

An Evaluation of the Tax System in Bangladesh



In brief

- **Tax systems in Bangladesh suffer from weaknesses in both tax administration and policy.**
The weaknesses in the tax system and tax administration have contributed to the very low level of tax collection in Bangladesh, undermining the government's capacity to provide necessary public services.
- **Modernization of VAT, income tax and customs administration would go a long way in enhancing tax revenue in Bangladesh. Tax administration should be geared toward providing taxpayers' services.**
Modernization of tax administration will be the key to realize revenue potential in Bangladesh. Outdated tax administration based on geographical basis (circles), absence of coordination among the three main wings (VAT, Income tax, and customs) of the National Board of Revenue (NBR), lack of computerization, and reliance on physical control instead of accounts, are the major factors contributing to the failures in tax administration.
- **The New VAT Act must eliminate existing distortions like truncated base, tariff values, account current and tariff values. Reforms on the direct tax systems should aim at reduction of exemptions/deductions and tax holidays, taxation of capital gains, and harmonization of corporate and individual income tax rates to improve equity and efficiency of the direct tax system.**
Despite some improvements, the current VAT Law has characteristics excise type and should be eliminated to have a modern accounts-based VAT system. The direct tax system suffers from a narrow tax base, horizontal and vertical inequity, and strong scope for evasion.

Policy Motivation

Accelerating Bangladesh's economic growth to the targeted 8% as envisaged in the Government's Sixth Five-Year Plan (FY11-15) over the medium term, would require massive public sector investment in power generation and distribution, construction of roads, bridges and expressways, and other infrastructure. Quality coverage of public service delivery (health care, education, agricultural extension services etc.) would also need to be improved and broadened. Without a substantial increase in domestic public resources, adequate and quality public goods cannot be provided to foster the target economic growth.

Project Summary

The present work reviews the official documents of the NBR to gauge the current practices associated with administration of the tax system in Bangladesh. It also compares the outcomes with best practices dictated by theory or as evident in other countries with similar levels of social and economic development.

Policy Findings

“Without a substantial increase in domestic public resources, adequate and quality public goods cannot be provided to foster the target economic growth.”

Though recent VAT performance seems to be quite buoyant, a VAT effort index at only 0.48 implies that Bangladesh is well below its potential. The estimate shows that Bangladesh's potential for higher tax revenues, given its VAT productivity, exceeds actual tax collection. Lower tax efforts in VAT collection reflect mainly weaknesses in tax administration coupled with identified deficiencies in tax policy/system. Deficiencies include a narrow tax base, multiplicity in effective tax rates, and administrative inefficiency involving truncated-base VAT system and excise-type administrative practices (declaration of prices, input-output coefficients, tariff values, account current etc.).

The current individual income tax law separates different types of income for administrative purposes since most tax revenue is received through withholding at sources. The continued use of certain allowances provides scope for tax avoidance mechanisms.

The generous tax rate for capital gains and de facto exemption of agricultural income creates horizontal inequities. Broadening the base of the income tax by eliminating special treatments would improve the horizontal equity of the tax, and make it fairer for all types of taxpayers.

Even though the statutory Bangladesh corporate income tax rates are broadly in line with the neighboring countries, except for somewhat higher rates for financial institutions and telecom companies, numerous exemptions and tax holidays and depreciation allowances erode the tax base. Non-compliance and tax holidays compromise the vertical and horizontal equity of Bangladesh's tax system.

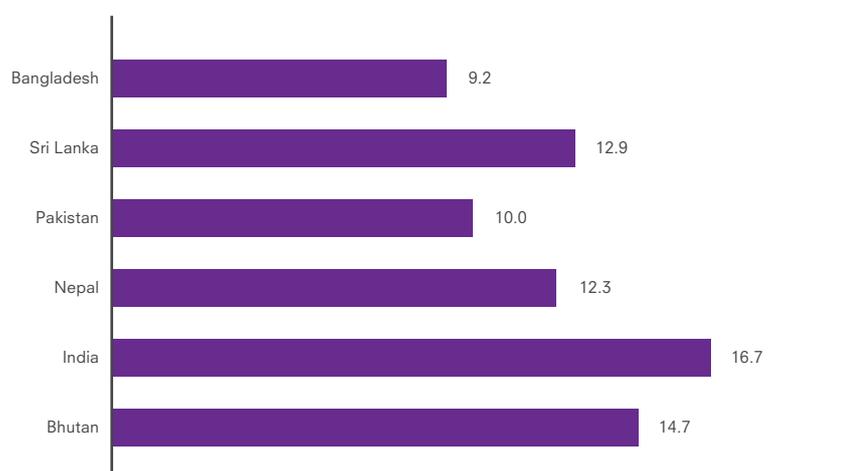
“Broadening the base of the income tax by eliminating special treatments would improve the horizontal equity of the tax”

Bangladesh’s Tax Efficiency, Given the Tax Rate Structures, is the Lowest Among Regional Comparators

Countries	Total Tax	Income Tax	Value Added Tax
Bangladesh	0.508	0.357	0.482
India	0.775	0.975	0.774
Pakistan	0.942	0.952	0.969
Sri Lanka	1.182	0.677	1.812
Indonesia	1.014	1.283	0.821
Philippines	1.02	1.19	0.743
Singapore	1.009	0.967	0.989
South Korea	1.206	1.372	1.572
Thailand	0.936	0.705	0.687

Source: Author’s Estimates

Bangladesh has the Lowest Tax-to-GDP Ratio Among Regional Competitors



“Lower tax efforts in VAT collection reflect mainly weaknesses in tax administration coupled with identified deficiencies in tax policy/system”

Implications

Improving tax efficiency will require major reforms in both tax policy and tax administration areas. Policy reforms must go hand-in-hand with the modernization of tax administration.

A large part of the tax efficiency loss is attributable to weaknesses and outdated (manual operations based) tax administration in Bangladesh.

Without a major reform initiative on the tax front, Bangladesh will never attain the tax to GDP ratio of 12.4 percent by FY15, from the current level of 10 percent in FY11, targeted under its newly announced Sixth Five Year Plan. The revenue gains made in recent years will not be sustainable without fundamental reforms. A failure on the revenue mobilization front will seriously undermine the government’s efforts on expanding public services and meeting the growing infrastructure needs of the

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economy. Without major reform, Bangladesh’s goal of reaching the middle-income status by 2021 will be unlikely.

Implementation

The present study is first of its kind. Further in-depth research will be needed on each of the major components of the tax system. Moreover, estimating the tax gap in Bangladesh, by types of tax gap and by taxes would enable the NBR to make better tax policy decisions regarding the tax system, including efforts to combat tax evasion where it is most prominent.

Like most other countries, a fundamental reform of the tax system encompassing all major types of taxes (VAT, Customs duty and direct taxes) will be a challenging task both politically and administratively. The NBR is currently working on a five-year plan for modernization of tax administration, tax policy reform, and capacity building for policy analysis by strengthening the Research and Statistical Division of the NBR. This is a major and a comprehensive undertaking. While the government is politically committed to the NBR modernization plan, its effective implementation will require support from development partners in terms of resources and technical assistance.

Despite political commitments for fundamental reforms at this early stage, there are vested groups in the business community and tax administration who would like to maintain the status quo and resist major changes. In addition to extensive consultations with the stakeholders, massive publicity campaigns will need to be undertaken to create awareness among the taxpayers about the reforms. They should inform the tax payer why such reforms would be needed, and of their enhanced rights and obligations. Taxpayers’ education campaigns will also be beneficial.

“Without major reform, Bangladesh’s goal of reaching the middle-income status by 2021 will be unlikely”

Further Reading

David A. Grigorian (2004). Tax Potential vs. Tax Effort: A Cross-Country Analysis of Armenia’s Stubbornly Low Tax Collection, IMF Staff paper

Joweria M. Teera and Professor John Hudson, 2004. “Tax Performance: A comparative study. Journal of International Development, Volume 16, Issue 6, pages 785–802.

Teera, J. (2002). “Tax Performance: A Comparative Study,” Working Paper 01-02, Centre for Public Economics, University of Bath.

About the authors

Ahsan H. Mansur is Executive Director of the Policy Research Institute of Bangladesh. Dr. Mansur started his career as a Lecturer, Department of Economics, Dhaka University in 1976. He left for Canada for higher studies in economics in the same year. As a graduate student and research assistant, he was also offering regular economics courses at the undergraduate level at the University of Western Ontario, Canada (1978-81). Dr. Mansur joined the IMF under its Economist Program in 1981, and completed his PhD in Economics (on general equilibrium analysis) from the University of Western Ontario in 1982.

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