

# Discussion: Institutional Dimensions of Tax Reforms in Bangladesh

Christopher Heady

## Introduction

The taxation system in Bangladesh is one of the worst in the world. It has a tax to GDP ratio of approximately 9%, as compared to the developing country average of 17–18%, and has been stagnant for the last eight years, reducing the scope for development spending.

The tax system is poorly administered and corrupt, with tax officials harassing taxpayers and extracting bribes to accept low tax payments. Also, politically connected taxpayers are able to reduce their tax payments. Even the government is complicit in reducing tax revenues by the use of SROs that effectively grant extra-statutory tax concessions to favoured entities, with no analysis of their revenue effects.

Also, the compliance rate for VAT-registered businesses is estimated at only 12%, among the lowest in the world. The VAT also has low productivity, of about 3% of GDP, when the statutory rate is 15%. This probably reflects the limited coverage of the VAT, which has not yet been extended to the retail level.

The corporate tax system is very unusual, with as many as nine different tax rates (from 45% to 3%), according to KPMG's Bangladesh Tax Profile (September 2018). Such a complex system must cause considerable administrative difficulties for businesses that produce products in different tax rate categories. As most countries have only one or two corporate tax rates, this structure suggests political favouritism for particular businesses, producing inefficiency and an uneven playing field for businesses.

## Difficulties in Raising Tax Revenue

Effective taxation in low-income countries is difficult for a number of reasons:

1. A large proportion of the population is likely to be self-employed, as farmers or individual businesses. This makes them hard to identify. It also means that they are unlikely to keep accurate accounts.
2. For this reason, tax authorities often focus on businesses, which are usually easier to identify as, normally, they need some sort of business licence in order to operate.
3. In some countries (including Bangladesh), corrupt tax officials conspire with taxpayers to reduce their tax payments, with the tax reduction shared between the taxpayer and the official.
4. Some countries (including Bangladesh) have unnecessarily complex tax schedules, especially for corporate income tax, increasing the burden on tax officials and increasing the scope for corruption.
5. As Bird *et al.* (2008) have argued, 'a more legitimate and responsive state appears to be an essential precondition for a more adequate level of tax effort in developing countries'. This argument has particular resonance for Bangladesh because its citizens generally see little in return for the taxes that they pay, with the resulting shortfall in tax revenue. It is therefore not surprising that tax compliance is so low.

### Businesses

Businesses generally provide the largest contribution to tax revenue in both high-income and low-income countries. This is partly because they can usually be identified easily, partly because of the requirement for accounts to be kept, and also because they are able to report the incomes of both the employees and of the owner(s) of the business. The accounts also provide information on business purchases and sales, allowing the calculation of liability for VAT or sales taxes.

However, there is a large incentive for businesses to understate their sales and overstate their costs, in order to reduce their tax liabilities. They may reduce their reported income by failing to give receipts to the purchasers of their products, reducing their apparent income. Some countries have tried to reduce this problem by providing purchasers with an incentive for purchasers to demand receipts. For example, in Italy, it is illegal to leave a shop without a receipt for the payment they have made, and the police can demand to see the receipt when the customer leaves the shop.

In addition, there are businesses that are unregistered and that operate outside of any regulatory control.

### The Self-employed

Although many self-employed people have low incomes, it is important to make sure that those on higher incomes are subject to tax. It is difficult to identify the wealthy self-employed because they have a strong interest in concealing

their incomes. However, this can be done by comparing the lifestyle of the self-employed with their declared incomes. As these investigations can take considerable time and require scarce specialist knowledge, it is best to focus on those self-employed people whose lifestyles are clearly beyond what can be afforded by most rich people.

Many self-employed people attempt to hide their existence from the tax authorities completely, as evidenced by the relatively small proportion of the population that submits tax returns. One way for the tax authorities to reduce this problem is to make use of the Block Management System developed by Tanzania in 2002, and subsequently adopted by Uganda (African Tax Administration Forum, 2014). This works by identifying an area, like a city block, and systematically counting all the people who live in the block and registering them for tax, making sure that all doors are opened to prevent people from hiding. This resulted in a very substantial increase in the number of businesses registering with the tax administration. Once registered, it is much simpler for the tax authorities to follow up businesses in later years.

### **Corruption**

In some countries, corrupt tax officials can be bribed to reduce the taxpayer's assessments, allowing the taxpayer to reduce their tax liability. This form of corruption can be reduced by ensuring that all communications between the taxpayer and tax officials are in written form and in such a way that the taxpayer does not know the identity of the tax official who assesses the taxpayer's liability.

### **Complex Tax Schedules**

Most countries have corporate tax rates that are very simple, with either just one rate that applies to all business profits, or one main rate and a slightly lower rate for small businesses. However, Bangladesh has a large number of different rates of corporate income tax for different products. This makes it very difficult for businesses to calculate their corporate tax liability and provides opportunities for businesses to reduce their tax liability by misrepresenting the type of product, or products, that they produce.

It also increases the burden on tax officials, to check that the correct corporate income tax rates have been applied.

In addition, SROs are used frequently to provide special benefits to particular target groups that are politically well connected, without any concern about the revenue losses.

### **Improving Tax Revenues**

It is very hard to improve tax compliance in a country whose tax system has been as dysfunctional as that of Bangladesh. However, Bangladesh will never

progress if important improvements are not made to both tax policy and tax administration.

The main measures that should be applied are the following:

1. Increase the number of tax officials and the level of their training.
2. Prevent tax officials from having personal contact with taxpayers. All communications between the taxpayer and the tax administration should be in writing and should be sent to the tax office for processing without revealing who dealt with the case. This should reduce corruption in the tax administration.
3. Increase the penalties for corrupt tax officials.
4. Ensure all taxpayers submit a completed self-assessment tax form, as the basis for the calculation of the tax due. This includes all government officials and their relatives.
5. Ensure a sample of these self-assessment is audited, in order to verify their accuracy. If the taxpayer's income is found to be higher than shown in the self-assessment form, penalties should be applied. The forms of government officials should be examined particularly carefully, with any irregularities reported to the legal authorities.
6. Remove the requirement for taxpayers to file a wealth statement along with their tax return. This should encourage taxpayers to file tax returns and allow them to become compliant with the tax system.
7. Ensure that SROs are only approved if their purpose is explained and their financial implications are properly calculated. All SROs should be published, including the reason for them and their financial implications. The costs of each one should be clearly stated as part of the annual financial statements of the Government.
8. The VAT administration should be modernised and computerised, to allow easy registration of traders and simple procedures for submitting tax assessments. VAT should be extended to the retail level as soon as possible.
9. The rate structure of the corporate income tax should be simplified to have one main rate. If particular products – such as tobacco products – are judged to require additional taxation, this additional taxation should be in the form of an excise duty rather than part of the corporate tax.
10. Each year, a sample of businesses should have their accounts audited, to ensure that they are reporting accurate VAT and profit figures and to ensure that they are fully reporting the wages that they pay to their employees.
11. A form of the Block Management System should be used to identify those businesses and the self-employed that operate outside the system, earning money without declaring it to the tax authorities.