BBS data.

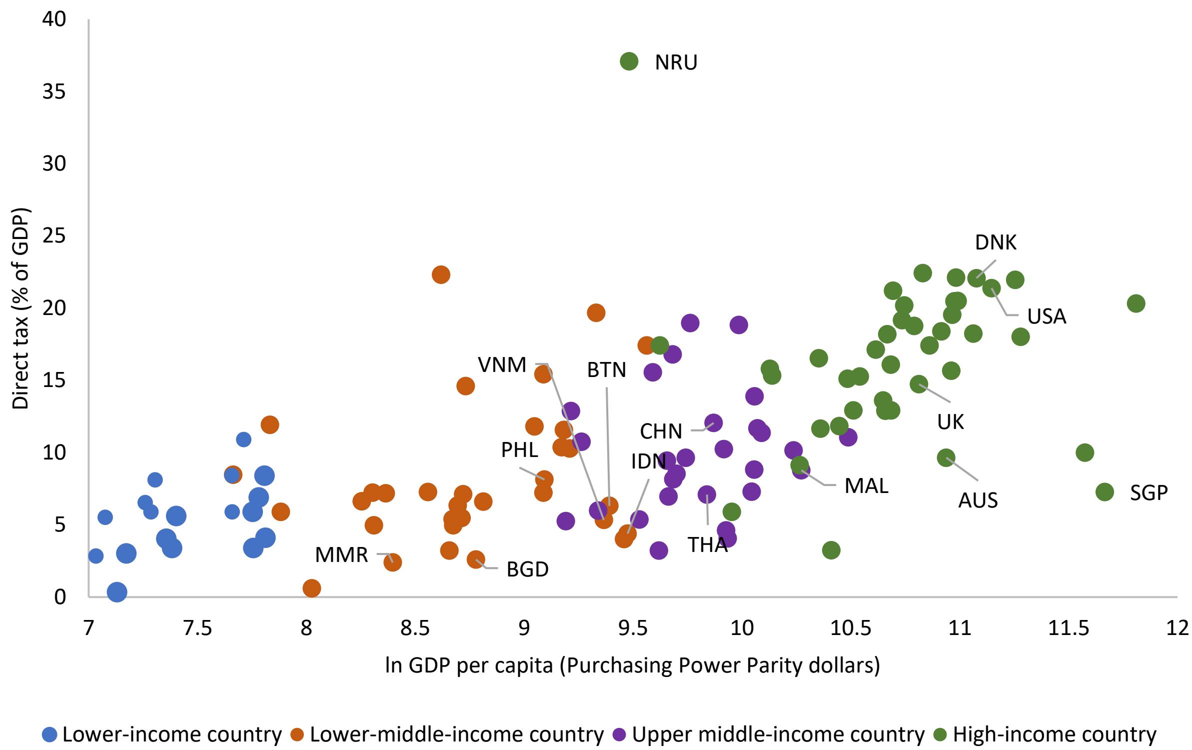
Figure 6: Revenue from personal income, profit and wealth stood at Tk. 1 trillion in 2021-22



Source: Author's presentation using data from the National Board of Revenue (NBR), Bangladesh.

Figure 7: Direct tax to GDP ratio is one of the lowest in Bangladesh

Direct tax as percent of GDP and per capita GDP



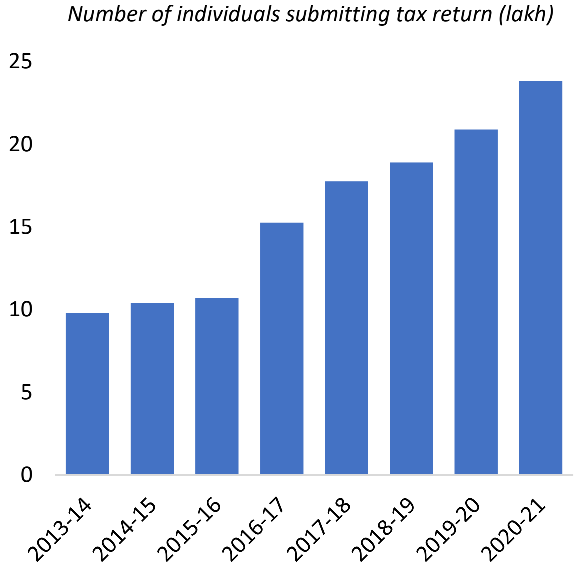
Note: Countries are indicated as AUS – Australia, BGD – Bangladesh, BTN – Bhutan, CHN – China, DNK – Denmark, IDN – Indonesia, MAL – Malaysia, PHL – the Philippines, SGP – Singapore, THA – Thailand, UK – the United Kingdom, USA – the United States of America, VNM – Vietnam.
Source: Authors' presentation using data from the Government Revenue Dataset (GRD), UNU-WIDER and the World development Indicators (WDI), World Bank.

State of personal and corporate income tax

Bangladeshi residents are taxed on their income – called personal income tax. Despite having a progressive income tax structure (Table 1), the revenue generation from personal income tax remained low – just around 1 per cent of GDP. This is much lower than India, China, Sri Lanka, Indonesia and other comparable countries. The narrow tax net is accountable for the low personal income tax revenue. Taxable income earners are obliged by the law to submit their tax return by 30 November each year against the tax identification number. The e-TIN system was introduced in FY 2013-14. Around 7.6 million people had a taxpayer identification number at the end of June 2022. This comes to just about 5.5 per cent of the working-age population and less than 10 per cent of the employed population.

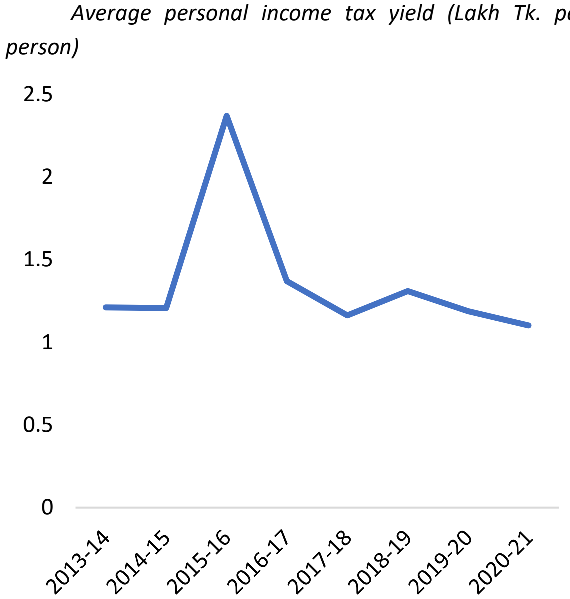
In 2020-21, 2.4 million individuals submitted personal income tax returns (Figure 8) and paid Tk. 262.4 billion. The number of individual taxpayers is just one-third of total TIN holders. The average tax revenue per taxpayer was 1.1 lakh in 2020-21, down from 2.4 lakh in 2015-16 (Figure 9).

Figure 8: Around one-third of registered TIN holders submit personal income tax return



Source: Authors' presentation using data from the NBR.

Figure 9: Personal income tax yield declined in recent years



Source: Authors' computation using data from the NBR.

The key challenges of the personal income tax system in Bangladesh include the very narrow tax net and, consequently, the uneven distribution of the income tax burden; lack of progress in digitalisation of the taxation system; lack of enforcement mechanism; large informal sector activities; lack of compliance; etc.

The government announces personal income taxation eligibility thresholds and tax slab rates. Bangladesh has been maintaining a progressive personal income tax. For 2022-23, the tax exemption limit is considered at Tk. 3,00,000. The limit is Tk. 3,50,000 for women and senior citizens aged 65 years and above, Tk. 4,50,000 for specially-abled persons and Tk. 4,75,000 for gazetted war-wounded freedom fighters. Income tax rates range from a minimum of 5 per cent to as high as 25 per cent (Table 1), depending on the level of income. The highest income tax rate was reduced from 30 per cent to 25 per cent in fiscal year 2019-20 due to covid-19 induced economic slowdown and income losses. In addition to income tax, as specified in Table 1, a wealth surcharge is payable if an individual's net asset holdings exceed a specific threshold. The wealth surcharge threshold is determined on the basis of deed value of the individual's assets. However, the surcharge is applicable on total payable taxes.[4] The wealth surcharge thresholds and rates are specified in Table 2. If an individual has a net wealth worth Tk. 3 crore or above, or owns more than one motor car or a flat of 8,000 square feet size within city corporation, the person will have to pay the tax ranging from 10 per cent to 30 per cent of the payable income tax as wealth surcharge. One certain limitation of wealth surcharge is that the deed value of asset mismatches with the current price, in most cases. In some cases, assets are owned by generations, and deed value is much

[4] For example, an individual has a total taxable income of Tk. 500,000 an assessment year and has a net wealth worth of Tk. 4,00,00,000. His/her income tax on total taxable income will be Tk 15,000. However, as the neath wealth exceeds the surcharge threshold, a surcharge at 10 per cent will be applicable on his/her total taxes. That is, he/she will have to pay Tk. 1,500 (10 per cent of 15,000) as wealth surcharge. His/her total tax obligation will be Tk. 16,500.

lower than the actual value of the asset. This approach also discriminates among the taxpayers. For example, the deed value of an asset which was registered in 1960s will be much lower than the value of similar asset registered in 2020. In the latter case, the individual might be taxed on the basis of the deed values, the earlier will be excluded.

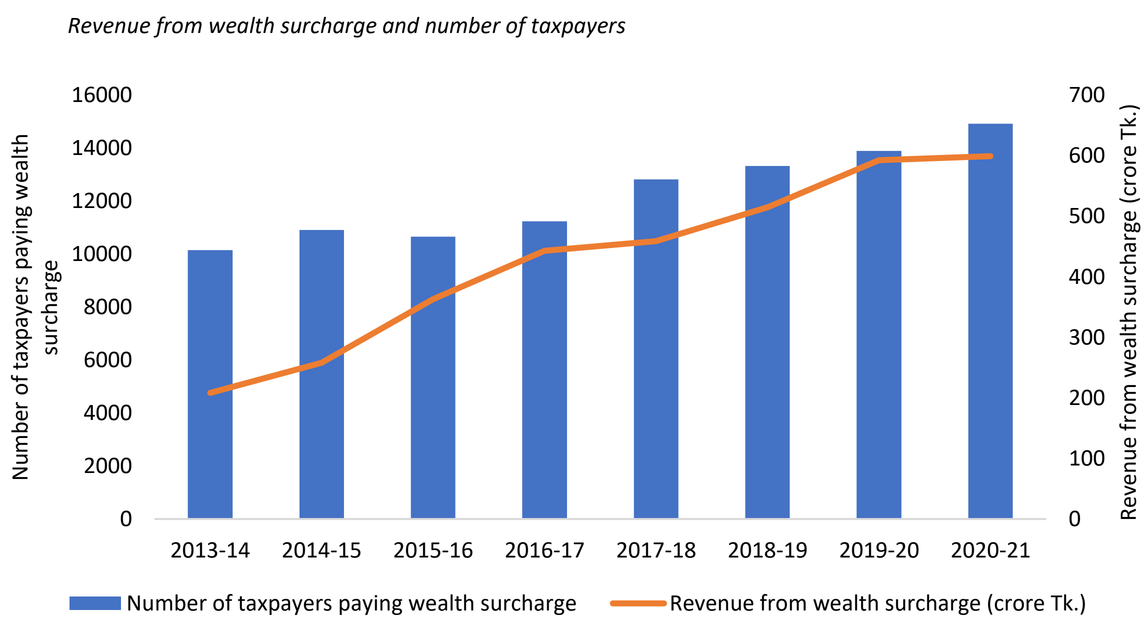
Table 1: Personal income tax rate in Bangladesh for 2022-23

Taxable income	Surcharge rate on total income tax
Less than Tk. 3,00,000	Nil
Tk. 3,00,001-Tk. 4,00,000	5 %
Tk. 4,00,001-Tk. 7,00,000	10%
Tk. 7,00,001-Tk. 11,00,000	15%
Tk. 11,00,001-Tk. 16,00,000	20%
Over Tk. 16,00,000	25%

Source: Income Tax Paripatra 2022-23, NBR.

Besides personal income tax, a wealth surcharge is payable if an individual's net asset holdings exceed a specific threshold. As of 2020-21, around 15,000 individuals paid Tk. 6 billion as a wealth surcharge (Figure 10). Despite the number of wealthy people is increasing in the country, the NBR has been struggling to expand the wealth tax or surcharge over the years. Key challenges for wealth surcharge are the unreported assets and difficulties in measuring asset values. The surcharge applies to the assets' deed values, which are generally several times lower than the actual values.

Figure 10: Revenue generation from wealth surcharge was not significant as very few people paid surcharge



Source: Authors' presentation using data collected from the NBR.

Table 2: The rate of surcharge for 2022-23

Total net wealth	Surcharge rate
Over Tk 30 million to Tk 100 million or owner of more than one motor car or owner of a flat of 8,000 square feet size within city corporation	10%
Over Tk. 100 million to Tk. 200 million	20%
Over Tk. 200 million to Tk. 500 million	30%
Over Tk. 500 million	35%

Source: Income Tax Paripatra 2022-23, NBR.

The corporate tax rate in Bangladesh is one of the highest in the region. It ranges from 12 per cent for RMG and some other manufacturing sectors to as high as 45 per cent for non-publicly traded mobile operator companies. In 2020-21, around 29 thousand companies submitted corporate tax returns and paid Tk. 604.5 billion. Despite robust economic activities, the number of companies submitting CIT remained almost stagnant over the past several years. As a result, the average corporate income tax yield remained below Tk. 150 lakh per company until 2019-20, before increasing to above Tk. 200 lakh in 2020-21. Table 3 shows corporate tax rates for different sectors in Bangladesh in 2022-23.

Figure 11: Number of companies submitting CIT remained almost stagnant

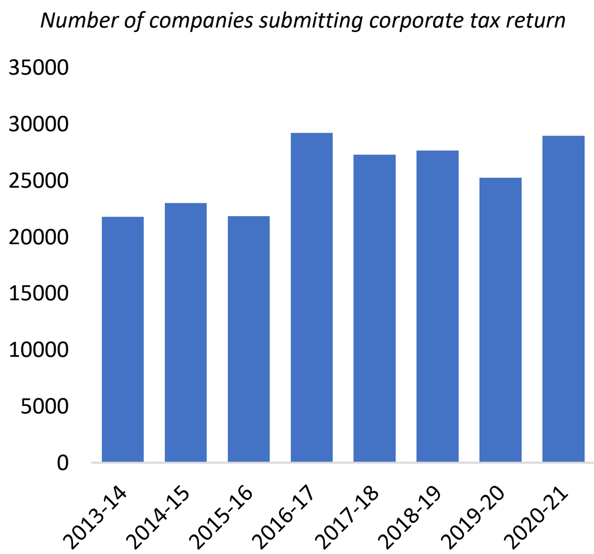
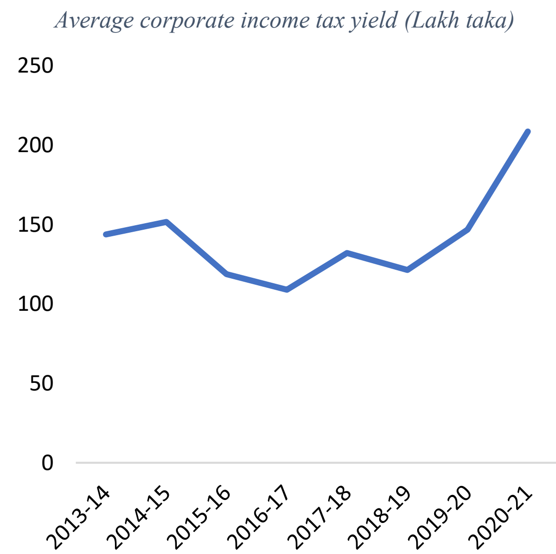


Figure 12: however, the average corporate tax yield increased in recent years



Source: Authors' presentation using data collected from the NBR.

Table 3: Corporate tax rate in Bangladesh for 2022-23

Category	Existing 2021-2022	Proposed 2022-2023	*Applicable tax rate if fails to meet the condition
Publicly traded company that issues shares worth more than 10 percent of its paid-up capital through Initial Public Offering (IPO)	22.5%	20%	22.5%
Publicly traded company that issues share worth ten percent or less than ten percent of its paid-up capital through IPO	22.5%	20%	25%
Non-publicly traded company	30%	30%	30%
One Person Company (OPC)	25%	22.5%	25%
Publicly traded bank, insurance, and financial institution (except merchant bank)	37.5%	37.5%	not applicable
Non-publicly traded bank, insurance, and financial institution	40%	40%	not applicable
Merchant bank	37.5%	37.5%	not applicable
Publicly traded mobile operator company	40%	40%	not applicable
Non-publicly traded mobile operator company	45%	45%	not applicable
Association of persons	30%	27.5%	30%
Artificial juridical person and other taxable entity	30%	27.5%	30%
Private university, private medical college, private dental college, private engineering college or private college solely dedicated to imparting education on ICT	15%	15%	not applicable
*Condition: All receipts and income must be transacted through bank transfer and all expense and investment over Tk. 12 lakhs must be made through bank transfer.			

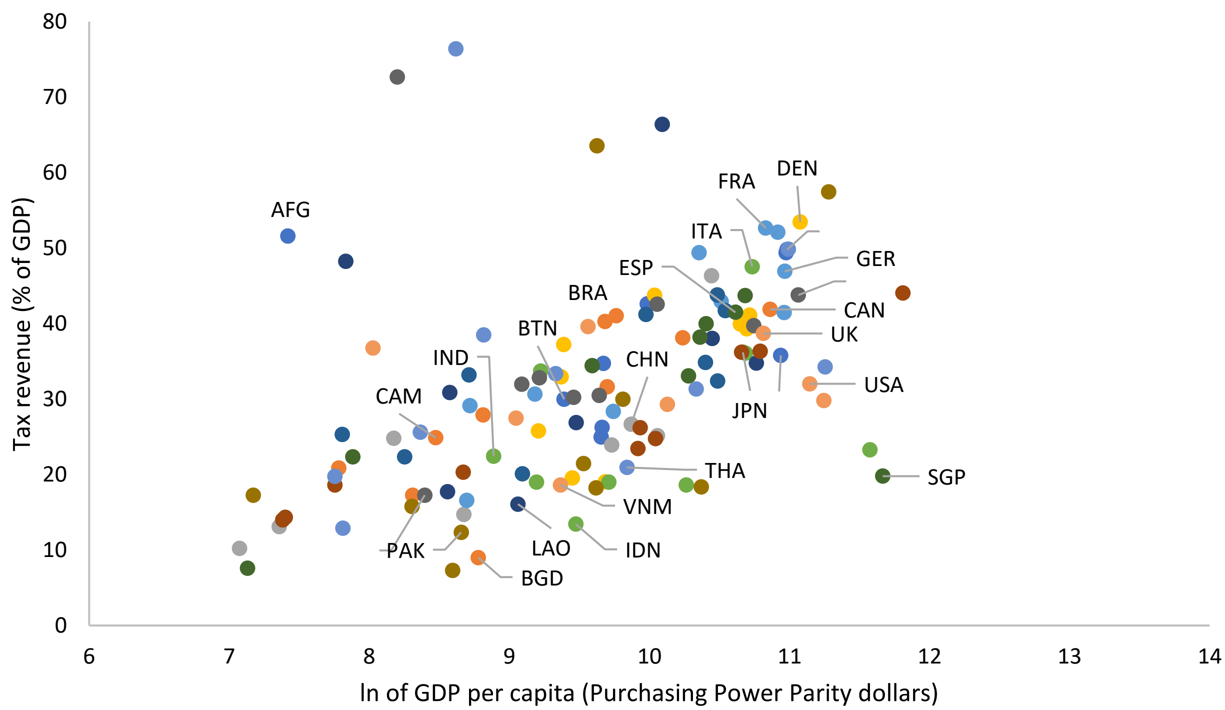
Source: Budget Speech 2022-23, Ministry of Finance.

The key challenges to streamlining the corporate tax system in Bangladesh include high tax rates, complexity in the tax system, narrow tax net, weak compliance, and widespread tax exemptions. In addition, widespread tax exemptions, incentives, and special corporate tax laws weaken the revenue potential.

Direct taxation and income inequality

Bangladesh has achieved commendable socio-economic development over the past decade compared to many other countries at a similar stage of development. It achieved faster progress in various social and human development indicators such as health, education, poverty reduction, nutrition, demographic, and gender equality outcomes. In the face of the onset of the Covid-19 global pandemic, Bangladesh's economy has shown tremendous resilience. However, despite significant growth in the per capita income, the overall tax effort in the country has remained quite low (around 9 per cent) and much smaller than that of many other competing countries.

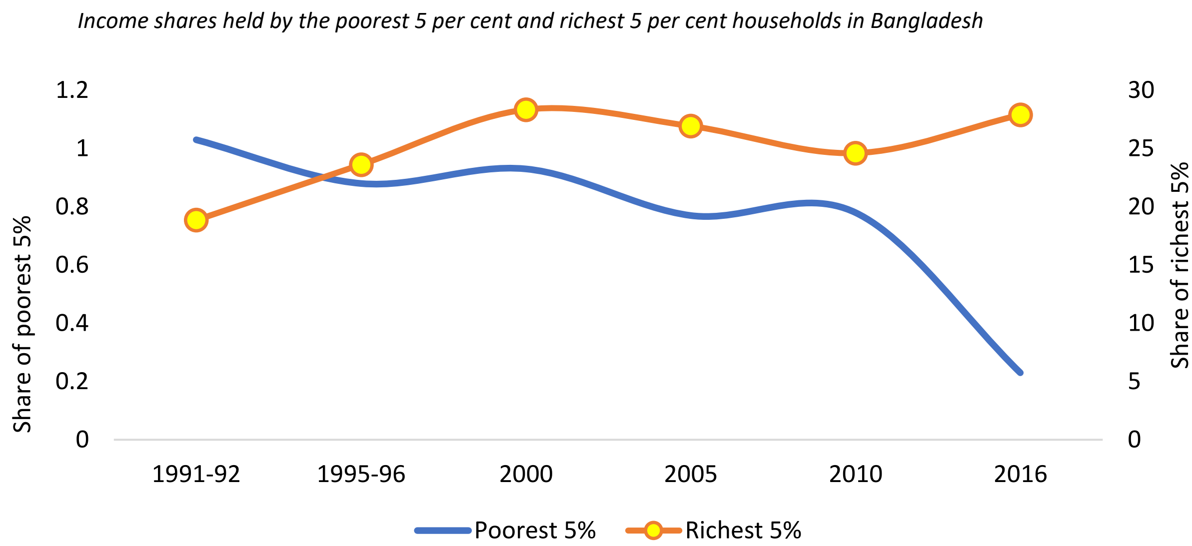
Figure 13: The overall tax effort in Bangladesh remained low compared to many other countries at similar stage of development



Note: Countries are indicated as AFG – Afghanistan, BGD – Bangladesh, BTN – Bhutan, BRA – Brasil, CAM – Cambodia, CAN – Canada, CHN – China, DNK – Denmark, ESP- Spain, FRA – France, GER – Germany, IDN – Indonesia, IND – India, ITA – Italy, JPN – Japan, LAO – Lao People's Democratic Republic, PAK – Pakistan, SGP – Singapore, THA – Thailand, UK – the United Kingdom, USA – the United States of America, VNM – Vietnam.
Source: Authors' presentation using data from the Government Revenue Dataset (GRD), UNU-WIDER and the World development Indicators (WDI), World Bank.

While maintaining a low tax burden can help to stimulate growth by leaving more wealth to circulate around the economy in private hands, rising income inequality in the county has become a major concern. The rising income inequality is evident from the latest round of the Household Income and Expenditure Surveys (HIES). The income shares of the richest 5 per cent of the population increased from around 17 per cent in the 1990s to 30 per cent in 2016, while the same share for the poorest 5 per cent declined from an already paltry 1.03 per cent to just 0.23 (Figure 14).

Figure 14: Income share of the richest 5 per cent of the population increased while the same declined for poorest 5 per cent households



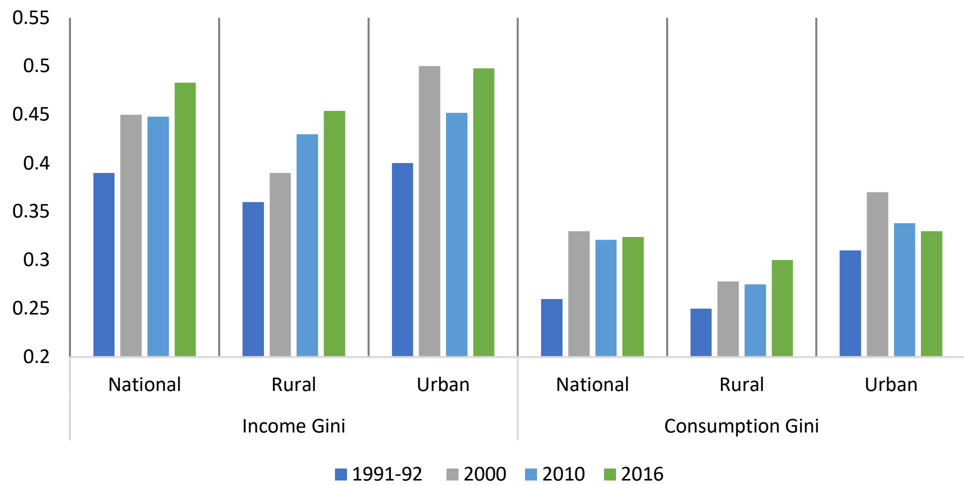
Source: Authors' presentation from the Household Income and Expenditure Surveys conducted by the Bangladesh Bureau of Statistics (BBS).

One of the most popular and widely accepted measures of inequality is the Gini index or coefficient.[5] It describes equal or unequal resource (income or wealth) distribution within a country's population. The Gini index calculated based on household income (often known as income Gini) increased substantially from 0.39 in the early 1990s to 0.48 in 2016 (Figure 15), suggesting an increasingly uneven income distribution over time. The worsening of income distribution has occurred in urban and rural areas. The Gini index computed from consumption expenditures (known as consumption Gini) depicts a moderate rise in inequality. However, the same for urban areas appears to have fallen over the past two decades. The differences between income and consumption inequality can be attributed to the disproportionately higher share of income spent for consumption purposes by the poorer households compared to richer one, and several public policies – including social safety net provisions – that aim to ensure a minimum level of consumption for various household and population groups.

[5] The gini index can take any value between 0 and 1. A coefficient of zero indicates a perfectly equal distribution of resources among the population while a value of 1 represents perfect inequality.

Figure 15: Gini index in the past few decades showed an increasing trend

Income and consumption Gini index in Bangladesh



Source: Author's analysis using the Household Income and Expenditure Surveys, various years, BBS.

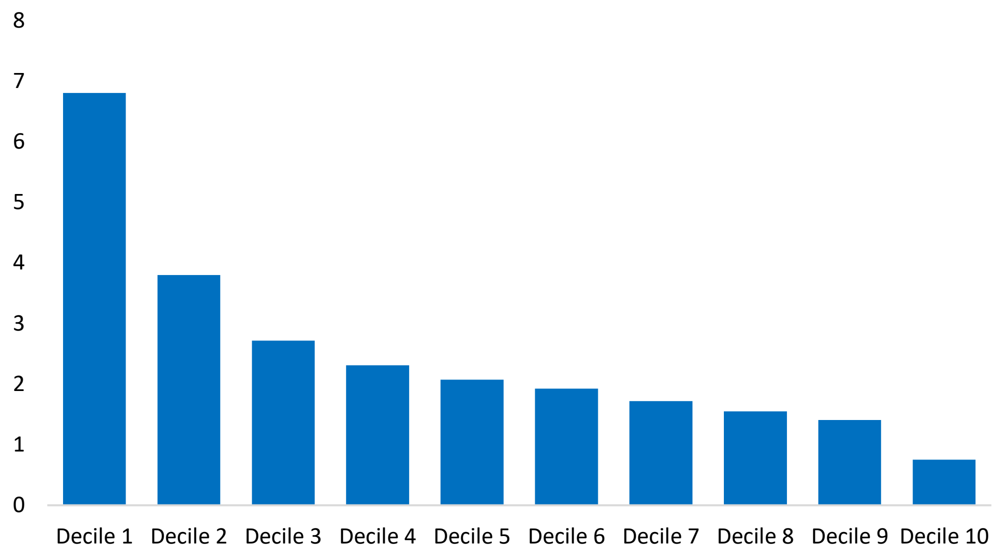
The rising income inequality associated with sustained growth means the benefits of growth have not trickled down. In this respect, public finance policies (i.e., taxation and expenditure) can be a powerful tool for addressing income inequality. Along with making the progressive direct taxation system work to its fullest potential, public spending on health, education, and social protection must be increased for the poor and vulnerable population groups to benefit from economic growth processes.

In the context of rising inequality and a low tax-GDP ratio, Bangladesh can take the opportunity by making strategic use of the direct tax system to boost domestic resource mobilisation. Direct taxation can help build an equitable society as the burden of direct tax is shouldered by the citizens and businesses based on their earnings. Contrarily, a focus on indirect taxes shifts the burden to consumers generally, the majority of whom come from low-income or impoverished households. Indirect tax tends to be more regressive as poorer households generally spend a larger share of their income on consumption and are likely to pay a higher average tax as proportion to their income than richer households. As low-income households pay a higher share of their income, indirect tax directly affects income distribution by rising income inequality. This affects the ability of low-income people to accumulate physical and human capital, thus affecting long term growth prospects of the economy. Empirical evidence suggests that indirect tax aggravates income inequality (Prasad 2008, Barnard, 2010). Woo et al. (2013) investigated the effects tax structure on income inequality in a panel of advanced and emerging market economies over three decades and found that a 1 percentage point increase in indirect taxes as per cent of potential GDP is associated with a 0.4-0.9 percent increase in income inequality.

To show the disproportionate burden of indirect taxation on poorer sections of the population, we estimate the total value-added (VAT) tax payment as a percentage of households' annual income, shown in figure 16. The burden of indirect taxation is disproportionately high for households at lower income deciles. As a result, lower-income households pay a higher fraction of their annual income as indirect tax, exacerbating income inequality in Bangladesh. The estimates suggest that the poorest decile households pay VAT which is around 9 times higher than the highest decile in terms of the share of their income.

Figure 16: Low-income households pay disproportionately higher share of their income as indirect taxation

VAT payments as a percentage of households' annual income by household income decile



Source: Authors' estimate from HIES 2016.

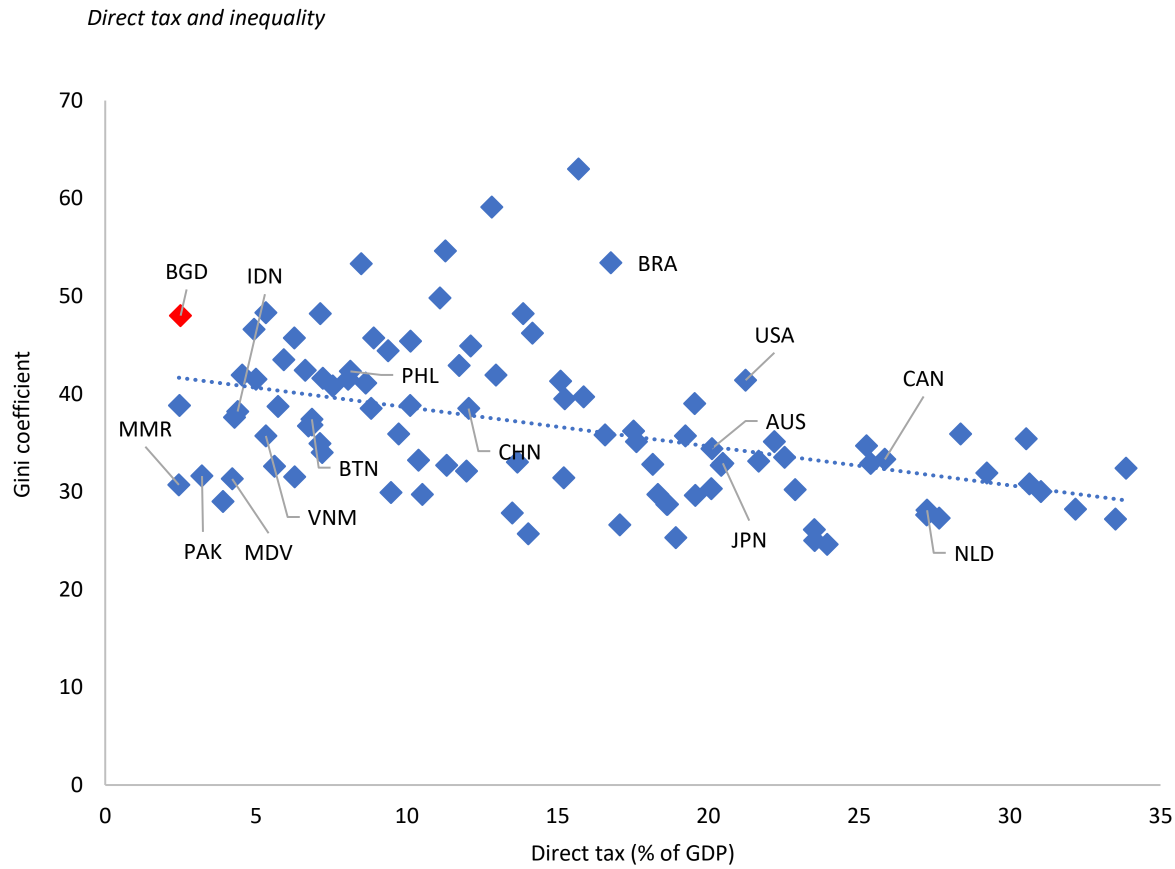
Direct tax on the other hand, is more progressive as it applies to the level of earnings and is entirely borne by the higher income deciles. Some argue that direct tax might be disruptive for economic growth as under a higher marginal tax, economic agents with improved human capital and productivity would be discouraged to exert labour, entrepreneurial efforts, adopting new technology, and accumulating capital (Fernandes et al. 2020). On the other hand, low-income people who benefit from government transfer may tend to offer less labour and be discouraged from investing on human capital accumulation. All these may result in a lower future growth. However, empirical evidence confirms that more equal income distribution is positively related to long term growth and aggregate welfare (Persson and Tabellini, 1994). Berg et al. (2012) found that income inequality hinders long-term economic growth.

In the face of rising inequality in Bangladesh, the role of a progressive direct taxation system (along with a redistributive public spending mechanism) is extremely important for ensuring both horizontal and vertical equity. *Horizontal equity* would ensure taxpayers in similar financial conditions being treated similarly. *Vertical equity*, on the other hand, means that taxpayers who are better off should contribute more or at least pay the same proportion of income in taxes as those who are less well off.

Tax systems with a higher share of direct taxes in total revenue have redistributive impacts capable of reducing income inequality and alleviating poverty. Maboshe and Woolar (2018) direct taxes and social grants in South Africa contribute to reducing the market income Gini from 0.73 to 0.66 while it reduces poverty headcount ratio by two-third. Direct taxes have redistributive impact and tend to favor a more equal distribution of income, while the rise in revenue from indirect taxes is associated with higher level of income differential (Fernandes et al. (2020), Martinez-Vazquez et al. 2014, Bastagli et al. 2012, Decoster et al. 2010, Chu et al. 2004)

A simple cross-country analysis on the relationship between direct tax and income inequality has been undertaken as part of this paper. It suggests that direct tax is likely to address inequality in income distribution to a large extent.

Figure 17: Cross-country evidence suggest that direct tax is likely to address inequality



Note: Countries are indicated as AUS – Australia, BGD – Bangladesh, BTN – Bhutan, BRA – Brasil, CAN – Canada, CHN – China, IDN – Indonesia, JPN – Japan, MDV – the Maldives, MMR – Myanmar, NLD – the Netherlands, PAK – Pakistan, PHL – the Philippines, USA – the United States of America, VNM – Vietnam.
Source: Authors' presentation using data from the Government Revenue Dataset (GRD), UNU-WIDER and the World development Indicators (WDI), World Bank.

The progressivity in tax structure is defined as the ratio of direct to indirect tax in a country. The current tax structure in Bangladesh with high dependency on indirect tax, as shown above, indicate a high degree of regressivity which can contribute to a high dispersion in income distribution in the country. The recent

NBR initiative to switch the tax structure to 70 per cent direct taxation is a welcome initiative and is likely to address inequality, if materialized. This year's budget can provide a strong policy signal towards tackling the growing inequality problem by focusing on the direct taxation system and allocating more resources to health, education, and social protection.

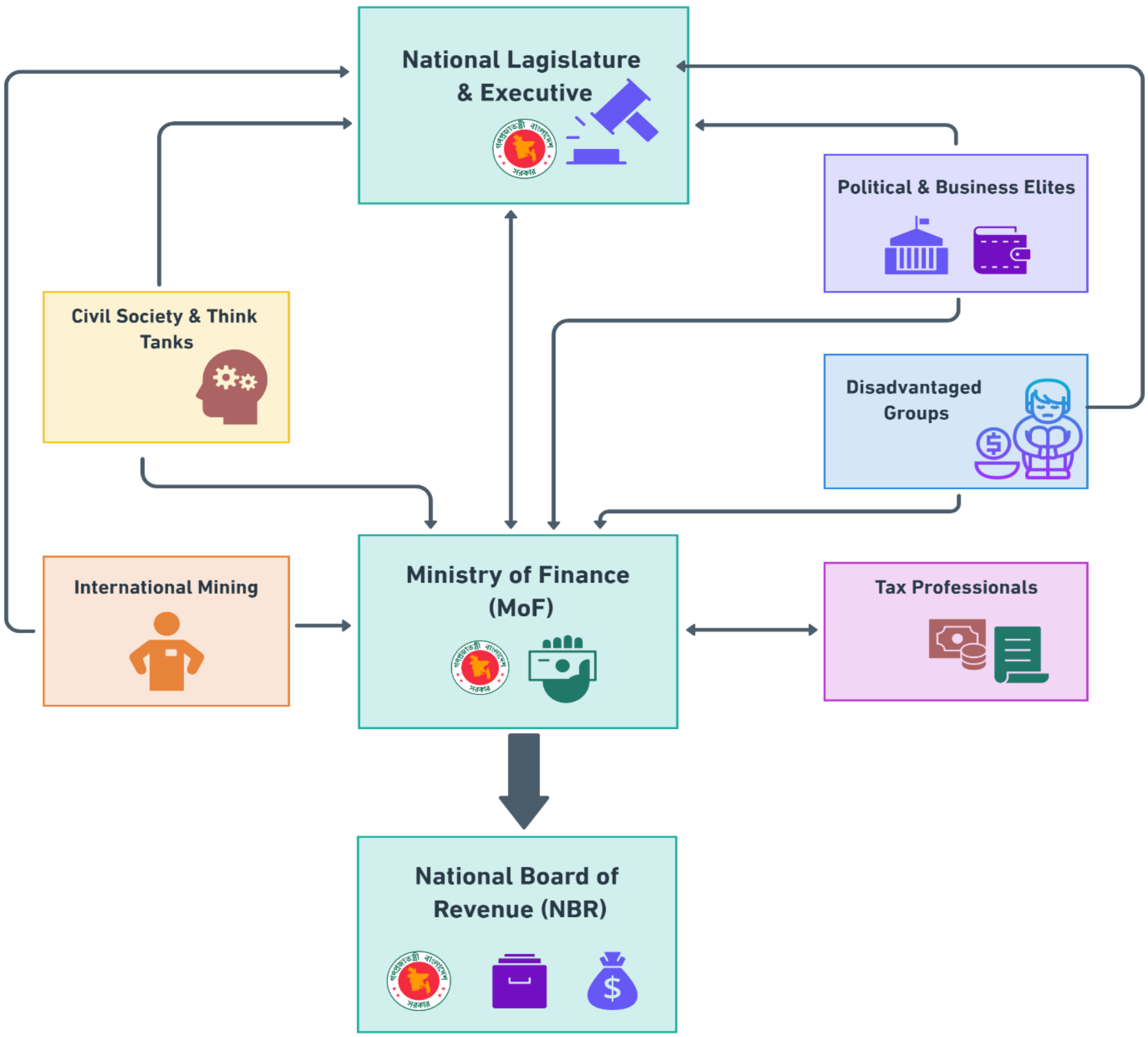
III. The political economy of direct taxation in Bangladesh

Direct tax as a percentage of GDP in Bangladesh has remained stagnant, as shown in the previous section. This lacklustre performance of direct taxation can be attributed to different interdependent political and economic interest groups. A change in the tax policies, such as a shift from indirect to direct taxation, creates winners and losers, and hence various interest groups attempt to tweak the policy to be on the winners' side. In this context, a political economy assessment of these interlinked factors might help identify the constraints to the overall progress and reform of the direct tax system as well as explore the possible ways to create an enabling environment for the development of direct taxation. Political economy analysis sheds light on incentives, relationships, and distribution and contestation of power between different groups and individuals. It has been argued that "The stakes are particularly high with tax reforms because substantial amounts of money are involved. The beneficiaries of the present tax system in Bangladesh (political elites, big business, the NBR administration) are happy with the status quo" (Ahmed, 2020, p.16). Again, others are of the view that, "the current system delivers low and predictable tax rates to businesses, provides extensive discretion and opportunities for corruption to the tax administration, and acts as an important vehicle for political elites to raise funds and distribute patronage and economic rents" (Hassan and Prichard, 2014). Furthermore, it is also suggested that "Reform initiatives at the NBR have mostly failed in recent decades because of lack of ownership and resistance at the level of field offices and unholy alliances between field officials and business entities (Mansur, 2020). The political economy assessment of direct taxation is essential to identify the power dynamics among the relevant stakeholders in mobilising resources as well as unpacking the role of political will for the reform or development of direct taxation.

Tax policy ecosystem and stakeholder power mapping

Before diving into the political economy assessment of the overall tax system of Bangladesh or direct taxation, in particular, it is indeed necessary to look into the tax ecosystem of the country which will help map the relevant stakeholders in this system and the power dynamics among the stakeholders. Figure 19 depicts these interlinks and the directions of interactions among different stakeholders in the tax policy ecosystem of Bangladesh. The national legislative and executive body, along with the Ministry of Finance, is responsible for formulating and amending the tax code of Bangladesh, while the National Board of Revenue (NBR) is entrusted to execute and implement the tax policy. When devising a new tax code or a change in the existing one, policymakers deal with different national and international stakeholders,[6] who exert significant influence in finalizing and implementing the tax policy.

Figure 18: Tax ecosystem of Bangladesh



Source: Authors' presentation based on USAID (2022).

The National Board of Revenue (NBR) is responsible for tax policy reforms and administration in Bangladesh. The tax administration of NBR has three separate wings, namely the direct tax wing, the VAT wing, and the customs wing. The quality of tax administration is frequently regarded as a prerequisite for tax revenue mobilisation and tax policy reform. The ability of the administration to properly enforce and collect taxes is unquestionably an important limitation. Although Bangladesh's tax administration has a

[6] Other interest groups in tax ecosystems include political elites who have political power and are therefore close to the government and tax administration; the disadvantaged groups who do not have any political power and are therefore less likely to exert any influence on the government; civil society, think tanks, and tax professionals who provide suggestions to the tax administration and the political government.

formal framework similar to that of most low-income countries, it has lagged behind most of the competing countries in terms of performance. The previous studies in the context of Bangladesh reveal widespread corruption in Bangladesh's tax administration, leading to very low tax compliance in all sectors of taxation (Hassan & Prichard, 2016; Ahmed & Heady, 2020).

The majority of tax processes are manual, with the exception of income tax and VAT registration. One example is audit selection, which is still done manually without any standard operating method. As a result, the officials of NBR enjoy a very high degree of autonomy and therefore have discretionary power. This opens the door to systemic corruption. In addition, the rent-seeking opportunity of NBR officials associated with the current tax system often encourages them to resist any reform for the system's modernisation steadfastly. This is a key limitation to direct tax revenue mobilisation in Bangladesh. However, the resistance to improving the efficiency and transparency of the tax administration of Bangladesh is not the same across all levels of tax administration officials. While the chairman and board members, who make up the senior leadership, have typically been more supportive of any reform, the front-line administration led by the deputy commissioner is commonly seen as being aligned against the reform (Hassan & Prichard, 2016).

Box 1: Improving tax administration and compliance: the experience of Japan

To ensure effective governance, the National Tax Administration (NTA) of Japan focuses on meritocracy in recruitment, well-structured training systems, an independent inspection system, wage levels comparable to those in the private sector, and regular personnel reshuffles. The NTA has placed emphasis on training to help employees grow their abilities and preserve their professional integrity. New recruits are provided with intensive training at the National Tax College in tax legislation, basic accounting, and related courses at the start of their careers, followed by three years of on-the-job training in a tax office. Then there are advanced courses on tax legislation, accounting, and civil law, among other topics. Moreover, for high-performing officials, there are opportunities to engage in international and domestic research courses.

Japan has strict laws and regulations against the corruption of tax officials. For example, government officials who violate the National Public Service Act or the National Public Service Ethics Act/Code may be dismissed, suspended, have their pay reduced, or be admonished. Internal inspection methods play a critical role in the early detection of corruption. Administrative audits are employed as monitoring techniques in the tax administration to prevent and detect corruption. Access to precise information on financial issues and personal relationships is a powerful tool for detecting problematic employee conduct. When officials are suspected of committing crimes, their cases are reported to the authorities, and investigations are launched. Administrative audits are supplemented by internal reporting systems as another anti-corruption measure.

To strengthen tax compliance, Japan has uniquely created the certified public tax accountant (CPTA) system that assists the general public in filing tax returns. In Japan, there are over 70,000 CPTAs who establish national and local CPTA groups. They are important stakeholders who work with tax authorities to disseminate tax information and improve compliance. After a sufficient number of years of service as a tax official, retired tax officials can become CPTAs. A CPTA's license is revoked if he or she colludes with a taxpayer in tax evasion. The NTA has also put emphasis on strengthening tax education at schools to foster a culture of tax compliance.

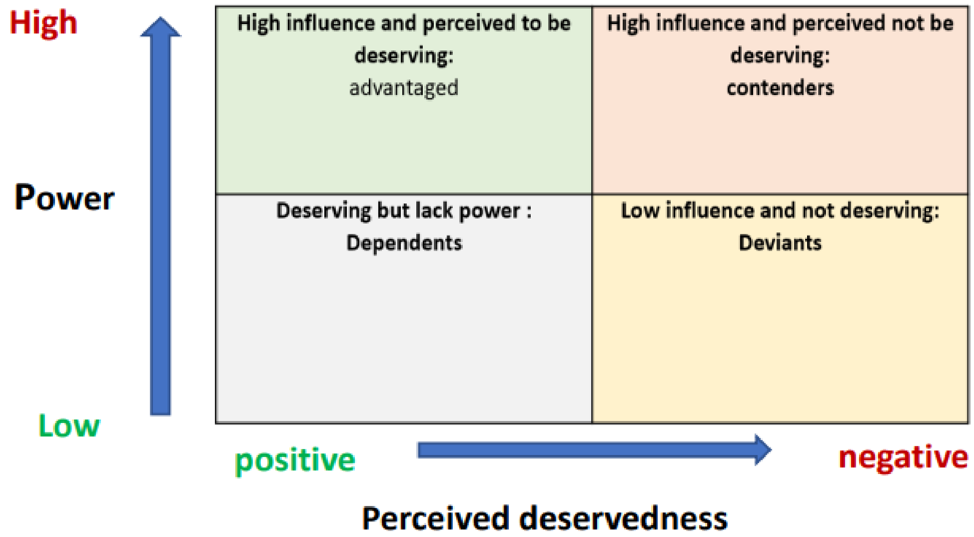
Source: Araki & Nakabayashi (2018)

The quality of socio-economic and political institutions as well as a check and balance among different organisations, are often considered an essential determinant of tax performance. Several studies identified the role of institutions and corruption in explaining tax performance (Ghura, 1998; Gupta, 2007; Phuong, 2015; and Ricciuti, Savoia, & Sen, 2019). Moreover, there is empirical evidence of the relationship between the type of government or political regime and tax revenue mobilisation, which shows that democracy is vital for higher domestic tax mobilisation in developing countries (Ehrhart, 2009). Modelling autocracy as a dictatorship of the wealthy and democracy as a dictatorship of the poor and middle class, Acemoglu & Robinson (2006) argue that fewer measures to raise taxes should be implemented in autocracy because the wealthy are opposed to redistribution and hence to taxation. Given that a significant number of parliament members in Bangladesh responsible for taking the initiative of tax policy reform have business interests, a serious conflict arises while formulating the tax policy or taking the initiative to policy reform. Conflicts of interest lead to corruption by allowing officials to make shady decisions in order to benefit personally.

Along with the institutions discussed above, agents or stakeholders are a major component of Bangladesh's political economy analysis of the tax system. Some economic agents, such as elite businesses and richer households, have a strong incentive to lobby or create pressure for a lower tax burden and enjoy larger benefits of the government resource redistribution initiatives. However, the success of the different groups of economic agents in accessing the benefits of government spending and ensuring a lower burden of taxation depends on their power or influence on the tax policy. Therefore, based on social construction theory, Ingram, Ramachandran, and Desai (2007) divided the economic agents into four groups by considering two factors, namely their political strength and their perceived deservingness (Figure 19).

A group's political strength is determined by its resources, including whether they are large, united, and simple to mobilise around significant issues of interest and how they traverse the informal policy formulation channels. The advantaged group, which can be found in the upper left quadrant of the figure, shows those who have both political power and are thought to be deserving to enjoy government benefits. These populations are more likely to receive a larger share of the benefits. This group comprises government officials, professionals, and small business groups in Bangladesh. The groups, contenders with significant political power but not considered deserving, can be found in the upper right quadrant of figure 20. Despite not being eligible, these groups receive substantial benefits in terms of tax exemption and lower tax burden through an informal political settlement. In Bangladesh, such groups consist of large businesses, influential or wealthy individuals, corporations, big banks, or polluting industries. These groups are often regarded as special interest groups that have a critical role in democratic and autocratic forms of government. The dependents in the lower-left quadrant consist of vulnerable households who deserve larger benefits from the government but do not have sufficient influence on government policymaking. Their ability to receive rewards is likely limited due to their lack of power.

Figure 19: Influences and deservedness of the target groups to the taxation system



Source: Authors' presentation based on Ingram et al., (2007).

This approach to identifying and differentiating among the different groups of agents in the economy provides insights to link the concept of equity with the current tax system in Bangladesh. The larger share of indirect taxation indicates a larger tax burden falls on low or middle-income households as they cannot evade the tax burden due to low political power. Moreover, due to the lack of political power, these groups have little access to the benefits provided by the government. On the contrary, the interest groups-consisting of larger businesses and high-income households can evade larger tax burdens because of their close link with the political government and tax administration. Moreover, they often exert their influence in enjoying larger benefits of government spending.

Political economy of personal income taxes

A number of direct taxation tools, such as personal income taxation, corporate taxation, and wealth taxation, are in place in Bangladesh. Yet, direct taxation fails to generate the desired level of revenue. Twisting of these tax policy tools by the different stakeholders is mainly responsible for the dismal performance of direct taxation. For instance, revenues from personal income taxes are very low in Bangladesh despite the very high growth rate in per capita income. The very narrow tax net is the main reason behind this poor performance of personal income taxation. Despite the very poor performance of personal income tax to generate revenues for the government, there is the absence of full-hearted effort from the government to increase the tax net by reaching the hard-to-tax individuals who are out of the tax net. While inadequate administrative capacity is a major reason behind this, there might also be a political economy perspective of this insufficient effort from the government. It is evident that lower-middle-income and low-income people often do not like to shoulder the tax burden. Therefore, it can be that the government does not like to lose its popularity by imposing the burden of direct taxation on lower-middle-income and low-income individuals.

The disproportionate income tax burden on middle and high-income individuals encourages them to use legal and illegal means to reduce or evade the tax burden. While tax evasion is closely linked to the high degree of the informality of the labour market of Bangladesh[7], the political settlement among the major actors and institutions of Bangladesh's tax system has played a major role in the dominance of tax evasion. Because of their political ties, most wealthy elites can avoid paying taxes by either not reporting or filing low returns that are not subject to audits. An inefficient and manual tax auditing system contributed to high tax evasion and avoidance. Moreover, it is commonly known that many taxpayers avoid paying taxes by striking informal settlements with tax collectors. This informal settlement among the key stakeholders is made so much easier by the manual approach to tax assessment. Therefore, tax avoidance is found to be very high at the highest level of income.

Box 2: Direct tax policy and administration reform in Tanzania

Tanzania experienced significant direct tax policy reforms in the 1990s including the reduction of both the personal income tax (PIT) and the highest marginal corporate tax rate to 30% in 1990. Moreover, the ceiling for the zero-tax income category was also lifted with little revenue loss. A new Income Tax Act was passed in 2004 to increase the tax base and reduce the tax burden. In 2005/06, the government implemented self-assessment and anti-avoidance measures and began imposing substantial interest charges and penalties for compliance failures and offences. In 2006/07, the government implemented a concessionary corporation tax rate and further cut the marginal PIT rate.

The reform of the Tanzanian Revenue Authority (tax administration of Tanzania) began in 1990's by putting emphasis on enhancing its capacity to handle enormous financial help from aid donor countries. As a result, during the first stage of TRA reform (from 1998/99 to 2002/03), a taxpayer identification number (TIN) and the Large Taxpayers Department (LTD) were established, and the tax appeals system was unified. The key objective of tax reforms during the second phase (from 2003/04 to 2006/07) was to improve the TRA's competence and accountability which helped to increase the tax revenue as well as the number of large taxpayers. Finally, the most significant result of the third stage (from 2008/9 to 2012/13) may be seen in the successful institutionalization of risk-based operations in tax administration, such as specialist audit capacity in high-risk sectors.

Source: Kim & Kim (2018)

Political economy of corporate income taxes

Bangladesh raises more revenues from corporate income taxes relative to personal income taxes. The highest corporate income tax rate is currently 45 per cent, which has remained relatively constant over the last few years. This is one of the highest corporate income tax rates in developing countries. Excessive tax exemptions, a narrow tax net, inequality in taxing the urban and rural sectors, and non-taxation of hard-to-tax groups are all contributing factors to this unusual tax burden distribution. Given that most taxpayers pay so little in taxes, the government mainly relies on corporate taxation to raise the necessary revenues. Therefore, the government often finds it difficult to reduce the corporate income tax.

[7] according to the 2017 Labour Force Survey, 85 percent of the workforce is employed in the informal sector, and the majority of workers are not taxed

However, with their connections to policymakers, many sectors have successfully sanctioned tax exemptions or lower rates for them. These include textile industries; garments exporters; jute industries; cooperative societies; public universities; medical and dental colleges; engineering colleges; companies engaged in the production of poultry feed and feed for fish, shrimps, and cattle; cattle farming; horticulture; floriculture; sericulture; poultry, shrimp, and fish production; etc. In addition, many large businesses in the formal sector enjoy tax benefits granted under different policies and have a zero corporate tax rate because they are either tax-free or have been awarded tax breaks for several years. However, the tax rates for other sectors or activities range from 12 per cent to 45 percent.

The existence of multiple tax rates along with significant tax exemptions is closely linked to the political economy perspective of the tax policy of Bangladesh. It has been mentioned in the above discussion that the political and business elites often exercise their power and close ties with the political government to get special incentives such as tax exemptions. The existence of informal rules, norms, and networks has served the interests of political and business elites with relatively low tax rates for certain sectors. However, such exemption or concession in tax rates in Bangladesh is not much systematic or based on rules. This becomes obvious while looking into the corporate income tax rates for different sectors. The corporate tax rate for the country's largest manufacturing sector, the readymade garment (RMG) sector, is just 12 per cent in comparison with 30 per cent for non-listed companies. Moreover, the NBR has placed high tax rates on a few sectors: cigarettes (45 percent), mobile phone businesses (40 percent), and banks and insurance companies (40–42.5 percent).

While the high tax rates for cigarettes can be justified given its adverse impact on health, the significantly different corporate tax rates for RMG and mobile phone business or banks and insurance sectors might seem contrasting given that the businesses in both of these sectors have close ties with the government or tax administration. One reason that can explain this contrasting finding is that the export sector is often considered more sensitive to the employment generation, poverty alleviation as well as overall economic stability of the country resulting in more incentives. Furthermore, the much higher level of foreign ownership in the telecommunications and banking sectors can be linked to this contrasted discrimination in corporate income tax, as it is often argued that the notion of corporate income tax has remained foreign in Bangladesh. Another reason might be the existence of a deals environment in the tax policy of Bangladesh. Due to the prevalence of informal institutions, the deals between the political and business elites might ensure special incentives for the special interest groups. Even within the politically powerful special interest groups, the efficiency of negotiations or bargaining as well as rent sharing between the political government and businesses determine the incentives received by such groups. The 'political settlement' in the form of a special incentive for the RMG sector can be characterised as the rent-sharing or the alignment of the economic interests of RMG company owners with the political interests of governments in terms of job creation (particularly for women) and poverty reduction.

Despite the very high corporate tax rates for certain sectors as specified above, the performance of Bangladesh in terms of corporate tax is not satisfactory. The main reason behind this is the low tax base, low tax compliance, inefficient tax administration as well as the dominance of tax exemptions. Many entities/companies remain outside the tax net due to a large informal economy and low administrative capacity. Most micro, small, and medium enterprises operate outside the formal sector, often lacking any credible and effective accounting practices. Moreover, the widespread use of tax exemptions, incentives, and special provisions reduces revenue collection because the effective tax base is substantially smaller than under the ordinary tax regime. It is generally assumed that broad exemption fosters tax evasion, erodes tax equality, and causes economic distortion. Various tax breaks allow many more people to legitimately avoid paying taxes.

Along with the poor tax performance, the low tax net and tax exemption have put a disproportionate tax burden on some sectors as specified earlier which adversely affects the overall business environment of the country. A small number of foreign corporations account for more than half of corporate income tax in Bangladesh. However, such an action hampers the international competitiveness of the country as many governments in the world have been aggressively competing for overseas investment by lowering corporate tax rates. As mentioned earlier, the very high marginal tax rate often encourages tax evasion as major business taxpayers often manipulate accounting information to display a lower level of income and therefore avoid paying taxes. Moreover, empirical research in the context of India suggests that reductions in marginal tax rates dramatically increase the tax compliance rate. However, despite such inefficiency of very high tax rates, the political economy of tax exemption or tax evasion forces the government to keep the rates high.

Box 3: Tax reform in Georgia

Georgia is often considered a success story of tax policy and tax administration reform over the last two decades. The government of Georgia initiated an extensive goal of regulatory and institutional reform in order to boost tax revenue collection. The State Revenue Service (SRS) was established to combine customs and tax administration under one entity. Corrupt tax officers were arrested and imprisoned. Tax reforms between 2004 and 2009 aimed to streamline the tax code and cut tax rates. The total number of taxes in Georgia was lowered from 21 to six. The personal income tax rate was blended with the social contribution (payroll tax) to create a single income tax of 20%. In 2009, taxes on business dividends and interest earnings were cut from 10% to 5%. By streamlining and automating most operations, establishing risk-based audit management, and massively extending e-services, the SRS improved tax collection. This streamlined the procedures for taxpayers and cut reduced face-to-face interactions between tax officials and taxpayers. They installed cameras in almost every area where people dealt with tax officials, resulting in considerably fewer improper public requests and increased treasury collections. The institutionalisation of the risk-based audit contributed to reducing the non-risk audit from 70 per cent in 2009 to zero percent in 2011. Moreover, the reform initiatives of the Georgian government helped to raise the domestic tax to GDP ratio of Georgia from 11 per cent in 2003 to 25 per cent in 2011.

Source: OECD & ITC (2015)

Box 4: Expanding the tax base of direct taxation: the case of SME tax in Indonesia

Small and medium-sized enterprises (SMEs) play an important role in Indonesia's economic development accounting for 5.8% of GDP and employing 6% of the workforce. In Indonesia, there is a strong reliance on corporate sector tax collections. The significant administrative and compliance costs that SMEs incur reinforce the need for tax policy simplification. Given the comparatively high growth rate of SMEs in Indonesia, SME promotion also strives to integrate the industry into the taxation system at the national level. In terms of SMEs, Indonesia adheres to the notion of presumptive taxation. It offers a special one percent final income tax rate on company income earned in a single year. Despite the fact that the maximum yearly sales result for SMEs is IDR50 billion, individual treatment is available to SMEs with an annual operating income of IDR4.8 billion. Businesses having annual revenues of IDR4.8 billion to IDR50 billion are subject to the general tax regime and are eligible for a 50% tax rate reduction from the current 25% rate. On July 1, 2013, a new taxes structure for SMEs went into effect. Previously, SMEs could determine their tax liability using considered net profit. The presumptive tax regime taxes eligible taxpayers at 1.0 percent of gross turnover rather than the taxable profits as the standard regime requires. Although this special status benefits the tax base, the streamlining of tax collection also benefits SMEs by lowering barriers to financial access. The presumptive tax regime for SMEs, however, does not apply to corporate taxpayers with a permanent establishment, street vendors, or non-commercial operators with income exceeding IDR4.8 million after one year of commercial activity.

Source: Araki & Nakabayashi (2018)

Political economy of wealth taxes

Wealth taxes have long been believed to be the best tool for addressing income and wealth disparities. Although there is no legal framework for wealth tax in Bangladesh, wealthy individual taxpayers pay a surcharge depending on their income tax instead of paying wealth tax.[8] Despite NBR's explicit interest in introducing the wealth tax on the grounds of equity, the matter received little attention due to resistance from within and outside the government. However, the proposal of introducing a wealth tax received limited acceptance with the introduction of a wealth surcharge in the budget of FY 2011-12. Since then, this surcharge clause has been in effect in every budget of Bangladesh. According to the budget for FY 2021-22, the surcharge for the richest residents who have more than Tk 500 million in wealth would be 35%, while the rate would be 20 per cent for those having wealth between TK 100 to 200 million and 30 per cent for those having 200 million to 500 million in wealth. The surcharge is 10 per cent for the owners of assets worth Tk 30 million to Tk 100 million, or more than one automobile, or land with an area of more than 8,000 square feet in city corporation regions, while people with a wealth of up to Tk 30 million have been exempted from the surcharge.

In Bangladesh, the feasibility of imposing a wealth tax depends on the status of the information held by the NBR. The main problem with introducing wealth tax is that taxpayers underreport their wealth. For example, many people do not divulge how much gold they own. Moreover, in the absence of an automated third-party system, large sums of money go unreported despite online banking and stock transactions because fixed deposit accounts and advance income tax payments are not linked to an

[8] The Wealth Tax Act of 1963 in Bangladesh was in effect until the end of the 1990s. Despite modifications made in the Finance Act of 1993, its implementation was questioned. The Act got abolished by 1999.

individual's TIN. While in the case of real estate, the wealth statements lack details, land valuations in wealth statements do not provide a clear indicator of current market value. According to Zohir et al., (2012), NBR's present pool of information is insufficient to allow for an accurate estimate of wealth based on market valuations. As a result, any attempt to apply wealth-related taxes based on such information before updating it and guaranteeing an appropriate system for ongoing updating may result in more distortions. Moreover, because the tax authority has limited information on individual wealth, the amount of tax income generated is likely to be insignificant. Therefore, they suggested maintaining the surcharge instead of introducing any wealth or property tax as a percentage of the gross or net wealth.

Other factors of political economy

Several other factors contributes to the low tax compliance in Bangladesh. Infrequent tax reforms or the lack of implementation of the reform initiatives can also be attributed to the stagnant tax revenue mobilisation in Bangladesh. For example, the current Income Tax Ordinance, which was enacted in 1984, is out of date and does not keep up with the changing needs of the time.[9] Since the politically powerful business community and high-income groups enjoy benefits from the informal political settlement in the current tax system, they often resist the reform of the tax policy. The government has expressly highlighted this resistance as a rationale for changing or abandoning reform plans at various times. However, although certain members of the political leadership have expressed a real desire for reform, overall, there is an absence of a larger push for reform by the political leadership, despite extremely low tax collection to fund government programs. While resistance from the power of organised opposition is a major reason behind the absence of major tax reforms, the financial gain of the political leadership from the current system of taxation can also be attributed to this reluctance to reform the tax policy. The cross-country experience of the political economy of tax reforms confirms that tax reforms necessitate broad political agreement or a national political agreement, strong buy-in from all parties involved, consistent effort and commitment of political leaders as well as an apparent institutional commitment (Martinez-Vazquez, 2021). It is obvious from the above discussion that most of these factors are not present in the policy sphere of Bangladesh leading to no significant reform in the direct system to streamline the tax policy or tax administration.

Figure 20: political economy factors of tax reforms

As mentioned above, one major issue that can be identified from the political economy assessment of the tax system of Bangladesh is the discretion of the political government or the tax administration in providing benefits to the political or business elites. For example, despite the absence of any effective tax

[9] The government drafted a direct tax act in 2011 which has recently been finalised in 2022

reform after 1991, in almost every annual budget of Bangladesh, tax laws, rules, and regulations are routinely updated giving exemptions or special tax treatment to different groups. In most cases, the deserving targeted stakeholders cannot enjoy such exemptions while the special interest groups enjoy most of these benefits through lobbying. One major problem of these impromptu tax policy changes every year is that it can have some adverse impact on the tax base as well as total tax revenue collection as these measures are often not backed by any in-depth analysis. Moreover, due to such exemptions, the government often needs to place a higher tax burden on some other sectors creating discriminatory tax treatment.

The need for reform

The importance of political economy factors in explaining the current inefficiency of the tax system of Bangladesh becomes obvious when comparing the characteristics of the current tax system of Bangladesh with the key recommendations of the tax system that has been outlined in theory. The major characteristics of the income tax system of Bangladesh that can be summarised from the above discussion are limited tax base, comparatively high tax rates, poor tax compliance, inadequate income tax administration, faulty accounting, and audit functions, lack of simplicity and transparency, corruption and tax evasions, lack of knowledge among taxpayers, income tax policy that is ad hoc and not comprehensive, convoluted tax legislation, and so on.

The above analysis highlights the challenges of the current taxation systems, particularly direct tax, from the political economy perspective. It identifies the role of different stakeholders in the current performance of the tax system, outlining the factors that facilitate or constrain the reform of the tax policy as well as tax administration in Bangladesh. Despite the challenges, there are opportunities to progress the taxation system reform agenda. Recently, in order to disburse a $4.5 billion loan to the Government of Bangladesh, the International Monetary Fund (IMF) set out conditionalities to improve the fiscal space by rising the tax-GDP ratio through modernisation of the revenue administration, gearing up the revenue collection process, reforming tax policy, and full-fledged implementation of the VAT law. Other conditionalities include lowering non-performing loans, restoration of good governance in the banking sector, among others. These conditionalities will put pressure on the government to put forward the tax reform agenda to expand the tax base.

The current low level of public resource mobilisation is becoming a binding constraint on Bangladesh's further development prospects. The impending LDC graduation in 2026 will restrict Bangladesh's access to LDC-specific funds and concessional loans, thus constraining the fiscal space further. However, Bangladesh will require more investment for the recovery from Covid-19 disruptions and put the economy back on the track of high growth path, implementation of the SDG strategies, and the country's much aspired transition to a middle-income country by 2031 and high-income country by 2041. Higher government revenues would create the much-needed fiscal room for manoeuvre and allow more spending in areas that are important for driving and sustaining growth in the medium- to long-term, including health, education, and infrastructure, social security and climate change etc. It cannot be overemphasized that without being able to enhance the tax effort significantly Bangladesh will not be able to stick to the development trajectory as envisaged. Therefore, reforming the taxation system and strengthening the tax institutions are today's priorities for medium- to longer-term development ambitions.

Supporting reform of direct taxes

Through the Research and Policy Integration for Development (RAPID) project to promote direct taxation to address inequality, and due to several ongoing developments (economic and social pressures, low government spending, greater need for infrastructural and human capital development etc.), a consensus has been developed among the policymakers to switch the tax structure and promote direct tax. The government recently provided a signal through last year's budget and the announcement of new target for direct taxation by the National Board of Revenue (NBR). There is a need for a longer-term vision and step-by-step action plan to be implemented to reach the target and achieve an overarching development agenda to build a fair society and become a high-income country by 2041.

IV. Policy recommendations

The above analysis shows that several challenges restrict Bangladesh's capacity to improve its tax base. The low tax-GDP ratio constrains government's fiscal space against the ever-rising demand for public spending in infrastructure, health, education, and social security. While the challenges towards any reform are prominent, the government recently expressed its commitment to undertake reform initiatives to transform the taxation system. Based on the analysis of quantitative data and a series of interviews with senior policymakers, experts, and private sector stakeholders, the paper highlights the barriers to improve revenue mobilization through direct tax.

The paper argues that in the context of rising inequality in income distribution, direct tax can be an effective tool to ensure equality and build a fair society. It can also help the revenue mobilization effort of Bangladesh. The NBR has recently set a target to increase the share of direct tax in total tax revenue from 35 per cent to 70 per cent. The target is welcome, but it is also ambitious. This target will not be achieved overnight and will take some time. Therefore, it is important to set out a series of step-by-step policy measures that will be necessary to achieve this target. In consultation with senior government officials and experts over feasibility and timeframes, the paper provides a longer list of evidence-based pragmatic policy recommendations that can help mobilise revenue from direct taxes.

Develop a roadmap and action plan of policy measures to achieve the new direct taxation target.
The ambitious target for direct taxation cannot be achieved overnight and will take some time. It cannot be achieved without time-bound policy actions. There is a need for a short-to-medium-to-long-term roadmap and implementation strategies. Therefore, it is important to set out a series of step-by-step policy measures that will be necessary to achieve this target. One target could be increasing the share of direct tax by 5 percentage points within the 8th Five-Year Plan period (2024-25). Following the example of Tanzania, Bangladesh can take a 2-3 stage tax reform initiative for 10-15 years, while focusing on

increasing tax net and modernization of tax administration in the earlier stage and resolving malpractices and redesigning exemptions and incentives based on systematic reviews in the later stages.

The following section provides a list of short-term and medium- to long-term feasible policy options as potential avenues to achieve the target for direct taxation. These policy actions can be considered within the roadmap and action plan.

Short-term recommendations

i) Implement the requirement to submit returns for taxpayers to access public services.

The finance minister, in the budget speech, announced making it mandatory to submit proof of the submission of income tax returns in order to get around 40 services. The Finance Bill 2022 then incorporated this provision. These services include opening and continuing bank accounts, getting credit cards, obtaining a loan, import or export registration certificates, renewal of trade license, obtaining or continuing gas connection for residential or industrial purposes, etc. This is a welcome initiative, and will likely help increase the tax net. Proper implementation of this measure needs to be ensured. Other government services should be included in the list in the following years based on proper assessment.

ii) Increase the tax eligibility floor and the highest rate of personal income tax

The highest personal income tax rate was reduced from 30 per cent to 25 per cent in 2019-20 in the context of the Covid-19 pandemic. However, since the economy has made a significant recovery from the pandemic-induced economic shocks, and since the highest income tax rate is less likely to affect lower- and middle-income people, consideration should be given to reinstituting the highest personal income tax rate at 30 per cent. Estimation based on HIES 2016 data suggests reinstating the highest income tax rate can help raise the revenue generation from personal income tax by around 0.5 per cent of GDP. While the highest income tax should be increased, it is also important to rethink the minimum tax eligibility threshold. Currently, the tax exemption limit is Tk. 3,00,000. Given the high inflation rate and increasing cost of living, the tax eligibility floor should be increased.

iii) Send notices to registered taxpayers to submit tax returns

More than two-thirds of currently registered TIN holders are out of the tax net. It is important to ensure all TIN holders are submitting tax returns and paying the appropriate amount of tax. On the corporate income tax front, currently, there are 2.73 lack traders registered with the Registrar of Joint Stock Companies and Firms (RJSCF). Only 11 per cent (around 30,000) of them paid corporate taxes in 2021-22. Like personal income tax, a large portion of the registered traders is outside the corporate tax net. Submission of the tax return for all registered businesses and TIN holders, irrespective of the level of income, should be made mandatory.

Currently, there is no mechanism to identify and inform the taxpayers (individuals and businesses) who are not submitting the return. The registered taxpayers, including individuals and businesses, should be notified through an automated system, keeping human interaction at a minimum level. The automated system can also send periodic reminders for return submission. The businesses registered with the

Registrar of Joint Stock Companies and Firms (RJSCF), who are not submitting corporate taxes are relatively easy to track. They should be tracked at regular interval and should be brought under the tax net. Imposition of a high compensation or penalty in case of tax evasion or avoidance will help expand the tax base and tax net simultaneously.

iv) Deduct calculable tax obligations at source and automate tax refunds

Currently, formal sector employers collect only 10 per cent advance income tax from their employees, at source (tax deducted at source - TDS). Around 60 per cent of the direct tax comes from tax deduction at source (TDS). It was found that many people try to escape paying additional tax after the TDS and in many cases, some of the income is not reported in tax returns. Thus, a system should be adopted where employers will collect all calculable income tax obligations from the specified employment at the source. In this case, if someone pays more than s/he is supposed to, the additional paid taxes should be refunded immediately after the assessment. However, there is no tax refund system in Bangladesh. A properly automated refund system should be introduced. This will help ensure accountability in tax administration and build confidence among residents.

v) Automated and centralise the audit system

The audit selection is still done manually without any standard operating procedure. There is evidence that in the absence of an automated tax audit system, tax collectors and assessors are involved in malpractices. An efficient tax audit system is essential to deal with many malpractices in the tax system. To minimise these malpractices, the NBR should introduce a risk-based, centralised and automated tax audit system that will randomly select taxpayers' profiles, based on specific criteria such as profession, income size, the volume of turnover, location of business of the taxpayer, etc. If only about 10 per cent of taxpayers are brought under the automated tax audit system, then within a decade it is possible that all taxpayers will be audited at least once, thereby helping achieve improved tax compliance.

Medium- to long-term recommendations:

vi) Increase the number of registered taxpayers

Bangladesh is facing several challenges in broadening the direct tax net. The presence of a large informal economy, weak tax administration, and people's misperceptions and tendency toward tax evasion are major challenges to broadening the direct tax net. Our analysis based on HIES 2016 data suggests that if all eligible individuals pay taxes according to their income tax slabs, revenue collection from PIT would rise to 3.1 per cent of GDP from just around 1 per cent currently.

Multiple time-bound policy actions should be undertaken to expand the personal and corporate income tax nets. One approach can be to increase the number of registered taxpayers. The government has a target to increase the number of registered taxpayers to 10 million. The number of registered taxpayers can be expanded by adopting a gradual and targeted registration approach. A geographic targeting approach can be adopted – first, focusing on large cities and emerging growth centres, and then gradually extending to small towns. Two potential interventions can be introduced to overcome these challenges in identifying the potential taxpayers: (i) conducting a socio-economic survey that will collect pertinent information about households including their income and tax status; and (ii) conducting a business prospect survey that will gather enterprise relation information on their business situation, income, and growth prospect. These surveys can help identify potential taxpayers by analysing the socio-economic profiles of individuals and businesses. This will also help identify poor and vulnerable households in the survey areas who need support from the social protection system.

vii) Adopt a universal registration approach for taxation

To achieve the objective of increasing the number of individuals paying personal income tax, the government could explore a universal registration approach. Under this approach, incentives for individuals can be provided to register via a unique personal identification number that links tax registration and eligibility to other public services or cash benefit entitlements. A system of providing unique identification numbers to every individual can be initiated whenever they enter the working age. In this approach, in the medium- to long-term, Bangladesh should establish a system of national registration or social registration, following the example of the United Kingdom's National Insurance number,[10] at the age of 18 (when individuals are permitted to work according to national jurisdiction), where everyone will be provided a registration number. This registration number should be made mandatory to enter the workforce, get access to any type of public services, and receive benefit from national social insurance or social security programmes. This national registration number will also be used for the purpose of taxation. Any individual will be tracked and obliged to submit the tax return after entering the workforce, irrespective of tax eligibility. This approach will generate a consensus among all people about their responsibility to pay taxes. It will also help the formalization of the economy. This option would support a 'soft hypothecation'[11] approach to a wider tax net, where the government will be committed to spending the additional revenue on health, education, and social protection.

viii) Rationalise corporate tax rate

Due to very high corporate tax rates, many businesses and traders try to escape taxes. Given the very narrow tax base, a small number of taxpayers disproportionately bear the burden of corporate income tax. The existence of several rates also worsened the problem. It is therefore imperative to rationalise the corporate tax structure. The number of tax rates can be brought down. For example, in India, there are only two corporate tax rates against many in Bangladesh. Bangladesh should have 3-4 corporate tax rates, which will make the administration easier. Hard-to-tax groups are equally important as the formal sector corporate businesses. Therefore, it is high time to focus on hard-to-tax groups for boosting tax revenue from corporate taxation. The taxation system with due compliance can help the formalization of many informal business enterprises. This can eventually generate benefits for businesses (e.g., accessing loans from the financial sector). Moreover, the government may think of reducing the marginal tax rates, in some cases, which would provide incentives for self-compliance. Recently, the government has taken

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[10] In the UK, the National Insurance number is used for the administration of the National Insurance or social security system. It is also used for taxation purposes. The lifetime tax obligation and payments, and the benefit received from the government under social protection are listed against this national insurance number.

[11] 'Soft hypothecation' involves a commitment where any additional revenues from a given tax or change in tax will be spent to a specific cause, for example health, education and social protection etc.

some initiatives to rationalise corporate tax rates. The differential between RMG and non-RMG exports has been removed by reducing CIT on non-RMG sectors from 30 per cent to 12 per cent.

ix) Review and ratioanlise tax exemptions and incentives

Tax exemptions in Bangladesh are provided on ad-hoc basis without prior assessments and are often motivated by the influential quarters to benefit a certain group of people. Tax breaks and exemptions, incentives, and special provisions reduce revenue collection by allowing many people to legitimately avoid paying taxes. Studies suggest that the revenue-GDP ratio would be 2 percentage points higher in the absence of exemptions. The government should conduct a cost-benefit analysis to assess the impact of all available tax incentives. Based on the assessment, the widespread tax exemptions should be eliminated or rationalised. This can be complemented by lowering tax rates. Tax exemptions might not be required for foreign investment if the corporate tax rate is rationalised.

x) Deal with malpractices in tax administration through digitalisation and automation

The tax filing process in Bangladesh remains a paper-based manual system that requires onerous documents. Given the manual processes in place, a very high degree of autonomy and discretionary powers of tax officials are important concerns of the existing taxpayers, discouraging potential taxpayers from filing for their returns or disclosing their incomes. Manual processes and discretionary powers tend to lead to malpractice and corruption. Therefore, the tax administration needs to fully adopt information and communication technology to manage all core processes. In this regard, NBR can launch a centralised data processing centre that can provide multiple services for a variety of functions such as taxpayer registration, detection of stop filers, tax return processing, and payment and correspondence with taxpayers.

With technical support from the European Union, the National Board of Revenue (NBR) has recently introduced automated income tax payments, at a limited scale, through online return submission for personal income tax. This is a welcome initiative that should be revamped. However, currently, there is no initiative for online submission of corporate income tax. The government should undertake a separate project for a time-bound direct tax modernisation plan that will include all online services including payment, submission, detection, and auditing.

xi) Strengthen the capacity of NBR

The NBR has capacity constraints to adapt to digitalisation and automation, and to undertake any tax policy analysis. Specialized training on technical adaptation, and legal, qualitative, and quantitative aspects of tax policies should be provided to NBR officials to strengthen their capacity. Analytical in-house capacity would allow the NBR to conduct surveys and/or analyse other national databases, e.g., the Household Income and Expenditure Survey (HIES) and labour force surveys of the Bangladesh Bureau of Statistics (BBS) to assess sector-specific economic activities/growth benefitting different households from various regions and occupational groups with potential for the expansion of the tax net.

The NBR has a huge shortage of manpower for implementing taxation policies, auditing, monitoring, and inspections. The absence of automation/digitalization makes these tasks even more difficult. The government can consider recruiting more manpower for the NBR to strengthen revenue mobilization efforts. The NBR estimates show that the administrative cost of collecting Tk. 100 as revenue was just Tk. 0.31. Our analysis suggests that the recruitment of an additional 100 revenue officers can generate Tk. 15 billion in revenue.

xii) Separate tax policy and tax administration

The 8th Five Year Plan suggests separating tax policy from tax administration beginning from 2023-24. However, no progress has been made so far. Given its current expertise, the NBR should be delegated the primary responsibility for tax revenue collection and reform implementation. An independent tax policy unit should be established, under the Ministry of Finance, for formulating tax policies based on proper assessments. The tax policy unit should be impartial and unaffected by political-economic factors.

xiii) Improve taxpayer services for increased tax compliance

The improvement in taxpayer service might also help increase tax compliance. In this regard, several measures can be undertaken such as creating easily understandable forms with clear instructions, assistance, and information; introducing taxpayer education programmes; improving phone advice service and website instructions; initiating online payment and automated refunds; and assisting in filing returns and paying taxes, including the use of pre-populated tax returns, etc.

xiv) Design a proper wealth tax

Wealth tax can be a potential avenue for mobilizing domestic resources. Currently Bangladesh does not have any legal framework for wealth tax. The wealth surcharge that the government imposes also has some significant limitations. Currently only a few people pay wealth surcharge and revenue collected from this source is very low or insignificant. Presently, the surcharge threshold is defined by the deed value of asset, but levied on total payable taxes. This approach itself discriminates among taxpayers as discussed earlier. In many cases, the assets are owned by generations and the values are significantly lower than the market prices. Therefore, the government should immediately launch a comprehensive study to assess the possible options of wealth tax that might work in Bangladesh. Another option could be imposing a wealth surcharge on the market values of the asset owned albeit it is difficult to determine the true valuation of the asset. However, the government recently announced to reform the land/asset registration system based on competitive market price.[12] It is now formulating a policy and guideline for determining the actual market price of assets. This can be used for imposing wealth surcharge on assets. The wealth surcharge/tax should be levied on the asset values, but not on the payable taxes.

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[12] https://thefinancialexpress.com.bd/national/govt-to-formulate-policy-for-land-registration-at-actual-price-1664117881, accessed on 26 December, 2022.

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