PA-ABZ-058

PIAG REPORT # 13
USAID PROJECT NO. 388-0076
USAID CONTRACT NO. 388-0076-C-00-2035-00

REFORMING THE BANGLADESH TAX SYSTEM FOR INDUSTRIAL DEVELOPMENT

ABDUR RAB
AUGUST 08, 1995

POLICY IMPLEMENTATION AND ANALYSIS GROUP (PIAG)
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A PROJECT OF THE

MINISTRY OF INDUSTRIES, GOVERNMENT OF BANGLADESH
USAID AGENCY FOR INTERNATIONAL DEVELOPMENT

MANAGED BY

INTERNATIONAL MANAGEMENT AND COMMUNICATIONS CORPORATION (IMCC), WASHINGTON

ACKNOWLEDGMENTS

Research for this work has immensely benefited from the generous information and insights about the Bangladesh tax system shared with the author by many officials of the National Board of Revenue (NBR) of the Bangladesh Government. Useful comments were received from Mr. E R C Mouat, ODA VAT Adviser with the NBR on the relevant VAT part of an earlier draft of the report. The description on the income tax system was seen by Mr. Khalilur Rahman, an Income Tax Adviser and was also discussed with Mr. Delwar Hossain, First Secretary at the NBR. Mr. M. Zohrul Haque, First Secretary, of the VAT and Excise Wing and Dr. Zahid Hossain, First Secretary, Customs Wing of the NBR provided helpful information respectively on the VAT system and import tariffs. Dr. Zaidi Sattar, then International Advisor with the NBR helped with some processed information on import tariffs as well as with helpful comments on the import tariffs part of an earlier draft. Mr. Saiful Islam Khan and Mr. A. S. M. Taibur Rahman, Members respectively of the VAT and Excise and Income Tax Wings of the NBR gave some comments on relevant parts of the earlier draft. The author also benefited from comments on the earlier draft of the whole report by Janet Stotsky, a Senior Economist with the International Monetary Fund. Besides the author gained some valuable insights from two IMF reports cited in the report, access to which was made available to the author by one of the Members of the NBR. Some recent general published or unpublished literature and papers on tax reform issues were consulted for general guidelines and approaches and other information on such issues. As usual, the author's debt to Ron Black, this project Chief, has been deep in many respects. His searching questions raised on many points, numerous suggestions for improvement in content and linguistic polishing and presentation style have immensely helped to improve this report. Last but not least, without receiving frequent unstinted support from my colleague Ahmed Ali, Systems Analyst of the Project, on numerous, including several intricate, computer problems faced by the author, it would have been difficult to produce this report at this time. The author gratefully acknowledges all this help. Although utmost care was taken to ensure accuracy of the documentation contained in the report, there may still remain some inaccuracies or deficiencies, full responsibility for which solely rests with the author. It is hoped that the effort put in this report will be of use to the Bangladesh Government for considering future reform of its tax system which apparently is in need of comprehensive reform, if it is to play its due role in accelerating industrial and economic development of this country.

This report has been made possible through support provided by the Office of Economics and Enterprise, the Bangladesh Mission, U.S. Agency for International Development and the Ministry of Industries, Government of Bangladesh. The opinions expressed herein are those of the author and do not necessarily reflect the views of the U. S. Agency for International Development nor the Ministry of Industries.

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1. INTRODUCTION

1.1 Government tax policy has an essential role to play in economic and industrial development. And, as such, it is an important component of a government's economic reform program. In the current phase of structural adjustment in Bangladesh, tax policy should be used to accelerate the pace of industrial development. One key requirement of tax policy in this phase of development is to ensure enough government resources to preclude the need for inflationary budget deficits. Taxes are preferred to inflationary bank financing for government budget deficits since this in effect amounts to the most regressive form of disguised taxation. Inflationary financing discourages private saving and it also distorts investment decisions in favor of less risky and shorter-term investments because of greater uncertainty associated with an inflationary environment. The uncertainty has the further effect of dampening private domestic and foreign investment. It is now recognized the world over that a stable macro-economic framework is the first key prerequisite for creation of an environment which is conducive to private domestic and foreign investment. A first fundamental requirement of tax policy is, therefore, to ensure government revenue adequacy and macro-economic stability.

1.2 "Although tax patterns differ across countries, tax-to-GDP ratios in developing countries are in the 10-20 percent range, about half of the levels of industrial countries, whereas expenditure levels are in the 20-30 percent range -- much closer to the levels of industrial countries." (World Bank 1991, p. 81). Countries which do not raise adequate tax revenues are usually found to incur large budget deficits. While a major part of such deficits in developing countries is generally covered by foreign loans and grants, a significant part is often found to be covered by internal bank financing. Such countries need structural tax reform to raise adequate revenue to eliminate or reduce the budget deficits. Tax reform to raise adequate government revenue assumes critical importance in developing economies not only because governments of such countries usually need to undertake a large developmental role through the development of basic infrastructure and provision of education and health services, needed for development of human resources, but also because they need to gradually reduce the reliance on foreign debt which imposes a burden on the future generations.

1.3 Two other fundamental tax reform objectives are: (1) minimization of tax-induced economic efficiency losses, and (2) ensuring as far as possible an equitable sharing of the tax burden among the tax-paying public and business units. Most taxes affect economic incentives such as those to work, save or invest, allocate resources among alternative uses or produce different goods. By affecting such incentives, taxes create distortions in the economy that reduce economic growth and welfare, which are referred to as economic efficiency losses or excess burdens of taxes. Developing countries are increasingly recognizing that taxes that affect incentives to do business are to be avoided, phased out or minimized as quickly as possible over time. They are accordingly placing a high premium on reducing and rationalizing taxes on international trade and transactions and on rationalizing domestic direct and indirect taxes which create differential incentive effects on different economic activities. Likewise equity aspects of tax reform, especially horizontal equity which requires similar tax treatment of similarly placed taxable entities, are also important. In the initial stages of structural reform in developing countries, vertical equity, i.e., progressivity aspects of taxes are generally less emphasized for the sake of promotion of private savings and investment. Nevertheless, they are given some weight in devising both direct and indirect taxes. It is also necessary to pay attention to retaining or improving features in the tax system that promote foreign investment in a capital-poor country. Other desirable objectives of a tax reform agenda generally include broadening the tax base along with lowering of high tax rates and reductions of special exemptions and concessions in order to simplify the tax system and its administration and reduce tax-induced distortions and evasion.

1.4 To recapitulate, taxes are required to raise government revenue to finance public spending. Tax reform issues necessarily include consideration of how to raise revenue, but this needs to be combined with consideration of other effects which the various taxes produce -- such as those on savings and investment levels, their allocation, the structure of production, and on the tax burden borne by different income classes. In this paper, we will attempt to address tax reform issues as they relate to the current major tax instruments used such as corporate and personal income taxes, value added tax (VAT) and import tariffs. In line with current advice offered by fiscal experts[1], major tax reform objectives should emphasize revenue adequacy and satisfactory revenue growth over time, trade neutrality (i.e., neutrality in incentive effects on trade and businesses), promotion of saving and investment, horizontal and, as far as possible, vertical equity, and simplicity and compatibility between the tax system and administrative capacity. A main objective should be to broaden the tax base so that the tax structure can be simplified and the tax rates lowered, where possible, thereby reducing tax-induced distortions and evasion. A comprehensive approach to tax reform should be applied which simultaneously considers all the tax reform objectives while taking into account the multifarious effects (such as revenue, economic efficiency, equity) of the use of different tax instruments aimed at achieving the objectives. A further elaboration of some of these objectives, which apply generally to a developing economy like Bangladesh, follows:

a. Tax reform should be directed to increasing government revenue both absolutely and as a share of GDP to enable the Government to increase its current low development budget as well as to permit increases in needed current expenditures.

b. For increasing tax revenue, attention should be primarily directed to broadening the tax base by (1) increasing the eligible taxpayer population covered and (2) reducing special exemptions and concessions.

c. Increasing tax revenue should go along with a reduction in the revenue being collected from the import taxes -- especially customs duties and other non-trade-neutral taxes. This underscores the need for a strategy for increasing tax revenue from the direct and indirect taxes on domestic goods and services.

d. In consonance with the need for liberalizing imports and rationalizing the structure of tariff-created widely varying industrial incentives (effective rates of protection), a primary focus will need to be placed on reducing high tariffs to a moderate level and compressing the current dispersion in the tariffs. While the former action may result in a reduction in tax revenue, depending on the import elasticity of the tax, the latter action will most likely yield greater

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1 See, World Bank, *World Development Report 1991* and *Lessons of Tax Reform*, 1991.

revenue. The net revenue effect will most likely be a decrease in revenue, which will need to be compensated by other tax revenue increases from direct taxes and indirect taxes on domestic goods and services.

e. Enhancing trade neutrality of tax will involve not only tariff reform but also reform of the VAT system including supplementary duties which fall on both imports and domestic goods and services. The needed VAT system reform will require redefinition of the current tax bases on products and services and extension of the coverage of these taxes to products and services which are being fully or partially exempt from these taxes on unsound reasons.

f. Promotion of saving and investment -- which are currently low in Bangladesh -- through tax instruments would involve redesigning the direct taxes, where required, to encourage private saving and investment including foreign private investment by such means as tax exemption of capital incomes (dividends, interests and capital gains), full tax exemption or reduced taxation of reinvestment made by existing enterprises, lowering of corporate tax rates, and offering appropriate selective tax incentives to foreign investments which are consistent with the tax practices of the countries from where the investments are to come and with the tax practices of countries with which Bangladesh competes for foreign investment.

g. Enhancing vertical equity of the tax system, or in the least to make it as equitable as possible, through levying supplementary duties at appropriate rates on luxury or semi-luxury goods consumed mainly by the rich.

h. Ensuring export promotion through zero-rating, under VAT as well as other indirect taxes, all inputs which go into export production in order to ensure such production at internationally competitive costs.

1.5 Many, both developed and developing, countries undertook extensive tax reforms during the eighties (Bagchi, 1991). Tax reforms have played an important part in helping rapid development of the East Asian countries whose spectacular economic success has come to be known as "the East Asian Miracle". The countries included in this particular league are South Korea, Taiwan, Hong Kong, Singapore, Indonesia, Malaysia, and Thailand. Tax policy, in these countries, has produced and maintained macro-economic stability, promoted private saving and investment, and promoted high growth with a measure of equity. Countries which revamped their tax systems through a comprehensive approach to tax reform include South Korea and Indonesia, from East Asia and Colombia, Malawi, Mexico and Turkey from other regions.

1.6 In recent years, Bangladesh has been engaged in a broad-based program of tax reform as part of its overall economic and structural reforms. Tax reform is being supported under some donor agency programs such as the World Bank's Public Resource Management Adjustment Credit (PRMAC) program and was supported under the Second Industrial Sector Adjustment Credit (ISAC-2) program. The PRMAC program is closely linked to the macro-economic program described in a Policy Framework Paper for 1991/92-1993/94 and the International Monetary Fund's (IMF's)

Extended Structural Adjustment Facility (ESAF) program. Some important tax reform measures including the introduction of the value added tax (VAT), were introduced before the PRMAC program became formally operational. Under the ISAC-2 program, the Government was engaged in rationalizing the structure of import taxation by lowering the maximum tariff rate and introducing other rationalizations.

1.7 In 1989, a World Bank study formed the basis for some Bangladesh tax reform measures including, importantly the introduction of the VAT.[2] A more recent 1992 Foreign Investment Advisory Service (FIAS) study made some specific recommendations to improve the system of company income tax incentives for spurring industrial investment.[3] Bangladesh has not yet satisfactorily responded to these latter recommendations.

1.8 Although Bangladesh has achieved some measure of success during the last four years in increasing government revenue, mainly through the introduction of the VAT, the levels of total current revenue and tax revenue still remain considerably below the averages even in other low-income countries (see next chapter). Bangladesh's public investment is quite small and needs to be considerably increased to meet the current deficiencies in, and future demands for, infrastructural development and social services to accelerate industrial development. In addition, government revenue needs to be increased to allow the substantial requirements in current expenditure for recurrent maintenance costs in completed development projects as well as to substantially raise the inadequate salary levels of, particularly senior, government employees. Further reform of the tax system to ensure revenue adequacy is urgently called for.

1.9 An examination of the current tax system of Bangladesh reveals several other shortcomings and weaknesses. The VAT system was introduced not only to raise revenue, but also to rationalize economic incentives across businesses by (1) replacing the previous system of cascade-type excise and sales taxes and (2) broadening the tax base by reducing extensive exemptions and concessions. VAT is being collected at the import and manufacturing stages as well as when some services are provided. The current VAT system's coverage of goods with extensive exemptions and exceptions leaves a substantial portion of the tax base untapped, and also at the same time leaves considerable scope for creation of tax-induced distortions in producer incentives for doing business in different activities. Taxes create economic efficiency losses when these have the effect of curbing the growth of activities with higher economic rates of return more than those whose economic return rates are lower. Such tax-induced economic efficiency losses are being created also because of the continued relatively heavy reliance on taxes on international trade -- a feature which suggests an unduly slow pace of reform of the tariff and other taxes on imports as well as a slow expansion of the domestic taxes. The system of direct taxes on industrial companies with: (1) comparatively high tax rates and an overly generous system of incentives, with apparent unsatisfactory provisions for promoting private savings and investment, and (2) unsatisfactory tax administration and weak enforcement of taxes on domestic companies exhibits features which indicate high inefficiency and

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2 World Bank, *Bangladesh: An Agenda for Tax Reform* (in three volumes), December 15, 1989.

3 Foreign Investment Advisory Service (FIAS), *Policy, Regulatory and Incentive Regimes Affecting Private Foreign and Domestic Investment in Bangladesh*, November 1992.

inequity --- a tax system which discourages foreign investment.

1.10 The current study examines and evaluates the progress Bangladesh has made to date in reforming its tax system and assesses further actions needed in this area. A conclusion is that the entire tax system is in need of significant improvement. The study focuses on the major taxes -- corporate and non-corporate income taxes, the VAT system including supplementary duties, and import tariffs. Though there are problems with a number of other relatively minor taxes being used, these are not covered except some, with a brief reference, which are essentially related to the reform of the major taxes covered. When a first draft of this study was nearing completion, the author came to know about two recent International Monetary Fund (IMF) reports, one on reform of direct taxation and the other on reform of the administrative aspects of income and value added taxation, which were prepared in response to requests from the Bangladesh authorities. The reports were dated respectively March and May 1994.[4] This study has subsequently taken account of these IMF reports. No effort, however, was made to take note of two other recent reports, one by the World Bank and the other by the United Nations Development Program (UNDP), both dealing with tax administration issues, which were mentioned in the May IMF report.[5]

1.11 The rest of this report is organized as follows. Chapter 2 presents a comparative analysis of such macro-economic aspects as levels of savings, investment, government total revenue and tax revenue, total government expenditure and tax structure of Bangladesh and selected developing countries -- which highlights features that indicate some major tax reform requirements for Bangladesh. In Chapter 3, an account of the current tax system of Bangladesh and its recent reforms is provided. The remaining four chapters, Chapters 4 to 7 turn to tax reform issues and options concerning major taxes of Bangladesh -- corporate income taxes, non-corporate income taxes, value added tax system including supplementary duties, and import tariffs. Each of these latter chapters contains a summary of recommendations relating to these four tax areas.

4 Sunley, Emil M. and John King, *Bangladesh: Reform of Direct Taxation*, International Monetary Fund, March 1994 and Heeden, K. van der, J. Brondolo, and A. Firestone, *Bangladesh: Toward Improving Income and Value Added Tax Administration*, International Monetary Fund, May 14, 1994.

5 World Bank, *Implementing Reform in Tax Administration*, August 1992 and UNDP, *Direct Tax Administration*, Final Mission Report, September 1993.

2. LEVELS OF SAVINGS, INVESTMENT, GOVERNMENT TOTAL REVENUE, TAX, AND EXPENDITURE, AND TAX STRUCTURE -- AN INTERNATIONAL COMPARISON

2.A Savings and Investment

2.1 As documented in last year's World Bank's country economic report on Bangladesh (World Bank, 1994) and the Finance Minister's Budget Speeches (GOB, 1994 and 1995), Bangladesh has achieved, during the last four years, a commendable improvement in fiscal management through better revenue collection, greater restraint over current expenditure, and a careful dovetailing of the development expenditure to the available internal and external resources. Fiscal deficit has been brought down from around 7 percent of GDP during FY 1990/91 (FY 91) to below 6 percent in FY 94. Bangladesh displayed an extraordinary record of macro-economic stability, with annual inflation brought down to within only 5 percent during FY 92-95 from the levels of 8 to 12 percent generally experienced during earlier years. There are few countries which are currently enjoying a comparable macro-economic record. This is indeed a welcome development.

2.2 Disconcertingly, however, the macro stability masks the fact that investment has been at a low level. Levels of saving and investment, which determine the pace of economic and industrial development, are strikingly low in Bangladesh, relative to the corresponding levels even in other low-income economies. Such low saving and investment are, in a major part, due to low levels of government revenue including the amount of tax raised.

2.3 In Table 1, levels of gross domestic saving and gross domestic investment, as shares of gross domestic product (GDP), are shown for 13 selected low-income and lower-middle-income economies including Bangladesh for three years, 1970, 1990, and 1992. Bangladesh's saving and investment rates look dismally poor, compared to these international references. Bangladesh's domestic saving and investment during 1970, 1990 and 1992 were for the most part not only the lowest but considerably below the averages of the other 12 countries. Bangladesh's investment was 11 to 12 percent of GDP during these three years. This was about half the averages for other countries, except for some low-income countries during 1970 when Bangladesh's investment rate was lower by about a third. Bangladesh's investment has been only 12 percent of GDP during 1990 and 1992, compared to a range of 18 to 23 percent in the low-income economies of India, Malawi, Nepal, Pakistan, and Sri Lanka, 35 to 36 percent in Indonesia, and a range of 20 to 40 percent in the listed lower-middle-income countries except Bolivia. Bangladesh's investment level has been consistently low when compared to that in neighboring countries of India, Nepal, Pakistan, and Sri Lanka, where the level has ranged between 16 percent and 23 percent of GDP (excluding the exceptional 6 percent of Nepal during 1970).

2.4 As shown in Table 2, Bangladesh's 1992/93 (FY 93) level of total investment shows little or no improvement over its traditional low level in the past. The overall low investment is due both to low public and private investment. However, while private investment has shown some increase over time, the public investment level of recent years, below 6 percent, marks a decline from the level

TABLE 1: GROSS DOMESTIC SAVINGS AND GROSS DOMESTIC INVESTMENT IN SELECTED DEVELOPING COUNTRIES

(Percent of GDP)

Country	Gross Domestic Saving			Gross Domestic Investment		
	1970	1990	1992	1970	1990	1992
Low-Income Economies: Bangladesh	7	2	6	11	12	12
India	16	20	22	17	23	23
Indonesia	14	37	37	16	36	35
Malawi	11	10	2	26	19	19
Nepal	3	8	12	6	18	22
Pakistan	9	12	14	16	19	21
Sri Lanka	16	15	15	19	22	23
Average for six countries (excluding Bangladesh)	11.5	17	17	16.7	22.8	23.8
Lower-Middle-Income Economies: Bolivia	24	8	5	24	11	16
Chile	20	23	26	19	20	24
Jamaica	27	30	--	32	30	--
Philippines	22	16	18	21	22	23
Thailand	21	34	35	26	37	40
Turkey	17	18	20	20	23	23
Average for six countries	21.8	21.5	20.8	23.7	23.8	25.2

Sources: World Bank, *World Development Report 1992 and World Development Report 1994*.

attained during the late eighties. This is a disconcerting development, which highlights the need for more efforts on the part of the Government to raise revenue on a more satisfactory scale. The Government needs to considerably increase public investment to meet the current critical deficiencies in infrastructural facilities in power, telecommunications, roads, etc., as well as to permit further needed increases in investments in social services to improve the level of human resource development. Foreign investors are dissuaded to come and invest in Bangladesh for a variety reasons, including, importantly, the poor infrastructure and the poor general state of human resource development. To raise the growth rate to a satisfactory level, from the present 4 to 5 percent, the overall investment rate will have to rise to 18 to 20 percent from the present some 14 to 15 percent.

2.5 The main reason for Bangladesh's low investment is a particularly low rate of domestic saving[6]. In terms of international comparison, shown in Table 1, Bangladesh's domestic saving rate

6 Domestic savings exclude remittances sent into the country by Bangladesh nationals working abroad. National savings include such remittances, which are higher (See below in the text Table 2).

looks even worse than its investment rate. During 1970 and 1992, this saving rate had been 6 to 7 percent of GDP. This was about one third of the averages of other countries, except again for 1970, when Bangladesh's rate was lower than the corresponding average for other low-income countries by about 40 percent. The relative situation of Bangladesh during 1990 was much worse, when the saving rate fell to an unus ial low of 2 percent of the GDP.[7]

2.6 In Table 2, a look at the saving and investment situation in Bangladesh of recent years, FY 1985 through FY 1993, shows a disconcertingly downward trend in public investment, despite some marked improvement in public saving. Private saving and investment, on the other hand, show an upturn. Overall investment remained basically stagnant at a little over 12 percent. This situation, in light of increasing public expenditure relative to public resource mobilization, points to a relative deterioration in the government budgetary situation over time: a smaller increase in government current revenue than that in government current expenditure. This situation further reinforces the inadequacy of government revenue and highlights the need for more concerted government efforts to mobilize public resources.

TABLE 2
SAVINGS AND INVESTMENT OF BANGLADESH IN SELECTED RECENT YEARS
(Percent of Nominal GDP)

Year/Description	FY 88	FY 90	FY 91		FY 92	FY 93 Preliminary
Savings National Saving	6.4	6.2	5.9	7.5	9.9	10.5
Public	0.9	1.0	0.6	0.9	2.6	3.0
Private	5.5	5.2	5.3	6.6	7.3	7.5
Domestic Saving	3.2	2.7	2.9	4.3	6.2	6.5
Investment	12.4	12.9	12.8	11.5	12.1	12.7
Public	6.0	6.4	6.4	5.7	5.5	5.7
Private	6.4	6.5	6.4	5.8	6.6	7.0

Source: World Bank, *Bangladesh: From Stabilization to Growth*, Report No. 12724-BD, p. 16, March 17,1994

Year/Description	FY 85	FY 86	FY 87
Investment	12.8	12.3	12.5
Public	7.4	6.7	6.3
Private	5.4	6.0	6.2
Domestic Saving	1.6	3.0	3.2

Source: World Bank, *Bangladesh: Implementing Structural Reform*, Report No. 11569-BD, March 24, 1993, p.9

7 For FY 90, the World Bank's current year's country economic report shows a savings rate of 2.9 percent. This Table's figures are from different World Bank reports.

2.B Government Revenue-GNP, Tax-GNP and Expenditure-GNP Ratios

2.7 In tax policy analysis, one can judge how well or poorly Bangladesh does in its efforts to raise public resources by also looking at Bangladesh's comparative situation *vis-a-vis* other countries in regard to the ratios of government revenue, tax revenue and expenditure to GNP (or GDP). Available information on these ratios for 17 low-income, and lower- and upper-middle-income economies for two years, 1980 and 1992, is presented in Table 3. The list includes several countries which have undertaken comprehensive tax reforms. Among these countries, only one country, Nepal, was similar to Bangladesh in 1992, in terms of revenue-GNP and tax-GNP ratios. Bangladesh's expenditure-GNP ratio has been lower than even that of Nepal. Compared to all other countries, all the three ratios of Bangladesh have been lower. This suggests a lower level of Bangladesh's public activities compared to the other countries, which is due mainly to a lower level of public resource mobilization. This point is brought out more powerfully by the following quantitative features revealed by the Table.

2.8 International comparisons of tax-GNP (or tax-GDP) ratios help one see the low level of tax effort in Bangladesh. Although this ratio has historically risen in Bangladesh, it still remains one of the lowest and much below the average in the developing world. Bangladesh's tax-GDP ratio during 1992 (FY 1991/92) was 8.8 percent, which was a little higher than the tax-GNP ratio of only Nepal, but considerably lower than the tax-GNP ratios of other countries -- about half the averages of the corresponding levels in the three groups of listed low-income, lower-middle-income and higher-middle-income economies. The comparative situation of Bangladesh was even worse during 1980, when the tax-GNP ratio was less than half of the average of other low-income countries except Nepal, and nearly one third of the averages of the lower-middle-income and higher-middle-income countries. Among the seventeen low and middle income countries, with the exception of extreme cases such as Nepal and Jamaica, this ratio ranged between 9.8 percent and 26.9 percent even in 1980 and it ranged between 11.1 percent and 22 percent in 1992. The neighboring countries of India, Pakistan and Sri Lanka had respectively the ratios of 9.8, 13.5 and 19.2 percent in 1980 and 11.1, 12.2 and 18.1 percent in 1992.

2.9 Bangladesh has gradually increased its tax effort over time. However, it will need to increase this effort more vigorously, if it intends to compete with other countries, in terms of sufficient provisions of infrastructure and human resource development, for scarce industrial investment. Because of recent reforms, the tax-GDP ratio in Bangladesh rose from 7.89 percent in FY 91 to 8.72 percent during FY 92 and to 9.67 percent during FY 93. For these two years, this development well met the World Bank's PRMAC program requirement that tax revenue should be increased by 0.5 percent of GDP every year. However, during the following year, FY 94, the tax-GDP ratio declined to 9.38 percent. During these three years, tax revenue increased by 19.94, 16.05 and 5.92 percent respectively. The revised estimate of total tax revenue during FY 95 marked a 14.40 percent increase from the FY 94 outcome. The FY 96 budget's projected tax revenue will mark another 9.86 percent increase from the last year. (See Tables 5-A, 5-B and 7 of the next chapter). It is evident that there has been a significant deceleration in the Government's effort to generate tax revenue. During the last four budget presentations, no significant new tax or tax base broadening

TABLE 3

Total Government Expenditure-GNP, Revenue - GNP, and Tax - GNP Ratios of Selected Countries

(In Percentage)

Country	1980			1992		
	Expendi-ture/GNP	**Revenue/ GNP**	**Tax/ GNP**	**Expendi-ture/GNP**	**Revenue/ GNP**	**Tax/ GNP**
Low-Income Economies						
Bangladesh	10.0	11.3	7.7	15.9 (17.2)	10.9 (11.7)	8.8 (9.4)
India	13.2	11.7	9.8	16.8	14.4	11.1
Indonesia	23.1	22.2	*21.1*	*19.2*	19.7	*18.2*
Malawi	37.6	20.7	*18.1*	26.6	20.7	*18.0*
Nepal	14.2	7.8	*6.5*	18.7	9.6	*8.0*
Pakistan	17.7	16.4	*13.5*	21.7	16.7	*12.2*
Sri Lanka	41.6	20.3	19.2	28.2	20.1	18.1
Average (excluding Bangladesh and Nepal)	26.6	18.3	16.3	22.5	18.3	15.5
Lower-Middle- Income Economies						
Bolivia	29.0	-	-	22.5	16.9	11.4
Chile	29.1	33.2	26.9	22.1	24.4	21.4
Jamaica	45.7	31.9	30.6	--	--	--
Philippines	13.4	14.0	12.5	19.4	17.4	--
Thailand	19.1	14.5	13.3	15.4	18.1	16.3
Turkey	26.3	22.3	17.7	29.4	22.9	18.5
Average (Lower-Middle-Income Economies)	27.1	23.2	20.2	21.8	19.9	16.6
Upper-Middle-Income Economies						
Brazil	20.9	23.4	*19.2*	25.6	21.6	*16.4*
Malaysia	29.6	27.3	24.4	29.4	30.1	22.0
Mexico	17.4	15.6	*14.8*	17.9	14.5	*13.4*
Korea, Rep. of	17.9	18.3	16.0	17.6	18.2	16.4
Average (Upper-Middle-Income Economies)	21.5	18.6	21.2	22.6	21.1	17.1

Notes:
1. Figures in italics are for years other than those specified.
2. Figures in parentheses for Bangladesh are for FY 1992/93 and are ratios to GDP, not GNP.

Sources: World Bank, *World Development Report 1994* except for Bangladesh for 1992 figures, which are taken from World Bank's current year's country economic report, p. 202, where the figures outside parentheses correspond to FY 1991/92 and those in parentheses correspond to FY 1992/93.

measures were introduced. Rather some significant domestic tax reducing measures were introduced. Emphasis was placed on improving tax collection through administrative measures. Because of still remaining serious weaknesses in tax administration, appropriate measures to improve the tax administration will remain a high-priority tax reform requirement for Bangladesh for quite some time. Such an emphasis without visible additional discretionary tax increasing measures is also politically more appealing. However, measures for improvement in tax administration alone can not be relied upon to bring about desired levels of increases in the revenue, because diminishing returns to such 0efforts will set in at some point in time.

2.C The Tax Structure

2.10 International comparisons of tax structures also point to certain shortcomings of the Bangladesh tax system. Information on the central government tax revenue structures of 10 selected countries including Bangladesh for two years, 1980 and 1992, is presented in Table 4. Some of the features of importance revealed by the Table are noted below.

TABLE 4: STRUCTURE OF CENTRAL GOVERNMENT TAX REVENUE IN SELECTED COUNTRIES
(Percentage of Total Tax Revenue)

Country	Year	Taxes on Income, Profits and Capital Gains	Domestic Taxes on Goods and Services	Taxes on International Trade and Transactions	Other Taxes	Total
Bangladesh	1980	14.8	37.4	42.0	5.7	100
	1991/92	16.4	24.0	51.2	8.5	100
	1992/93	17.6	23.3	50.6	8.4	100
India	1980	21.9	51.0	26.4	0.7	100
	1992	22.0	44.6	33.0	0.5	100
Indonesia	1980	82.0	9.0	7.6	1.3	100
	1992	*62.9*	*28.5*	*5.5*	*3.0*	100
Korea, Rep. of	1980	25.5	52.5	17.1	4.9	100
	1992	37.6	39.6	9.3	13.4	100
Malaysia	1980	41.9	18.8	36.9	2.5	100
	1992	46.8	27.4	20.4	5.6	100
Nepal	1980	6.6	43.9	39.6	9.8	100
	1992	*11.9*	*44.3*	*37.2*	*6.6*	100
Pakistan	1980	16.8	40.9	41.9	0.2	100
	1992	*13.7*	*44.2*	*41.5*	*0.4*	100
Philippines	1980	23.6	46.9	27.1	2.5	100
	1992	33.5	30.0	32.8	3.7	100
Sri Lanka	1980	16.4	28.3	53.3	2.0	100
	1992	12.4	53.0	30.6	3.9	100
Thailand	1980	19.3	50.1	28.4	2.2	100
	1992	30.5	46.2	18.5	4.8	100

Note: Figures in italics are for years other than those specified.

Sources: Bangladesh for 1991/92 and 1992/93: National Board of Revenue, Bangladesh Government and Bangladesh for 1980 and all other countries: World Bank, *World Development Report, 1994.*

2.11 The feature that strikes one most is the relatively heavy dependence of Bangladesh on the taxes on international trade and transactions. During FY 93, half the total tax revenue came from these taxes,[8] compared to a range of 5.5 percent to 33 percent among the remaining nine countries except Pakistan which had a relatively high 41.5 percent share from this source. The countries which show very low relative tax collections, 5.5 percent and 9.3 percent are Indonesia and South Korea. These are the countries which are known for their comprehensive tax reform -- one essential and very important element of which was to reduce the dependence on trade distorting taxes and to also bring about the required export orientation in the development strategy. As early as 1980, both Indonesia and South Korea had already relatively low dependence on this source of revenue, with shares of 7.6 percent and 17.1 percent. This dependence was further reduced over time. Except for India, Pakistan, Bangladesh, and the Philippines, all the other countries listed in the Table improved their tax structure in this regard over time. Sri Lanka reduced the very high 53.3 percent share of these trade taxes in 1980 to 30.6 percent in 1992, Malaysia from 36.9 percent to 20.4 percent, and Thailand from 28.4 percent to 18.5 percent during the same period. Malaysia and Thailand are among the fast growing newly developing economies of East Asia.

2.12 It is also disconcerting to note that the already heavy relative dependence of Bangladesh on taxes on international trade and transactions in 1980 at 42 percent, instead of declining over time because of recent trade liberalizing tariff reductions, rather increased to 50.6 percent in FY 92/93. In the following year, FY 94, this tax component went down below 50 percent, but went up again to over 50 percent in the revised budget estimates of FY 95. This situation does not significantly change in the budget estimates for the current year, FY 96. (See also Tables 5-A and 5-B). The overall dependence on the trade taxes remains very high despite significant tariff cuts in recent years. This development is explicable partially, and probably only for the last year in recent years, by a rapid growth in the import trade. Overall, however, this suggests that effective tariff reduction on imports has not, in effect, gone very far and that the nature of the tariff reform has been significantly influenced by revenue consideration. (For more details see Chapter 7).

2.13 The main reason for the increase in the overall tax on imports is a relatively higher increase in trade-related taxes (due to increases in the new VAT and supplementary duties on imports in FY 92 over those of the sales tax on imports in FY 91) compared to the increase in other taxes (due to the increases in the VAT, supplementary duties and excise on domestic goods and services in FY 92 over the excise on the same goods and services in the previous year). As can be deduced from Table 5-A of the next chapter, in the former case -- trade-related taxes -- the increase was as high as 62.3 percent, while in the latter case -- other taxes -- the increase was only 8.4 percent. The increase in tax on imports in FY 93 from FY 92 due to the same taxes was also considerably higher (36.1

8 Value added tax (VAT) on imports is included in these taxes, which , according to some, should not be so included, as the VAT is considered to be a tax on domestic consumption. However, that part of the VAT which falls on the imported final consumer goods should be included in the taxes on imports until and unless the domestic trade sector is brought under the VAT net and the import tax is credited against the domestic tax, which is the case in Bangladesh. The VAT on imports could not be readily separated into parts falling on final consumer goods and other goods. Also note that a substantial part of the Bangladesh VAT is unilaterally placed on imports, not on domestic production, including importantly textile goods -- a factor which makes such taxes non-trade-neutral and of the nautre of trade taxes.

percent) than that in the corresponding tax on the domestic goods and services (13.2 percent). On the other hand, the value of imports during these two years did not increase rapidly. This clearly suggests the lopsided pattern of the newly introduced VAT on imports and domestic goods and services. During the past , the revenue from domestic excise tax had been higher than that from the sales tax on imports. This clearly signifies that the VAT coverage on domestic goods and services has been particularly unsatisfactory. (More on this in Chapter 6).

2.14 Table 4 also shows the low contribution of the taxes on income in Bangladesh relative to most other countries. Bangladesh collected 17.6 percent of total tax revenue from income taxes in FY 1992/93 -- which is though higher than the corresponding figures in Pakistan, Sri Lanka and Nepal during 1992 -- was considerably lower than those of India (22 percent), Thailand (30.5 percent), Philippines (33.5 percent), South Korea (37.6 percent), and Malaysia (46.8 percent). Indonesia's still specially higher revenue receipt from such taxes at 62.9 percent is, of course, explicable in view of its taxes on oil income. Worse still, Bangladesh's relative collection of revenue from income taxes -- which remained around the same level as in FY 93 for several years beginning from FY 91-- sharply declined to 14.04 percent in the revised budget estimate of FY 95 (See Table 5-A in the next chapter).

2.15 The comparatively low overall level of tax in Bangladesh, combined with the relatively poor domestic tax, demonstrates that a comprehensive approach to tax reform in Bangladesh would require placing a greater emphasis on a major expansion of the domestic taxes in tandem with a strategy to reduce the taxes (especially customs duties) on imports. The shortcomings in the current structure of the domestic VAT and supplementary duties need to be seriously addressed if some satisfactory growth in revenue is to be ensured along with a rationalization of the tax-induced incentive effects across businesses.

3. CURRENT TAX SYSTEM AND RECENT REFORMS

3.1 In this chapter, a brief description of major taxes of the current tax system, along with documentation of some salient features and recent reform changes, is provided. Tax reform issues that can be identified in regard to the major taxes as having significant policy implications will be taken up in more detail in the subsequent chapters.

3.A Salient Features of the Tax System

3.2 Major taxes by which Bangladesh currently raises revenue are customs duty on imports,[9] VAT on imports and domestic goods and services, supplementary duties on imports and domestic goods and services, company income tax, and personal income tax. During FY 94 as well as in the revised budget estimates of FY 95, these taxes accounted for nearly 90 percent of the total tax revenue. During the same years, customs duty on imports and the VAT, along with supplementary duties, accounted for 71.7 to 77.6 percent of the total tax revenue. The VAT system, including the supplementary duties, is the highest collector of tax revenue, with its relative contribution at 41 to 44.5 percent, followed by customs on imports, with relative contribution of 30.7 to 33 percent during these years. Other taxes are excise duties remaining on a few domestic goods and services, a stamp duty and a registration fee on property transfer transactions, a land development tax, a foreign travel tax, an electricity duty, a motor vehicles tax and a few other taxes of very minor revenue importance. (See Tables 5-A, 5-B and 6).

3.3 In Table 7, information on overall tax to GDP ratio and the corresponding ratios by major tax groups is documented for a larger selected number of years while some additional features are documented for the recent years in the nineties. As already mentioned earlier, the overall tax-GDP ratio has gone up significantly in recent years from its past level in the eighties. However, while reaching the level of 9.67 percent during FY 93, it marked some decline in the following year. It was pointed out that the level as such is considerably low by international standards, even when compared to other developing countries. With about 14 percent increase in total tax revenue during FY 95 and the budgeted increase of about 10 percent for the current year, there is a strong likelihood that the overall tax-GDP ratio may even record a further deterioration during these years. During FYs 92 and 93 when this ratio marked a significant increase, the annual increase in total tax revenue was 16 to 20 percent. The Table also shows that the taxes on income are doing relatively most poorly in terms of growth in revenue collection after FY 93. The lower part of the Table shows that there has been a clear deceleration in the growth of total tax revenue as percent of GDP. The deceleration in FY 93 from FY 92 took place despite some acceleration in the growth of revenue from the VAT system, while a still steeper deceleration in the growth of total tax revenue as percent of GDP in FY 94 -- which accounted for a fall in the tax-GDP ratio in that year -- was associated with a nearly similar deceleration in the VAT part of the revenue. This clearly suggests that the Government has slackened its effort to increase tax revenue as percent of GDP over time to mobilize an increasing level of domestic financial resources to increase public investment and other necessary expenditures.

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9 Note that up to FY 95, import taxes including customs duties shown in Tables 5-A and 5--B included a small part on account of duties on exports, which were only on raw and wet blue hides and skins. These latter duties have been withdrawn by this year's budget.

TABLE 5-A: STRUCTURE OF TAX REVENUE IN BANGLADESH BY MAJOR TAX GROUPS

In Tk Million and (Percent)

Year/Description	1990/91	1991/92	1992/93	1993/94	1994/95 Revised Budget	1995/96 Budget
Customs Duty	23741.3 (36.04)	27460.2 (34.76)	28757.2 (31.86)	29798.7 (30.68)	36,700.00 (33.03)	39,790.00 (32.60)
Excise Duty	17474.4 (26.53)	14033.5 (17.76)	3309.0 (3.61)	1605.9 (1.65)	1800.0 (1.62)	2000.0 (1.64)
Sales Tax	7983.9 (12.12)	None	None	None	None	None
VAT (on imports)	None	12697.4 (16.07)	17317.7 (18.89)	17134.9 (17.64)	20900.0 (18.81)	22990.0 (18.84)
VAT (on dom. goods, services)	None	4655.3 (5.89)	8319.6 (9.07)	10327.6 (10.63)	11850.0 (10.67)	13300.0 (10.90)
Sup. Duty (on imports)	None	257.1 (0.33)	311.2 (0.34)	1884.0 (1.94)	1600.0 (1.44)	1900.0 (1.56)
Sup. Duty (on dom. goods)	None	260.1 (0.33)	9812.3 (10.70)	10479.1 (10.79)	12900.0 (11.61)	13950.0 (11.43)
Income Tax	11267.5 (17.10)	12940.3 (16.38)	16131.7 (17.59)	17012.5 (17.52)	15600.0 (14.04)	16350.0 (13.40)
Other Taxes	5406.4 (8.21)	6703.4 (8.48)	7729.1 (8.43)	8869.3 (9.13)	9750.0 (8.78)	11770.0 (9.64)
Total Tax Revenue	65873.5 (100)	79007.3 (100)	91687.8 (100)	97112.0 (100)	111100.0 (100)	122050.0 (100)

TABLE 5-B: TAXES AS PERCENT OF TOTAL TAX AND GDP

Year/Description	FY 91	FY 92	FY 93	FY 94	FY 95 Revised	FY 96 Budget
Taxes on Imports	31,725.20	40,414.70	46,386.10	48,817.60	59,200.00	64,680.00
As % of Total Tax	48.16	51.15	50.59	50.27	53.29	52.99
As % of GDP	3.80	4.46	4.77	4.71	n.a.	n.a.
Taxes on Domestic Goods	17,474.40	18,948.90	21,440.90	22,412.60	26,550.00	29,250.00
As % of Total Tax	26.53	23.98	23.38	23.08	23.90	23.97
As % of GDP	2.09	2.09	2.21	2.16	n.a.	n.a.
Income Tax	11,267.50	12,940.30	16,131.70	17,012.50	15,600.00	16,350.00
As % of Total Tax	17.10	16.38	17.59	17.52	14.04	13.40
As % of GDP	1.35	1.43	1.66	1.64	n.a.	n.a.
Total Tax Revenue	65,873.5	79,007.3	91,687.8	97,112.0	111,100.00	122,050.00
As % of Total Tax	100.00	100.00	100.00	100.00	100.00	100.00
As % of GDP	7.89	8.72	9.67	9.38	n.a.	n.a.
GDP at Current Market Price	834,392.00	906,502.00	947,896.00	1,035,464.0(p)	n.a.	n.a.

Notes: n.a. means "not available"; (p) means provisional estimate.

Source: NBR and Ministry of Finance, Finance Division, *Details of Revenue Receipts 1955-96* (in Bengali).

TABLE 6: REVENUES FROM MINOR TAX SOURCES
(Tk Million)

Year/Tax	1990/91	1991/92	1992/93	1993/94	Percentage of Total Tax (1992/93)
Stamp Duty (Non-judicial)	1867.0	3,020.2	2,800.0	3,500.0	3.05
Land Development Tax	600.0	1,081.7	900.0	1,200.0	0.98
Foreign Travel Tax	603.8	668.0	718.1	784.0	0.78
Registration Fee	700.0	844.2	900.0	1,200.0	0.98
Electricity Duty	334.3	397.0	635.9	633.0	0.69
Motor Vehicles Tax	350.0	411.6	470.0	600.0	0.51
Wealth Tax	14.6	20.1	37.9	48.4	0.04
Turnover Tax	0.2	3.9	6.3	16.9	Near zero
Other taxes	936.5	256.7	1,260.9	335.2	1.38
Total	5,406.4	6,703.4	7,729.1	8,317.5	8.43

Sources: National Board of Revenue and Ministry of Finance, Finance Division, *Bangladesh Economic Survey 1991/92*

3.B The System of VAT and Related Taxes

3.4 A major recent tax reform measure was the VAT introduced in FY 91. The tax has been introduced at the import and domestic manufacturing stages at a uniform 15 percent rate -- with exceptions made to the base to which the tax is applied in some cases, replacing sales tax on imports and excise duty on domestic products. Some excisable goods like petroleum products, gas and tobacco products, which were not VAT-covered in the initial year, were subsequently brought into the VAT net along with supplementary duties on gas and tobacco products (cigarettes).

3.5 Industrial units with capital below Tk 300,000 or with annual turnovers below Tk 1.5 million are given a cottage industry status and such units are exempted from the VAT, with certain exceptions, which include a number of previously excisable goods. The VAT-exempted items under cottage industry status are also exempt from a lower turnover tax at a rate of 2 percent of turnover. Products of other industrial units with annual turnovers below Tk 1.5 million are also exempt from the VAT, but these products are subject to a turnover tax at a rate of 2 percent of turnover. The turnover threshold for VAT coverage was initially set at Tk 500,000, raised to 750,000 in the budget for FY 94, and during the same year, further raised to Tk 1.5 million.

3.6 The current VAT coverage with extensive exemptions and exceptions leaves much room for improvement. Excluded from the VAT coverage are (1) primary unprocessed agricultural products, (2) a number of both imported and domestically manufactured products, including imported capital goods, which are fully exempt from customs duty (as in the case of 100 percent export oriented industries) or those which are eligible for concessional duties, and (3) several domestically manufactured products including, importantly, textile products. Supplementary duties, which are essentially part of the overall VAT system, were levied on 426 good items and a few service items, at rates varying from 10 percent to 350 percent during FY 94. Last year's budget drastically slashed the number of items subject to supplementary duties to 131. The VAT is zero-rated for exports. The VAT coverage has not yet been extended to the wholesale and retail trade stages.

Table 7: Selected Features of the Bangladesh Tax System in Selected Years
(In Percentage)

Year	Tax to GDP Ratio				Growth in Tax Revenue from Previous Year			
	Total Tax	Income Tax	Taxes on Domestic Goods & Services	Taxes on International Trade	Total Tax	Income Tax	Taxes on Domestic Goods & Services	Taxes on International Trade
1985/86	7.2	1.01	1.73	Figure not collected	---	---	---	---
1987/88	7.9	1.2	2.2	Figure not collected	---	---	---	---
1990/91	7.89	1.35	2.09	3.8	---	---	---	---
1991/92	8.72	1.43	1.95	4.46	19.94	14.85	8.44	27.39
1992/93	9.67	1.66	2.21	4.77	16.05	24.66	13.15	14.78
1993/94	9.38	1.65	2.29	4.6	5.92	5.46	4.53	5.24
1994/95 (Revised Budget)	n.a.	n.a.	n.a.	n.a.	14.4	-8.30	18.46	21.27
1995/96 Budget	n.a.	n.a.	n.a.	n.a.	9.86	4.8	10.17	9.26

Memorandum Items

Year/Description	1990/91	1991/92	1992/93	1993/94	1994/95 (Revised)	1995/96 Budget
Increase in Total Tax Revenue from Previous Year as Percent of GDP	---	1.45	1.34	0.52	n.a.	n.a.
Increase in Revenue from VAT System or Substitute Taxes from Previous Year as Percent of GDP	---	0.71	0.76	0.23	n.a.	n.a.

Sources: World Bank, *An Agenda for Tax Reform*, Vol. 1, December 15, 1989 and Tables 5-A and 5-B.

3.C Import Tariffs

3.7 The current tariff structure on imports consists of 7 customs duty rates: 0, 7.5, 15, 22.5, 30, 45 and 50 percent. In recent years, the tariff structure has been considerably reformed, with progressive reductions in the maximum tariff rate, which was as high as 350 percent in FY 92, as well as reductions in other tariff rates covering most goods. A major simplification has also been brought about by progressively reducing the number of duty rates (including the zero rate), from 19 in FY 92, to 14 in FY 93, to 11 in FY 94, and to 6 in FY 95 and raised to 7 during the current year. This has resulted in a significant compression of the spread of the tariff rates, a desirable aspect of tariff reform. Tariff reform has also included elimination of certain extra levies on imports, such as a 6-percent Development Surcharge, a 2-percent Jamuna Bridge Levy, some regulatory duties and reductions in user-defined duty concessions and in discriminatory duties on similar goods. The tariff structure reform has been aimed at a progressive reduction and rationalization of the taxes on imports to liberalize imports and reduce and rationalize the structure of protection for the domestic production of goods. Some evaluation of the tariff reform will be provided in Chapter 7.

3.D The System of Corporate Income Tax

3.D.1 The Tax Rate Structure

3.8 The corporate income tax rate structure differentiates between companies whose shares are traded on the stock exchange (i.e., publicly traded) and those whose shares are not publicly traded and, among the latter companies, between industrial and non-industrial companies. In addition, because of a 50 percent tax rebate on income from exports, the effective tax rate on companies' income from exports is subject to half the otherwise applicable normal tax rate. The current rates are as follows:

	Normal Rate	Rate Applicable to Income from Exports after Tax Rebate
Publicly Traded Companies		
Industrial or Financial including Insurance Companies	35 percent	17.5 percent
Not Publicly Traded Companies		
Industrial Companies	40 percent	20 percent
Financial Companies and Autonomous Bodies	47.5 percent	23.75 percent

This is a somewhat moderated rate structure effected in this year's budget from the previous year's (FY 95) structure with 37.5, 42.5 and 50 percent respectively on publicly traded companies, non-publicly traded industrial companies, and non-publicly-traded financial companies and autonomous organizations. Prior to last year, the rate structure differentiation was different both in nature as well as in the tax rates applied. Only industrial companies were treated differently according to whether they were publicly traded or not and the highest tax rate was applicable to financial companies regardless of whether they were publicly traded or not. The tax rate on publicly traded industrial companies was 40 percent during FY 94 and 45 percent during FY 93 and during several past years. During FY 94, non-publicly-traded industrial companies faced a tax rate of 45 percent and non-publicly-traded financial companies faced a 55 percent rate. Intercorporate dividend income is taxable at a special concessional rate of 15 percent. Capital gains of companies are taxable at a special concessional rate of 20 percent.

3.D.2 The System of Tax Incentives

3.9 The corporate tax system has a lavish array of incentives for industrial companies, the most important and generally availed one of which is a tax break called the "tax holiday" for new companies currently ranging from 5 to 10 years. Industries located in export processing zones (EPZs) are generally provided with a 10-year tax holiday. The tax holiday outside the EPZs currently ranges between 5 and 7 years -- 5 years for industrial companies located in Dhaka and Chittagong divisions except three hill districts and 7 years for those located in other divisions and the three hill districts. This new tax holiday structure provision was adopted in this year's budget, which is modified from the earlier structure with provisions for 5, 7, 9 and 12 years' tax holidays depending on the location of the industrial companies. The tax holiday facility for new industrial enterprises was due to expire for companies set up after 30 June 1995. This year's budget has further extended this facility for a further period of five years up to 30 June of the year 2000. Industrial companies which do not opt for or get the tax holiday benefit can apply for accelerated depreciation allowances. These allowances range from 80 percent to 100 percent in the first year of commercial production -- 100 percent for industrial companies located in the EPZs and 80 percent for industries located in other areas.

3.10 Besides accelerated depreciation allowances which can be availed in lieu of the tax holiday by new industrial companies, there are other liberal depreciation allowances available to fixed assets of companies: (1) a normal depreciation allowance, (2) an extra depreciation allowance, (3) an initial depreciation allowance, (3) a special depreciation allowance, and (4) an investment allowance for investment in balancing, modernization and replacement (BMR). The normal depreciation allowance for general buildings is 10 percent and that for factory buildings is 20 percent. These rates are quite generous by international standards. Extra depreciation allowance is available for plant and machinery for additional shifts run. Initial depreciation is at the rate of 10 percent allowed for new buildings, 25 percent for plant and machinery and 30 percent for ships registered in Bangladesh. Special depreciation is allowed at a 40 percent rate for the first year and at a 30 percent rate for the second and third years for passenger vessels plying in inland waters, ocean-going vessels and fishing trawlers registered in Bangladesh. Special depreciation can be combined with initial depreciation, which results in a more than 100 percent cost recovery. Investment allowance is allowed for certain vessels and for plant and machinery which are eligible for accelerated depreciation.

3.11 There are also other incentives available for companies. Income from exported products is entitled to a rebate equivalent to 50 percent of the corporate tax rate. (This incentive is also available for unincorporated firms at half the normal tax rate applicable for them.) This simplification reform was introduced in FY 93 from an earlier complicated rebate structure ranging from a minimum 30 percent to a maximum 60 percent of the taxable income depending on the proportion of export sale in the total sale of a firm, provided the firm exported beyond 10 percent of total sale. However, there is no general tax credit for reinvestment made out of earned profits. Nor are reinvestments in expansion of capacity in the same industry or in new industries given any special tax treatment. Capital gains earned on the transfer of land and buildings of industries are eligible for full tax exemption if they are reinvested. The condition that such gains are required to be reinvested in the same businesses to qualify for the tax exemption has been waived by this year's budget. Capital gains on the transfer of government securities, and stocks and shares, except bonus shares, of public limited companies have been fully exempted from tax. The exemption was first introduced in FY 93, but by a subsequent NBR circular, capital gains tax was reimposed on the sales of stocks and shares bought from the secondary market. This year's budget has again lifted the tax on the capital gains on the transfer of all shares, except bonus shares.

3.12 Foreign investors are eligible for tax deduction on foreign borrowing and tax exemption on royalties, technical know-how and technical assistance fees, on capital gains on shares transferred to others and avoidance of double taxation on the basis of bilateral agreements. Currently Bangladesh has avoidance of double taxation agreements with 14 countries.[10] Bangladesh has tax sparing agreements with Japan and some European countries included in this list -- which tax the foreign income of their investors investing abroad after giving full credit for any income tax paid to the other countries where the investments have been made -- to fully exempt such foreign income from the domestic income tax, if the other countries also fully exempt this income under a tax break.

3.E The System of Non-Corporate Income Taxes

3.13 The individual or personal income tax system has been considerably reformed over time, especially starting with the FY 86 (Finance Ordinance 1985). The reform consisted in simplification of the general rate structure, lowering of the top marginal rate as well as of other rates applicable to particular brackets of taxable income and of the total tax liability in relation to total income, reduction in exemptions or deductions, and conversion of a tax filing threshold system into a straight general basic deduction or conventional exemption limit. Currently, this exemption limit is Tk 55,000, which is allowed as a general basic exemption for all higher-income tax payers in the sense that the first bracket of income up to this amount is subject to a zero rate. Following introduction of the conventional exemption system and drastic reduction in the personal income tax rates, all previously allowed exemption allowances have been eliminated except an investment allowance, which also has been reduced in scope and amount. Currently the investment allowance is up to 20 percent of total

10 The countries with which Bangladesh has avoidance of double taxation agreements to date are Japan, the United Kingdom, Canada, Sweden, Malaysia, Singapore, Republic of Korea, Sri Lanka, France, India, Pakistan, Germany, Romania and the Netherlands.

income or Tk 100,000, whichever is less, and the investment eligible for exemption is that in unit certificates issued by the Investment Corporation Of Bangladesh (ICB) and in newly floated shares and debentures of industrial and insurance companies approved by the Government. In last year's (FY 95) budget, the Government has withdrawn the previously available tax exemption benefit on investment in government Savings and Defense Certificates. Other exemption allowances permitted in the past included an "earned income allowance" applicable to particular categories of income, an entertainment allowance, a conveyance allowance, a children's education allowance, a book allowance, and a donation allowance for donation to government-approved charity funds. However, in the case of salaried employees of non-government organizations and firms, if the employers provide house rent and transport benefits or monetary allowances separately, such employees are entitled to a tax-exempt house rent allowance currently up to 50 percent of total annual salary or Tk 72,000, whichever is less, and a tax-exempt annual transport allowance up to Tk 6,600 in the case of a car, Tk 4,200 in the case of a motor cycle, or Tk 3,000 in other cases.

3.14 The current general rate structure is composed of only three marginal rates: 15, 20 and 25 percent applicable to different brackets of taxable income above the basic exemption of Tk 55,000. This is a radical departure from the nine-rate structure, starting with 2.5 percent and ending with 60 percent, which had been in force for a period till FY 85. In addition, during FY 89-91, a surcharge was payable on top of the normal income tax at a rate of 8 percent of income tax starting in FY 89, which was later raised to 15 percent of income tax. The surcharge was withdrawn in FY 92. The top marginal rate, which was 57.5 percent including the surcharge during FY 91, has been progressively reduced over time to the present moderate 25 percent. This has been in line with the general global trend in personal income tax rates over the past decade in both developed and developing economies and has been prompted by the consideration that high tax progressivity undermined taxpayers' work effort and saving, and encouraged tax avoidance and evasion (See Shome, 1994).

3.15 There are certain exceptions to the general personal income tax rate structure. Capital gains, income of non-residents, income from winnings from lotteries and similar-category incomes are subject to different rates. Capital gains of individuals are taxable at a special rate of 15 percent if the assets concerned were held by the owners for more than 15 years or at a rate of 20 percent if the holding period is less than 15 years. Partners of partnership firms also face separate tax rates with a distinction being maintained between firms which get registered with the National Board of Revenue and those which do not get so registered. The registered firms face tax rates of 10, 15, 20 and 25 percent on different brackets of income after an initial tax-exempt bracket of Tk 55,000. In addition, the tax-paid income of such firms which is received by the partners is also taxable with a certain adjustment made in the tax rates. Unregistered firms and their partners face a somewhat harder tax situation. Individual proprietorships face the same tax rate structure as other individuals. In the current system of income taxes on different taxable business entities, it is the sole proprietorships which receive the most favorable treatment, while companies and, among them particularly financial institutions, are the most severely taxed. The different tax treatment of different taxable business units as well as corporate firms *vis-a-vis* distributed dividends taxed in the hands of individual shareholders raise issues of tax harmonization and appropriateness from the point of view of promoting the larger goals of economic growth and efficiency. These issues will be dealt with in the next chapter.

3.16 Special exemptions are available to certain categories of income. Incomes of co-operative societies engaged in certain specified businesses are totally exempt from tax. Certain categories of income such as those from fish, duck, poultry, cattle, dairy, and frog farming, horticulture, and cultivation of mulberries, cocoons and mushrooms and floriculture are totally exempt from tax up to 30 June of the Year 2000 -- subject to a certain investment of profits in government securities including Savings Certificates. In addition, salary income of government employees is deemed to be income net of income tax. Imputed income from owner-occupied houses, which had been previously subject to tax, became fully tax-exempt since FY 94.

3.17 There are certain features to encourage private saving and investment. Interest on government securities including Savings Certificates is fully tax-exempt. Interest income on the debentures of companies and dividend income from shares in public limited companies are tax-exempt up to certain specified amounts (Tk. 20,000 and Tk. 30,000 respectively). However, because of withholding at source of a dividend tax at a rate of 10 percent if the dividend exceeds Tk 10,000 -- applicable for resident shareholders, and the official requirement that the eligible shareholders would have to procure a certificate from the concerned Deputy Commissioners of Taxes to the effect that the assessees have no other dividend income -- effectively negates or substantially further restricts the limited exemption of dividend income from public limited companies. (This will be discussed further in the next chapter). Currently no exemption is allowed to dividend income from private limited companies. As noted before, the law allows a special limited tax credit at a rate of 15 percent for investment in government-approved shares or debentures of companies, up to 20 percent of income, subject to a ceiling of Tk 100,000. The limited tax credit previously available for investment in government savings certificates has been withdrawn in last year's budget. During FY 93, Bangladesh residents' overseas income, if invested in industry, also became fully tax-exempt. Last year's Finance Act fully exempts also overseas income brought into the country by non-resident Bangladeshis through the official channel, provided such income is invested directly in new industry or in stocks, shares, or government bonds and securities. This provision has in fact created a confusion in business circles, which contradicts the 1984 Income Tax Ordinance and other National Board of Revenue instructions to the effect that all overseas income of Bangladeshis earned while resident abroad is fully tax-exempt (more on this in the next chapter). Capital gains also receive more generous tax treatment to encourage certain investments. The special exemptions for capital gains noted under corporate tax are also applicable under personal income tax.

3.18 Foreign investors are entitled to full tax exemption on dividend income received during the tax holiday from companies located in the EPZs. Such dividend also gets this exemption after the tax holiday period on reinvestment of this dividend. Capital gains earned by non-residents on the transfer of shares except bonus shares are also eligible for full tax exemption. Foreign technicians employed with registered industrial companies are entitled to tax exemption up to three years.

3.19 Taxable agricultural income is defined after allowing a liberal 60 percent deduction in the value of agricultural produce. In Bangladesh, not much tax revenue is collected in the form of either agricultural income tax or a land development tax levied separately on both agricultural and urban non-agricultural land. Capital gains earned on the transfer of land 5 miles beyond the frontiers of municipal areas are completely tax-exempt. Rental income from housing property is eligible for up to a 25 percent deduction, subject to production of satisfactory records of expenses on account of house maintenance, repair, rent collection and other services on the house. This provision has been introduced in this year's budget, which raises a flat 20 percent deduction allowed earlier.

3.F Tax Administration Reforms

3.20 The kinds of measures that have been undertaken, particularly in recent years, to improve tax administration for the income tax include:

a. Introduction of full or partial deduction of tax at source, wherever found appropriate and feasible;

b. Requirement of advance payment of part or, in some cases, all of the possible tax liability;

c. Introduction of a self-assessment scheme for income taxpayers with certain exceptions;

d. Introduction of a presumptive tax system for certain categories of taxpayers;

e. Introduction of an obligatory system of filing tax returns to the tax department along with payment of due taxes assessed by the taxpayers;

f. Introduction of penal interest and/or other penalties for late payments or for non-tax compliance or evasion of tax; and

g. Other administrative measures such as simplification of the tax system and rationalization of the methods of tax assessment and appeal procedures for better tax compliance and enforcement, quicker assessment and disposal of pending tax cases, quicker resolution of tax disputes and settlement of appeal cases, strengthening of the tax department and its logistic methods including surveys to unearth cases of tax evasion and avoidance.

Some of these measures, which need some elaboration, are noted below.

3.F.1 Deduction at Source and Advance Payment of Tax

3.21 The major categories of income from which taxes are currently being deducted fully or partially at source include the following:

a. **Income from salaries.** The deduction of tax is to be made by the employer at an average rate applicable for total salary income of the employee.

b. **Interest income from securities (including treasury bonds).** Unless exempted (such as interest on government Savings and Defence Certificates), such securities are tax-deductible at the standard maximum rate or at a rate applicable for the particular amount of income, whichever is the greater.

c. **Contractors' and suppliers' and agents' payments.** These payments include those received by contractors and suppliers, and travel, indenting, shipping and manpower exporting agents. The tax is deducted at certain rates prescribed by the tax authority and treated as an advance payment of income tax to be adjusted against final assessment.

d. **Import payments and export receipts.** An advance tax is payable on the value of imports, with the exception of certain import items (such as capital goods for hundred percent exporters, which are presently exempted from customs duty, or capital goods subject to concessional customs duties), currently at a rate of 2.5 percent, to be adjusted against assessee's final tax assessment. An advance tax on export earnings -- except earnings on certain export items such as jute goods, fresh fruits and vegetables and, since the current year, except earnings made during the tax holiday period of the export firms -- is payable at a rate of 0.25 percent. The advance tax on export receipts was introduced in FY 91/92 at a rate of 0.5 percent of the value of exports. This rate was reduced to the current rate during FY 95.

e. **Interest income from bank deposits.** Required since FY 90/91 (by Finance Act, 1991), an advance tax on such income is deductible at a rate of 10 percent.

f. **Income from rented houses.** Tenants of rented houses are currently required to deduct as advance income tax (on behalf of house owners) at a rate of 2 percent, 3 percent, 4 percent or 5 percent (5 percent when the monthly rent exceeds Tk 30,000) of the rental payments depending on the amount of rent paid provided the monthly rent exceeds Tk 7,500. The deduction at source was first introduced in FY 1987/88 by Finance Act, 1988.

g. **Receipts on transfer of housing or landed property.** An advance capital gains tax, introduced by Finance Act, 1991, currently at a rate of 6 percent of the registered value of transacted property, is collected at the time of registration of such transactions.

h. **Dividend income.** An advance tax is deductible at the time of distribution of such income by the companies distributing such income, subject to available limited tax exemption of such income from public limited companies up to Tk 30,000. This tax deduction at source applies for resident shareholders if the total dividend exceeds Tk 10,000. The exemption limit has been raised from Tk 5,000 in this year's budget to provide further encouragement to investment in the stock market by small savers. The rate of tax deduction applied is: (1) 10 percent in the case of resident individual shareholders, (2) 15 percent in the case of resident companies, which is the full tax rate on dividend received by such companies, and (3) the maximum income tax rate applicable for non-resident individual or company shareholders. The tax deduction at source was introduced in FY 92 by Finance Act, 1991. Interest on debentures of companies also falls in the same category.

of income receiving similar tax treatment with the small exception that the limited tax exemption available in this case is Tk 20,000.

i. **Commissions of Insurance Companies.** Income tax on such commissions is fully deductible at source, subject to the condition that the commission earned by an agent exceeds Tk 25,000. The limited exemption has been provided for in this year's budget to provide relief to small agents.

3.22 Advance tax payments up to the full amount of the tax liability assessed by the respective assessees are also required to be made by regular company and income tax assessees for each quarter of the tax assessment year, if the annual taxable income exceeds Tk 100,000. Simple interest at an annual rate of 10 percent is payable on any tax later assessed by the tax authority which is found not to have been paid in advance by the due date.

3.F.2 The System of Self-Assessment

3.23 To facilitate tax assessment and tax compliance by taxpayers, a system of self-assessment of personal income tax has been introduced by Finance Act, 1990. The self-assessment scheme is not, however, applicable in the case of certain taxpayers such as directors of companies, contractors, indenting agents, etc. These assessees are currently required to pay a minimum tax of Tk 1,200, reduced from Tk 1,800 by this year's budget.

3.F.3 Presumptive Tax Assessment

3.21 A presumptive tax was first introduced by Finance Act, 1990 for business income earners other than companies, which do not maintain any acceptable books of accounts. Its application was extended by Finance Act, 1991 to individuals with income from professions. A minimum tax, currently Tk 2,000, is assessed under this scheme.

3.F.4 Other Tax Administration Reforms

3.22 Other measures introduced in recent years to improve administration of the income tax system, where the administration is admittedly especially weak, include: (1) simplification of the tax system by introducing the conventional exemption system and eliminating numerous tax exemptions, by reducing the number of tax rates applied and eliminating the surcharges, by substituting flat deductions in certain cases such as for income from houses and agriculture and by introducing a flat deduction for bad debts, for assessing taxable income of financial institutions, and by introducing flat or fixed tax rates for certain transport business such as by buses and trucks; (2) reduction in the top and high middle-range marginal rates of the tax; (3) introduction of automatic acceptance, without question by the tax officials, of the tax returns with audited accounts submitted by public limited companies and foreign companies; (4) rationalization of procedures of appeal of tax assessments made by tax officials to give adequate opportunity to the taxpayers to have their views ventilated and make justifications of tax assessments more transparent as well as to reduce the time involved in settlement of tax disputes and the establishment of a Taxes Settlement Commission to dispose of tax appeal cases filed by all assesses other than limited companies having a paid-up capital of more than Tk 5 million; and (5) carrying-out by the tax department of periodic surveys to detect cases of tax evasion and avoidance. Through this year's budget, a number of additional measures have been introduced, especially in the area of income tax administration, to simplify tax assessment and payment procedures and bring about transparency and other tax administration reforms, including some new steps to expedite tax assessment and settlement of tax appeals and curb the discretionary powers of tax officials.

3.23 Despite all these measures, administration of the income tax system remains very weak as evidenced by piling up pending assessments to be disposed of by the tax department and the particularly poor tax collection made from the domestic companies (See the next chapter for some documented evidence).

3.24 Serious problems lie also with the administration of other taxes like import taxes and the VAT. Some transparency in administration of the import taxes has been recently established by publication of operative tariff schedules using the harmonized system (H.S.) tariff codes and simplification of the tariffs and reduction in their number. A voluntary system of pre-shipment inspection to assess values of the imported goods (the cost of which is borne by the importers themselves) has been introduced. This system facilitates the use of values of imports assessed through such a process instead of the use of official tariff values. The latter were established for numerous items to simplify and help tax administration, but they also introduced a distortion in the system where such tariff values add to, or reduce, the intended protection accorded by the tariff to a domestic industry. Despite these measures, the business community often complained about serious problems faced with customs. Quite recently, by a notification issued in the first week of November 1994, the National Board of Revenue has appointed four international firms to perform pre-shipment inspection for the importers at their cost. But the difference from the earlier practice is that the pre-shipment valuation now made by any of these firms would prevail over the officially set tariff values irrespective of whether the valuation was higher or lower than the tariff value. Since 1992, the rule had been that the pre-shipment valuation would be valid only if it was higher than the tariff value. Serious problems are also heard about the administration of the VAT system. Originally the VAT system was, with the help of technical assistance, designed to be computerized. However, the computerization part has only been partially implemented. Much remains to be done to strengthen the staffing situation of the various wings of the National Board of Revenue, including their training, as well as to establish the accountability of tax officials.

4. REFORM ISSUES AND OPTIONS: CORPORATE INCOME TAXES

4.A Introduction

4.1 From the point of view of promoting industrial investment and growth, particularly foreign investment and export-led growth which are top-priority objectives in the current phase of industrial development in Bangladesh, the two categories of taxes which deserve greatest attention for reform purposes are the trade taxes on imports and corporate income taxes. The former taxes determine the effective rates of protection for industries, which in turn affect the industries' pre-tax (i.e., pre-income tax) rates of return. The latter taxes affect the industries' post-tax rates of return. Both taxes are, therefore, important among possible considerations of investors for deciding on whether to invest at all or for deciding on investments in particular industries. In Bangladesh's current tax policy regime, which considerably restricts imports through relatively high and widely varying tariffs (in some cases, applying in addition official tariff values for customs assessment, and / or complementing with partial import restrictions, or applying a complete import ban), the reform of the trade policy and taxes on imports is more important than the reform of corporate income taxes. Without the former reform, investments will continue to depend upon protection and not on international comparative advantage and the latter reform will fail to attract investments in export-oriented sectors and in those sectors where the trade and tariff policy-created pre-tax rates of return are not sufficiently high.

4.2 Some basic features of the corporate tax system of Bangladesh were noted in the preceding chapter. According to the Bangladesh National Board of Revenue (NBR), the total number of company submissions of tax returns during FY 93 and 94 was 11, 743 and 15,228. How many of these were from industrial firms is not known. Of these, 1,274 and 1,258 companies, i.e., 10.8 and 8.3 percent of the respective total of these years, were enjoying the tax holiday benefit during these two years. The cumulative and additional numbers of tax holiday cases, apparently outside the export processing zones (EPZs), during the first three fiscal years of the nineties have been as follows:

	Cumulative	Additional
Up to FY 1990/91 --------	1,645	Not known
Up to FY 1991/92 --------	1,830	185
Up to FY 1992/93 --------	2,063	233

FIAS reports that during 1991/92, about half of the cumulative cases were still enjoying the benefit (FIAS, 1992). According to the IMF March report, 2,911 companies received tax holidays since 1972, many of which have since passed the tax holiday period or gone out of business. In addition, during 1992/93, 58 companies, mostly foreign-owned, were enjoying 10-year tax holidays in the EPZs.[11] According to disclosures by the Finance Minister in his FY 96 Budget Speech, while the average annual number of tax holiday-enjoying company undertakings during 1973-75 and 1976-81

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11 See IMF, *Bangladesh: Reform of Direct Taxation*, March 1994, op. cit., p. 9.

had been respectively only three and 18 with average annual investment of Tk 0.9 million and Tk 87 million and 392 and 1,267 new jobs respectively, the average annual tax holiday-enjoying company cases shot up to 102 and the average investment went up to Tk 1,410 million and 9,024 average new jobs were created per year during the period 1982-90. During 1991-94, the corresponding figures were 185 tax holiday cases, Tk 5,250 million of investment and 23,000 new jobs. The jumps in industrial investment and employment during the late eighties and, more strikingly in early nineties, which were associated with the tax break benefit, could be attributed also to the progressive improvement in the private sector and freer market-oriented general policy environment made by the Government during these later years. However, as we have noted in Chapter 2, investment in Bangladesh so far has remained low by international standards.

4.B Corporate Income Tax Issues

4.3 Under corporate income tax, the two most important issues relate to the corporate tax rates and the incentive system. In industrial policy analysis, the reference to fiscal or tax incentives usually or predominantly implies that to incentives offered through direct taxes (income taxes, more importantly, the corporate system of income tax in conjunction with the tax treatment of dividends under personal income tax). However, because other considerations -- such as the degree of openness of the economy (the trade policy consideration), the macro-economic environment, the general industrial regulatory system, adequacy of the infrastructure, the level and quality of available human resources, labor-management relations, the legal framework affecting business, and, not least, the general law and order and political situation -- count importantly in investors' (especially foreign investors') matrix of pre-investment analysis, many contend that tax incentives are of secondary importance and not a critically important factor in determining the overall level of investment including foreign investment in a country. Indeed, Bangladesh has maintained a system of very liberal tax incentives, al beit along with high tax rates, for a long time. So far, this has not resulted in satisfactory private industrial investment or attracted a satisfactory flow of foreign investment. Of course, the high tax rates could be offsetting the incentives. Still, it suggests that unless the general investment climate is improved by setting right other policies and improving other conditions affecting investment, fiscal incentives will have limited impact.

4.5 Having said all this, the approach we would like to take to corporate tax reform in Bangladesh will be along the lines which are generally observed to have been applied to such reform in other fast developing countries, especially during the past decade. In such countries, tax policy has been used to promote private saving and investment. To promote investment and growth, generally low tax-rate regimes have been maintained and use of special incentives coupled with a high-rate tax system was avoided with few exceptions. Hong Kong, for example, started maintaining low rates of both corporate and personal income taxes from 1987, when the standard rates of these two taxes were 18 percent and 16.5 percent. Taiwan, by a 1960 statute later revised through 1986 lowered the maximum business tax rate on approved industries from 32.5 percent to 18 percent and provided for deduction of reinvested profits. In South Korea, corporate tax rates have been kept at low to moderate levels.[12]

12 For some information on the tax policies of the four East Asian economic tigers, South Korea, Taiwan, Hong Kong and

The current tax rates in South Korea for private companies range from 18 to 32 percent depending on adjusted taxable income, while those for public corporations vary from 10 to 25 percent. To promote private savings and investment, Korea also largely excluded capital income (interests, dividends, capital gains and other returns on assets) from the tax base. These features were introduced as early as 1973. Even earlier in 1967, the tax rate on open corporations was reduced and dividends and interests on bank deposits of such corporations were exempted from tax. At one phase of its development process, Korea also made extensive use of investment tax credits and special depreciation allowances for what the Government thought to be "key industries". This differentiated tax incentive policy was later questioned and abandoned.[13]

4.6 A comparative study of contemporary investment promotion policies in currently fast developing countries in the Asian region, which have succeeded in attracting substantial flows of foreign investment and are emerging as new economic tigers, such as Thailand, Malaysia, Indonesia, China and Vietnam, also suggests the importance of the maintenance of a low-tax regime. The socialist countries of China and Vietnam maintain very low corporate tax rates in the range of 15 to 25 percent and other tax advantages in the special economic zones, which have been the loci of industrial development in both countries. Thailand and Malaysia apply a 30 percent general corporate tax rate for industrial companies. Indonesia applies the same tax rates to both corporations and individuals -- graduated rates starting with 15 percent for the lowest income bracket up to Rp. 10 million to a maximum marginal rate of 35 percent on earnings over Rp. 50 million.[14]

4.7 Even though this study has not attempted to look at average effective tax rates in place in various countries taking into account tax deductions and exemptions along with the tax rates applied, there is hardly any doubt that Bangladesh continues to maintain relatively high corporate tax rates compared to most, if not all of the above-mentioned countries. The attraction of foreign investment to Bangladesh would undoubtedly be enhanced if taxes were at low-enough levels -- at levels comparable to those maintained in foreign investors' own countries and in other countries which are competing with Bangladesh for foreign investment. Apart from these arguments, two other important reasons why Bangladesh should use low tax rates are:

a. Bangladesh has a relative disadvantage, *vis-a-vis* other fast developing countries which have been able to attract substantial foreign investments in recent years, in terms of infrastructure, regulatory, bureaucratic and other impediments to industrial development, which, because of their inherent in-built rigidities and other problems, are difficult to overcome overnight or in a reasonably short period.

b. The level of tax compliance and enforcement is very low here, which discriminates against foreign investors.

Singapore, see Rabushka, Alvin, "Tax Policy and Economic Growth in the Four Asian Tigers". *Journal of Economic Growth*, Vol. 3, No. 1, 1987.

13 See in particular, World Bank, *World Development Report 1991*, and *The East Asian Miracle*, 1993 and Yu, Shi-Kwon, "Structural Adjustments and Taxation (The Case of Korea), typescript, presented to a Seminar in Dhaka during 15-16 September organized jointly by the Asian Development Bank and the Planning Academy of Bangladesh.

14 See PIAG Report #8 (Draft) by Clifton Barton and Richard Koskella, *Comparative Study of Investment Promotion Policies, Structures, and Activities in the Asian Region With Applications to Bangladesh*, December 1994.

Placed in such a situation, Bangladesh can offer a higher fiscal incentive, basically in the form of a lower tax rate, as an offset to its disadvantages.

4.8 Apart from the experience of generally low-tax policies of the fast developing Asian countries, the very pattern of effective taxation in Bangladesh has also important bearing on the specific issues of corporate tax rates and tax incentives. The pattern that can be observed suggests that there exist serious problems of tax compliance and enforcement, which make the effective rate of taxation much lower than what the statutory rate would suggest, particularly in the case of local firms. The compliance and administration problems make the corporate tax system inequitable, particularly between local and foreign investors and discriminate against foreign investors. In this regard, some available empirical evidence is provided by the data contained in the tax returns filed by a sample of nearly 200 industrial firms to the National Board of Revenue, of which 169 were tax holiday cases and 32 were non-tax holiday cases. The information was looked at by this author in early 1992. The tax holiday cases included 4 joint- venture and 165 local firms. The non-tax holiday firms consisted of 2 joint-venture and 30 local ones. Some of the results of the analysis of these data, which are relevant to the present study with respect to the tax rate and special incentive issues, revealed the following:

a. A very high proportion of firms failed to submit tax returns for periods of one to three years after their tax holiday status had ended as well as during the closing years of the tax holiday period or after this period, which, *if so facto*, means that the tax administration faces a high proportion of arrear cases to deal with for tax assessment. For example, in the case of a small sample of local firms not on tax holiday status, it was found that half of the firms involved, numbering 30, did not file returns up to early 1992 for tax assessment year 1990-91 (FY 91 which ended on June 1991), and out of 26 of those firms, which were in business and involved for tax purposes for tax assessment year 1989-90, about 15 percent did not file returns up to early 1992 for the year ending in June 1990. In the case of a larger sample of firms -- all local -- which were being treated as tax holiday cases, as many as two thirds of 165 private firms and about one third of 5 public firms did not file returns for a few immediately preceding years. This reflects not only poor tax compliance on the part of the tax paying firms but also serious weakness in tax administration.

b. Among the sample of tax holiday cases covered, one striking feature observed was that although a majority (58 percent) of the firms reported increasing business over time in terms of sales realized and showed profits during part of the tax holiday period, an overwhelming proportion (about two thirds) of those which submitted returns reported losses while the others reported reduced profits for the few closing years of the tax holiday period. A similar pattern could be discerned for some of the firms for some years after the tax holiday period expired.

c. Another finding from the smaller sample of non-tax holiday cases is that about half the firms systematically report losses year after year. This suggests deliberate misreporting of business accounts as it could hardly be true that such businesses were still in operation while persistently losing money.

d. It was also found that among the local firms which actually reported profits and paid taxes, shown average taxable profit constituted about 2 percent of reported sale and the tax paid was less than one percent of sale. This clearly shows that the effective level of corporate taxation is quite low in Bangladesh, even without counting the effects of the special tax holiday incentive. This suggests that there should be no serious adverse effect on Government revenue if the high statutory rate is lowered, especially since a significantly lower tax rate is likely to increase compliance on the part of the tax payers. It also has the implication that special tax incentives like the tax holiday have likely had little incentive effect, especially for local companies.

e. Although the incidence of corporate taxation on the few joint-venture firms covered was also found to be fairly low, it was nevertheless found to be much higher than in the case of the local firms. In the case of the two non-tax holiday joint-venture firms which were to pay tax, the payable tax amounted to 1.5 percent to 2.2 percent of sales. The ratio of shown profit to sale was 3.7 to 4.8 percent.[15]

4.9 A 1985 TIP study also found that tax evasion was pronounced in the case of local firms as a much lower proportion of them paid corporate tax than in the case of multinational firms and that the latter group bore a disproportionate share of the tax burden paying at an average effective rate of 4.8 percent of sales, as compared with less than one percent paid by local firms.[16]

4.10 A Government Committee at the National Board of Revenue, in 1990, studied 25 tax holiday cases which entered the taxable phase and observed a similar typical pattern of tax behavior of the firms, as found by this author. Out of 25 firms, 15 reported profits during the tax holiday period but reported losses afterwards; 3 reported profits both during and after the tax holiday period; while 4 reported losses both during and after the tax holiday period.

4.11 One conclusion which can be drawn from the above-cited evidence is that corporate firms in Bangladesh report too little of their taxable profits and thus go without paying much corporate tax. The Foreign Investment Advisory Service received further corroboration of this point by other pieces of evidence provided by two private international banks on the tax paying habits of a group of 10 of their locally-owned manufacturing clients. One bank found that their clients reported 10 to 20 percent of their real profits. The other bank found that three companies showed losses on their tax returns and the remainder showed insignificant taxable profits, which may not have been the real situation. (See FIAS report cited in the footnote).

4.12 A second conclusion, of the evidence on the tax behavior of the companies which enjoy the tax holiday benefit, is that the income tax holiday has probably led to further erosion of the tax base by encouraging tax avoidance behavior when the tax holiday is over. In some cases, the tax holiday benefit may have been abused also by (1) the practice of transference of profits from taxable units to

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15 For these pieces of evidence and greater details on them see the author's "Notes on Fiscal Incentives for Industry". April 1992. Also see, for reproduction of most of these findings, Foreign Investment Advisory Service (FIAS), *Policy, Regulatory and Incentive Regimes Affecting Private Domestic and Foreign Investment in Bangladesh*, November 1992.

16 See Wasow, Bernard, *Company Income Taxation and Tax Incentives*, Trade and Industrial Policy Reform Program (TIP), Planning Commission, Government of Bangladesh, June 1985.

other units, owned by the same group of manufacturers, that enjoy a tax holiday or (2) by the practice of setting up new units that would enjoy a tax holiday and closing down old units that have newly become taxable or scaling down their operations or shifting profits of older units to the newer units which are under tax holiday.

4.13 There is little available evidence that lends support to any claim that the tax holiday system is serving its mandated purposes of stimulating domestic and foreign industrial investment and, through the differentiated structure of tax holidays, of efficiently contributing to regional dispersal of industries. Foreign direct investment flow has remained low and local investment has not yet shown any robustness despite significant industrial deregulations undertaken in recent years. The tax holiday system had little incentive effect for the domestic investors since without it they would not face in practice a harsh tax situation in the first place. The tax holiday system combined with high tax rates rather works as a disincentive for foreign investors since the existing system in practice differentiates against them adversely *vis-a-vis* the local investors.

4.14 Besides being responsible for substantial government revenue losses both directly and indirectly, this fiscal benefit, according to a disclosure in this year's Budget Speech of the Finance Minister, has also resulted in discouragement of industrial companies to go public: 97.4 percent of the companies which enjoy this benefit are private.

4.15 Bangladesh has been using a differentiated structure of tax holidays, combining this policy with one of differentiated duty concessions on imported capital goods, to promote regional dispersal of industries. Using fiscal incentives to promote such an objective is not a sound economic policy. There is evidence to think that this policy has encouraged mislocation of industries. For example, some textile manufacturing units were set up in far-flung areas of the country with poor infrastructure facilities, where the locational disadvantages have made them financially non-viable. Industries also grew up in the backward outskirts of metropolitan areas, which have been entitled to higher tax holidays and other tax advantages (like duty concessions). There are also reports of abuse of the tax concessions on regional basis by some firms which first located their units in the backward regions and then shifted the establishments to more developed locations at a subsequent time. Development of a good infrastructure -- roads, railways, waterways, tele-communications, power and gas supplies, etc. -- is a sounder and more effective way to promote regional dispersal of industries than tax incentives.

4.16 If it is still thought necessary to use a tax incentive, it is preferable to use incentives like accelerated depreciation allowances, which are alternatively available, and/or tax credits than complete tax exemptions. A tax holiday loses tax revenue for ever while an accelerated depreciation allowance postpones tax revenue for a while. Accelerated depreciation allowances are, therefore, superior as an investment incentive to the tax break option on revenue consideration. Such allowances are also more advantageous than the tax break for a limited initial period for firms which are unable to earn profits or earn not much profits in early years after commencing of production. However, accelerated depreciation allowances, combined with interest rate deductions for tax purposes have the disadvantage that they encourage capital-intensive industrial operations. The tax holiday, also, is not immune from this disadvantage either, depending on the structure of capital intensity of the firms which avail themselves of this benefit. There is not much to choose between these two options on consideration of their effects on capital intensity of industrial operations.

4.17 This year's budget has introduced accelerated depreciation allowances and no extension of a tax holiday benefit for expansion units of a company already enjoying the tax holiday benefit. This is a welcome reform in the right direction. Now it remains for the Government to move further and limit the tax holiday benefit only for foreign companies, keeping the accelerated depreciation benefit as the only option available for local companies. (See below for reasons why a need still exists for continuing the tax holiday option for foreign companies.)

4.18 Although tax incentives like tax holidays being continued in many developing countries including those with which Bangladesh competes for foreign investment, in recent years fiscal experts have become more skeptical about the value of such fiscal incentives to promote foreign investment or other special objectives like promoting regional dispersal of industries or promoting specific industrial activities for a number of reasons such as:

a. Special tax incentives lead to distortions in resource allocation;

b. Tax concessions erode the tax base;

c. They are inequitable;

d. Such special incentives are often a response to pressure groups; and

e. They foster tax evasion and avoidance.[17]

4.19 In developing countries, there exists an ambivalence toward the use of tax incentives to promote industrial investments in general or specific industrial or other activities in particular, or to promote other forms of corporate behavior. However, the experience of investment promotion policies and tax reforms in developing countries in recent years suggests a trend away from the use of special tax incentives like tax holidays and toward using lower tax rates and simplified rate structures combined with efforts to broaden the tax base. For example, Indonesia abolished special tax incentives including tax holidays, and adopted a policy of lower tax rates and more generous depreciation allowances, as part of its 1984 income tax reform. Vietnam, following UNDP recommendations, opted for fairly low overall company tax rates, with only marginal incentives offered for certain types of investments. Mexico is one of many countries that in recent years have responded to falling revenue and a shrinking corporate tax base by limiting the use of fiscal incentives. Such reforms were also undertaken in Bolivia and Jamaica. Thailand has also made some progress in reducing corporate tax rates while scaling back tax concessions offered to investors. South Korea, which used special tax incentives to promote special industries at one stage, later abandoned such policies. (See the World Bank's tax reform study cited in the footnote , Barton and Koskella op. cit.,

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17 See the World Bank, *Lessons of Tax Reform*, op. cit., pp. 36-37.

and Yu op. cit.)

4.20 Thailand, Malaysia, China, and many other countries, on the other hand, continue to use tax concessions (tax holidays, preferential rates, and special exemptions) as a central element in their investment promotion programs. One reason why a tax holiday system in a modified and reformed form may be retained in Bangladesh for some specified time is that other countries competing with Bangladesh for foreign investment are using the system and that such a system is existing in some of the countries from where the foreign investors come. However, to adequately respond to this, it is not necessary to use a generalized system of tax holidays for all types of industrial investors and investments. Only foreign investors should be entitled to a tax holiday on a selective basis. Since tax holidays or tax reductions below the limits home countries establish for credits paid on foreign taxes are unlikely to be of any value as an investment incentive for foreign investors of countries which offer such tax credits, it is not advisable to extend such tax benefits to investors from countries offering such tax credits such as the United States and possibly some European countries with which Bangladesh still has no tax sparing agreement which can enable such countries to provide similar tax benefits to the income of their investors accruing to investments in Bangladesh. The tax holiday benefit should, therefore, be limited to (1) only those foreign investors who come from countries other than those which provide unilateral credit for foreign taxes paid on overseas investments and (2) those investments which are located in special industrial or export processing zones and investments in predominantly export activities (with export of, say, a minimum 80 percent of total sales) located outside such zones. India, for example, offers the tax holiday incentive only for special industrial zones and export activities. Malaysia offers the tax holiday incentive to investors, subject to creation of minimum employment of 500 jobs on completion of the concerned project.[18] It makes sense to offer a special tax holiday incentive to foreign investors where tax concessions are likely to be an important consideration for investors, for example, those coming from countries which provide unilateral tax exemption on profits repatriated from investments in third countries or to investors from countries (e.g., Hong Kong) which do not tax off-shore incomes.

4.21 It is also worth noting that a number of other countries which use the tax holiday incentive, use either a standardized uniform tax holiday, e. g., a 5-year holiday used in India, Pakistan, and Sri Lanka, or a holiday of a more limited duration. China and Vietnam, the two communist countries, which have become particularly successful in attracting foreign investment in recent years, offer foreign investment enterprises full initial tax holidays of a limited duration of 1 to 4 years, coupled with reduced tax rates afterwards for specified periods. As noted earlier, the normal corporate tax rates in these countries are also low, in the range of 15 to 25 percent, for activities located in special economic zones. Bangladesh is using a much more lavish system of tax holidays -- 10 years for export processing zones, 5 years for underdeveloped regions and 7 years for developed regions. The structure of tax holidays had been even more liberal through last year, with four different durations -- 5, 7, 9 and 12 years -- for various specified regions outside the export processing zones. In addition, Bangladesh offers other generous tax concessions including: (1) 50 percent rebate on the tax on income from export activities, (2) liberal normal and other additional depreciation allowances, and (3) tax exemption on capital gains for shares and securities traded on the stock exchange. It will be

18 The author is grateful to Dr. Kazi Firoz Alam of Massey University of New Zealand for sharing with him some of the information noted in this paragraph.

desirable to limit and standardize these lavish tax holiday and other tax concessions.

4.C Recommendations on Corporate Tax Rate Issues

4.22 The implication of the preceding discussion is that Bangladesh should use low corporate tax rates and that special tax incentives including tax holidays should be used selectively. In so far as the corporate tax rate issue is concerned, the following actions are recommended:

a. This rate should be brought down to a level not higher than 20 percent from the current 35 to 47.5 percent.

b. The currently maintained differentiation in corporate tax rates for industrial and non-industrial companies and between publicly traded and not publicly traded industrial companies should be eliminated.

c. Along with lowering of the maximum corporate tax rate to 20 percent, the special tax rebate on income from export activity (at the rate of 50 percent of the tax) should be withdrawn.

d. Inter-corporate dividend income should be completely exempted from tax rather than being taxed at the current rate of 15 percent..

e. In view of the recommended reduced corporate tax rate of 20 percent, the current tax rate of 20 percent on corporate capital gains should be reduced to 10 percent.

f. Other special tax rate reductions allowed, e.g., 50 percent reduction allowed in the case of income from passenger launch service business[19], should be withdrawn.

4.23 The FIAS has recommended both a substantial reduction in the corporate tax rate (to around 25 percent) and unification of the rates (See the FIAS report, op. cit.). We would recommend a still higher reduction in the corporate tax rate, since this is more in line with the corporate tax pattern observed in the fast growing countries like Hong Kong, Taiwan, China and Vietnam, and since the 20 percent rate is more consistent with the current personal and non-corporate business income tax pattern of Bangladesh. The Bangladesh Government has effected a revolutionary change in the rate structure of personal income taxation. The current top marginal rate is 25 percent. This, combined with the initial tax-exempt income bracket of Tk 55,000 and the two lower rates of 15 and 20 percent, would keep the average effective personal tax rate below the 25 percentage point. The top marginal rate in the case of non-corporate business income is also 25 percent and the rate structure is also similar to that of personal income tax (same in the case of proprietorship firms but slightly different in the case of registered firms). For tax harmonization as well as to provide some incentive to business firms to set up corporate business, it is advisable to have a tax rate for companies lower than the tax rate applied in the case of individuals and non-corporate firms. Also, there should not be

19 The Finance Act of year before last introduced this tax concession.

a large difference between the tax rates applied for corporate and non-corporate business entities as this will encourage tax avoidance behavior through transfer of profits from higher-taxed to lower-taxed units owned by the same group of people. Thus the tax avoidance prevention requirement suggests that a uniform or fairly uniform pattern of taxation should be maintained for all categories of business organizations. The IMF has also recommended unification of the corporate tax rates, but they recommended reduction in the rate to 35 percent even though it states that the goal should be to bring down the corporate tax rate to the personal tax rate level (Cf., IMF March 1994 report to the Bangladesh Government, op. cit.). For the reasons spelled out, we do not think that reducing the corporate tax rate to 35 percent will effect a sufficient reform in the corporate tax system of Bangladesh, especially in view of its need to attract foreign investment on a massive scale. The FIAS recommendation to reduce the rate to 25 percent is more acceptable, which can be adopted immediately, but there obviously is a need to move to a still lower corporate tax rate for the sake of tax harmonization across both corporate and non-corporate sectors.

4.24 The currently maintained tax differentiation between industrial and non-industrial companies, taxing the financial sector more heavily, is utterly irrational not only because it provides a relative discouragement to the development of the financial sector in Bangladesh and whereby it indirectly hampers the very industrialization process, but also because this sector remains in a basically poor and unsound financial shape -- a factor which also has been having an adverse repercussion on the development of the industrial sector itself.

4.25 Although there is a case for providing a more favorable tax treatment to publicly traded industrial companies, it does not warrant maintaining a lower tax rate for these companies than what is applied in the case of publicly traded non-industrial companies. If income tax on dividend income is eliminated, which is our recommendation, this would be a strong incentive for companies to go public.

4.26 To provide a strong stimulus to the current industrialization drive and encourage greater inflow of foreign investment, it is essential that the corporate tax rate be kept at a sufficiently low level and that the tax on dividend income be abolished altogether. The tax on both intercorporate dividends and those received by individual shareholders should be eliminated, another reason being that such a tax in addition to company taxation amounts to double taxation.

4.27 In the event of our proposed low corporate tax rate, it does not seem either necessary or desirable to maintain a further special lower rate for export activities. Special tax incentives for export activities can work only when sufficient and attractive pre-tax rates of return can be expected in the first place from such activities. In Bangladesh, the trade and tariff policies still leave much room for improvement and rationalization in terms of removal of high distortions in the levels of effective protection received by export and import substitution industries and improvement of competitiveness of export industries. In this situation, elimination of all remaining quantitative import restrictions on trade ground and a more radical progress in tariff reform than has hitherto been accomplished would be more effective in encouraging export activities than special income tax incentives. Note that the IMF has also recommended withdrawal of this special income tax rebate for export activities, but for still other good reasons. The present export rebate complicates tax administration for appropriately taxing firms which sell both in the domestic and export markets and it also creates scope for profit transfer from domestic to export sale operations and other abuses of this benefit by business firms and corruption by tax officials in collusion with the taxpayers. (Cf.., its March report to the Government).

4.D Recommendations on Corporate Tax Holidays and Other Incentives

4.28 The following recommendations are made with respect to tax holidays.

a. Do not extend the current tax holidays for industries set up after June 2000, the date up to which this benefit has been extended by this year's budget.

b. Introduce a new tax holiday of the duration of 5 years, valid for investments made from now on for the next, say, about ten years up to June 30 of the year 2005, for only foreign investment enterprises including joint-venture firms and for investors coming from countries other than those which provide unilateral offset for foreign taxes paid. Introduce the same tax holiday for such enterprises located in both export processing zones and other areas and outside the EPZs limit the benefit only to predominantly export activities (exporting, say, a minimum 80 percent of total sales) as in neighboring India.

c. Provide the tax holiday without requiring the firm to invest part of its profits in government securities. Such conditionalities dilute the intended incentive effect of the measure.

d. Provide accelerated depreciation allowances -- which are at present available as an option in lieu of the tax holiday -- as the only available incentive to the wholly-owned local enterprises. Eliminate the current difference in accelerated depreciation allowances allowed to industries located in export processing zones and outside these zones.

e. Do not make enterprises which avail of the accelerated depreciation allowances also eligible for other special tax benefits like the investment allowance of 25 percent.

f. In view of the proposed reduced corporate income tax at a rate of 20 percent and capital gains tax at a rate of 10 percent, withdraw the current tax exemption on capital gains on shares traded on the stock exchange.

g. Introduce a partial tax credit, subject to a maximum of 50 percent of the corporate tax, for any reinvestment made out of the undistributed profits and capital gains of the firm -- in the latter case, reducing the current full tax exemption granted to capital gains on real assets, if reinvested within a period of two years, to 50 percent of the tax.

h. Reduce the normal depreciation allowances for general and factory buildings, from respectively 10 and 20 percent -- which are quite generous by international standards -- to respectively 8 and 15 percent. Also, the method of calculating depreciation allowances should be simplified, based on adjusted values of assets which equal values of earlier values of assets adjusted for depreciation plus values of new net accretions of assets placed in service during the year. (A generally declining balance method of calculating depreciation which requires detailed records of original acquisition costs of assets and depreciation previously availed has been in place at present). These recommendations were made by the IMF in its March 1994 report to the Government (op. cit.).

i. Withdraw other special tax exemptions or concessions, such as the full tax exemption allowed up to the Year 2000, for incomes in some farming activities such as fish, poultry, cattle, etc.

4.E Revenue Implications of Proposed Corporate Tax Changes

4.29 It is not possible to have a precise understanding of the effect which our proposed corporate tax changes would have on tax revenue because of the absence of required differentiated corporate tax revenue data. No information is available about tax revenue collected separately from industrial and non-industrial companies. There is no estimate available on the revenue loss due to the tax holidays. Even an accurate estimate of total corporate tax revenue is not available with the National Board of Revenue as the Board does not separate the income tax collections at source by corporate and non-corporate origin. Table 8 shows income tax revenue collections during FYs 1991/92 through 1993/94, available by deductions at source and other collections, the latter collections by a further breakdown for public sector companies, private sector companies, non-corporate entities and salaried employees. These data look suspect by most individual categories as they show an inexplicable drop in shown collection of corporate tax revenue without the part included in the deduction at source during FY 1992/93. (The variation does not appear to be explained by a possible delay in payments during 1992/93 and addition of the delayed payments with the collection of 1993/94). Hence it is difficult to establish even the exact magnitude of total corporate tax revenue collection excluding collection at source.

Table 8: Income Tax Revenue By Some Selected Categories
(In Taka Million)

Year/Description	1991/92	1992/93	1993/94
Public Sector Companies	5,359.8	1,735.7	5,582.3
Private Sector Companies	2,717.6	1,901.0	2,238.8
Sub-Total	8,077.3	3636.7	7,821.1
Non-Corporate Firms	---	7,792.5	1,022.4
Salaried Persons	655.7	518.7	457.7
Deduction at Source	4,207.3	4,183.6	7,747.8
Total	12,940.3	16,131.5	17,049.0

Source: National Board of Revenue

4.30 The deduction at source includes taxes by corporate and non-corporate origins. No intelligent clue is available to use a basis for even a rough allocation of this revenue by separate categories. Using 1993/94 data and making a guess, on basis of the observed allocation between the two categories excluding the deduction at source, that two thirds of the deduction at source, i.e., of about Tk 5,160 million, came from the corporate sector and adding this with the total corporate tax revenue collection shown outside the deduction at source gives roughly a revenue of the magnitude of around Tk 13,000 million as having been collected on the corporate tax account during that year. For arriving at a rough estimate of the breakdown of this total corporate tax revenue into respective contributions from public and private sector companies, the revenue collections on this account for FYs 92 and 94 appear more relevant for our purposes because of a similar pattern of the distribution between these two categories, which suggest that near about 30 percent of the total corporate tax revenue is accounted for by contributions from the private sector companies. (This was apparently due to a very substantial revenue collection from one public sector corporation, the Bangladesh Petroleum Corporation.) However, taking account of the fact that the relative private sector corporate revenue contribution is likely to increase due to faster growth of private activities and mounting losses of public enterprises, we may take a higher proportion, say, 40 percent of the total corporate tax revenue as attributable to private companies in coming years. This basis would suggest a revenue collection of roughly Tk 5,200 million from the private sector firms, if the total corporate tax collection is Tk 13,000 million as in 1993/94.[20] Since the revised estimate of total income tax collection during FY 95 shows some decline from the corresponding total collection during FY 93 and since corporate tax rates have marked some decline during these years, this estimate of corporate tax revenue contribution from private companies can be taken as a fair basis for estimation of the possible revenue loss of our proposed recommendations on tax rates and tax incentives.

4.31 To make some rough estimate of the possible revenue loss due to our recommended corporate tax changes, it is worth noting that the corporate tax revenue loss on account of private sector firms is all that counts, since whether the Government collects income tax revenue from public sector enterprises is immaterial as whatever is not collected in the form of an income tax can be assumed as collectible by the Government in the form of a profit transfer. Our proposals mean the following changes:

a. A considerable reduction in the tax rate on publicly traded non-export companies from 35 percent to 20 percent.

b. Some increase in the tax rate on publicly traded export companies from 17.5 percent (half of the total corporate tax applicable) to 20 percent.

c. A considerable reduction in the tax rate on non-publicly-traded non-export companies from 47.5 percent to 20 percent.

d. Some decrease in the applicable tax rate on non-publicly traded export companies from 23.75

20 This figure is considerably higher than an average annual figure of Tk 1,907 estimated and shown by FIAS as corporate tax collection attributable to private companies on the basis of NBR-provided figures for three years 1988/89 - 1990/91. (See FIAS, op. cit., p. 42.) .

percent to 20 percent.

e. Reduction in the tax holiday from a range of 5-10 years to 5 years.

f. Making the tax holiday available only for foreign and predominantly export companies that can effectively take advantage of it.

g. Making accelerated depreciation allowances available to foreign companies as an option in lieu of the tax holiday and to local companies as the only available alternative incentive in place of the tax holiday.

4.32 There would be both revenue losses and gains involved in the above cases. The outcome is expected to be a net revenue loss. While it is well nigh impossible to arrive at a reliable estimate of this loss, it can be concluded that the net revenue loss is likely to be between what the maximum difference in existing and proposed corporate tax rates and what the minimum difference between these two rates would suggest, i.e., between 27.5 percent (i.e., 47.5 percent minus 20 percent) and zero percent of the total corporate tax revenue raised from private sector companies. Since the estimated total revenue raised on account of corporate tax on private sector firms is assumed, on the liberal side, to be 40 percent of income tax revenue, which is equivalent to some 5.6 percent of total tax revenue (during FY 95 the revised estimate shows 14 percent total income tax contribution to the total tax revenue collection), it can be concluded that the revenue loss on account of our proposals on corporate tax would be within roughly five percent of total income tax revenue and within 0.7 percent of total tax revenue, and hence manageable. The possible short-term revenue loss due to these reforms is small, compared to the dimensions of the projected revenue losses associated with tax reforms or reductions effected by the last and this years' budgets (projected revenue losses associated with such budget measures during these two years run into figures of respectively Tk 4,370 million and Tk 3,500 million -- i.e., 4.1 and 2.9 percent of the respective budget estimate of total tax revenue during these years). Note that the possible short-term revenue loss due to our recommendations does not take into account the revenue gain which is likely to come in the long term due to the spurred growth of lower-taxed corporate sector as well as due to an expected increased taxpayer compliance in the lower tax rate situation. This gain may largely compensate or even more than compensate for the possible revenue loss that is likely to result in the short run from the corporate tax rate cuts.

4.33 Note also that the possible short-term government revenue loss from our recommended abolition of the tax on dividend income is not likely to be important. During 1993/94, the amount of tax deduction at source shown on this account was Tk 125.8 million, while During 1992/93, only Tk eight thousand was shown as the amount of this tax deducted at source. The long-term revenue gain out of the increase in investment and growth due to the effect of stimulation to investment is, however, likely to far outweigh the short-term revenue loss due to the abolition of the dividend tax.

4.F Other Corporate Tax Issues

4.34 There is one issue that relates to the current tax law provision which treats each company as a separate taxable entity and does not allow the pooling of accounts of companies under conglomerate corporate umbrella, a practice which is reportedly found in some countries. The pooling practice will enable the business firms under the same corporate ownership to offset losses of the loss-making firms against the profits of the profit-making ones and would thus reduce their tax burden, enhance their overall financial balance and enable them to exercise greater maneuverability to manage their corporate firms. Such a provision could spur financially secure well managed corporations to purchase sick industries and turn them into profitable ones. This could be a desirable outcome in the current Bangladesh situation, where, as business people complain, sick industries proliferate.[21] We would, therefore, recommend a change in the income tax law permitting pooling of accounts of business entities under the same corporate roof.

4.35 In Chapter 2, we presented a comparative picture of the tax structure of ten selected developing countries including Bangladesh and found that Bangladesh's relative dependence on the taxes on international trade and transactions was much too heavy when compared to the other countries. On the other hand, the revenue raised through direct income and other taxes and indirect taxes on domestic goods and services was relatively too light (See Table 4 of Chapter 2). We have also observed that Bangladesh needs to raise tax revenue over time as a percentage of GDP in order to be able to satisfactorily meet the Government expenditure requirements on various counts, as well as to maintain fiscal balance and macro-economic stability. Bangladesh is thus caught in a difficult dilemma since tax reform requires undertaking of measures like lowering of rates of certain taxes, which involve possible reductions in tax revenue. That means that if the relative contribution of taxes such as income taxes is to be raised, this will need to be accomplished through improvements in tax administration and, where possible and appropriate, through improvements in coverage of the underlying tax bases.

4.36 In the case of corporate and personal income taxes, the relatively small revenue raised by these taxes[22] highlights the feature that tax administration is weak. The empirical evidence, with tax return information of a sample of corporate firms presented in this chapter, attests to wide scale tax evasion and abuse of the tax holiday benefit. We have recommended abolition of the tax holiday benefit for wholly local-owned firms. This is likely to attenuate to some extent the scale of tax evasion, but to address this problem satisfactorily will require genuine improvement in tax administration. The following steps are recommended to improve tax administration:

a. There appear to be shortages of some categories of income tax personnel; such shortages should be met on a priority basis.

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21 This point was made by Mr. Latifur Rahman, the previous President of the Metropolitan Chamber of Commerce and Industry in a recent seminar organized by the Dhaka Chamber of Commerce and Industry.

22 In Bangladesh total income tax revenue is some 1.6 percent of GDP, in contrast to 2.8 percent in India, 2.6 percent in Sri Lanka and 6.0 percent in Thailand. The corresponding percentages are still higher in Malaysia and Indonesia, which can be attributable to significant oil tax revenue. See the IMF March report, op. cit., and this year's *Budget Speech* of the Finance Minister.

b. The administration should be tightened to ensure that no cases of tax assessment remain pending for more than, say, six months. Presently, there are numerous cases remaining pending for a period more than a year or so. There should be regular tracking and monitoring of such cases. By this year's budget provision, the maximum time limit for completing tax assessment by tax officials has been reduced from two years to one from the end of the relevant assessment year. This is a change in the right direction. However, to bring about a substantial change in the number of cases remaining pending for assessment, it is necessary to further reduce this maximum time limit for completing tax assessment.

c. Where possible and appropriate, processing of the tax returns should be computerized. Some work in computerization of the tax administration was initiated this year. This work should be completed expeditiously.

d. The Government (National Board of Revenue) should introduce heavy penalties for submitting deliberately suppressed business accounts and for failure to submit the returns within a certain period after the expiry of the due date. The NBR should hold the directors and senior managers of a company directly responsible for the accuracy of accounts submitted to it and for other acts of default on the part of the concerned firm.

e. The Government should introduce appropriate measures to detect cases of corruption resorted to by tax officials and to sternly deal with such cases. To the extent possible, discretionary powers exercised by the tax officials should be curbed. In this regard, the Government's recent tax law provision that the audited accounts of the multinational and public limited companies will be automatically accepted by the tax officials for tax assessment purposes was a definite improvement. Some new measures have been introduced by this year's budget in this direction.[23] Further measures are needed to reduce tax officials' discretionary powers as well as to deal with corruption.

f. Another tax administration issue relates to the current delays involved in the resolution of tax disputes. Some recent measures have been taken to reduce the delays, including establishment in the current year of a Taxes Settlement Commission to dispose of tax appeal cases filed by all assessees, other than limited companies having a paid-up capital of more than Tk 5 million. The establishment of the Taxes Settlement Commission, done on the advice of the World Bank, marks an improvement in this area of tax administration. The Commission -- constituted with one Chairman, two permanent Members and ten part time Members, the latter Members representing the private sector -- is empowered to deal with appeals made against tax assessments made by

23 These are: (1) introduction, on an experimental basis for two years, of a provision which obliges the tax officials to accept, without any question, the tax return for a concerned year filed by taxpayers if it shows more than 10 percent increase in their taxable income compared to the previous year's income assessed by tax officials or if it shows an excess in declared income over the last assessed income by 10 percent for every unassessed year, (2) replacement of the tax officials powers to decide on the amount of tax to be paid first by an assessee before filing the first appeal against the tax assessment by a requirement that the assessee pay 15 percent of assessed tax or of tax payable on the taxpayer's own admitted income, whichever is higher, (3) waiving of the requirement of payment of minimum tax before filing an appeal against the orders of the Income Tax Appellate Tribunal to the High Court and against the orders of the High court to the Supreme Court, (4) withdrawal of the powers of the tax Commissioners to appeal against any decision of the appellate authority independently without prior approval of the National Board of Revenue, and (5) limiting the powers of tax officials to reopen cases, where tax evasion is suspected, to five years from the previous eight-year limit.

Deputy Commissioners of Taxes or by Inspecting Additional/Joint Commissioners of Taxes and required to dispose of such cases within a maximum period of six months. The Commission's judgment will be deemed final and binding on both the taxpayers and the tax authority. The establishment of this Commission obviates the need for the taxpayers to go to the Assistant Joint Commissioner Tribunals for resolution of tax disputes. However, it is still not clear whether under this new arrangement, the problems being currently experienced by taxpayers in getting proper tax assessments are fully resolved. The appellate tribunals will remain in operation side by side. One key issue in this regard is that the current system to deal with tax appeal cases is not fully independent of the National Board of Revenue as the appellate division including the appellate courts are largely manned by NBR staff. During the Pakistan time, the appellate division was under the Ministry of Law and independent of the NBR. To ensure independence of the tax appellate division, it should be taken out of the NBR fold and placed under the Ministry of Law. In addition, the interim tax payment required to be made on the disputed portion of a tax assessment should be just a nominal one, if any, but with the penal interest rate applicable for late payment. The aim should rather be to resolve the tax dispute and deal with the appeal process as expeditiously as possible. The taxpayers should not be penalized for the delays involved in this process.

4.37 The IMF, in its both March and May 1994 reports[24], has made a number of suggestions for improving direct tax administration. Some of their recommendations which, we think, merit special consideration by the Government for acceptance are summarized below. (For details, the reader is referred to its reports.)

Short-term measures

a. Establish a ledger card system to maintain the current status of taxpayers.

b. Adopt a self-assessment system and extend initially to company tax returns and related company directors.

c. Redesign and simplify income tax "chalans" and forms.

d. Initiate audit of company tax returns.

Medium-term measures

e. Revitalize the tax recovery functions.

f. Establish the audit program to review on a post-assessment basis selected taxpayer returns.

Medium-term measures which will also help administration of other taxes

24 The title of the May report is: *Bangladesh: Toward Improving Income and Value-Added Tax Administration.*

g. Human resource management should receive a much higher priority in the NBR.

h. Remuneration systems in tax administration need an overhaul.

I. Budget allocation should be the prerogative of the NBR.

4.38 In addition, the IMF has put forward a number of recommendations for reorganization of the tax administration (1) at the NBR, (2) at field level, (3) for consolidating operations, (4) for combating evasion and corruption, and (5) for initiating computer systems. The Government should give serious consideration also to these recommendations.

5. REFORM ISSUES AND OPTIONS: NON-CORPORATE INCOME TAXES

5.A Introduction

5.1 Reform issues in the area of non-corporate income taxes would include rationalization of the tax rates used and special exemptions or deductions allowed. As in the case of corporate income tax, tax administration issues are of major significance. Additionally, both administrative and other measures should be taken, which will help broaden the current extremely narrow tax base. For raising future government revenue, a major emphasis will need to be placed on broadening the personal income tax base and improving the administration of this tax.

5.2 According to information available from the NBR, the total number of non-corporate tax payers was 483,195 during 1992/93 and 533,778 during 1993/94, which meant a coverage of only about 0.4 percent of the total population and which would be a little over one percent of the economically active population, I. e., the labor force. This is an extremely poor personal and other non-corporate income tax coverage, when compared with what is found in most other developing economies. In Jamaica, for example, taxes on personal income and profits raised government revenue equivalent to nearly 11.5 percent of GDP in 1988/89[25]; in contrast, Bangladesh raised during 1992/93 only some 0.4 to 0.5 percent of GDP in the form of non-corporate income taxes. Of the total number of taxpayers paying both corporate and non-corporate income taxes, 15 and 27.9 percent reported net taxable income respectively during 1992/93 and 1993/94 above Tk 50,000, while only 3.6 to 4.6 percent showed income above Tk 100,000 during these two years. During the same years, about 13 to 15 percent of the taxpayers were salaried income cases, only about 20,200 to 27, 700 taxpayers (about 4 to 5 percent) paid taxes on a self-assessment basis and about 2,800 to 4,800 were assessed on presumptive basis. About 86 to 89 percent of the total income tax collection, including collection on the corporate tax account, came from the advance taxes and tax deductions at source during these two years.[26] Although no accurate information is available on the extent of the relative contribution of personal income tax to total income tax collection, it is believed by the NBR to be of the order of one third of the total income tax. Currently no satisfactory data base exists to allow the establishment of trends in personal income tax collection. The Chairman of the NBR disclosed in a seminar that during FY 95, only 170,000 taxpayers submitted income tax returns, which he characterized as a poorer show and as signaling a lower income tax revenue collection for the year over the previous year. The Finance Minister also expressed dissatisfaction with the poor tax assessment and collection of income tax -- which was especially marked outside the self-assessment cases during that year. The Finance Minister emphasized the need for increasing income tax collections in view of dwindling tax revenue from customs duties due to tariff reform requirements in a post-GATT environment and asked income tax officials to bring more taxpayers under the income tax net. These scattered pieces of evidence suggest that taxation in the personal income tax area not only covers an extremely tiny base, but that serious problems of tax compliance on the part of taxpayers and with tax enforcement

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25 See World Bank, *Lessons of Tax Reform*, op. cit., p. 38.

26 See NBR, *Annual Report 1992-93* (in Bengali), pp.34-36 and *Annual Report 1993-94* (in Bengali), pp. 36-38.

by tax officials continue to exist, despite recent reforms.

5.B Issues and Recommendations Relating to Tax Rates

5.3 An important issue relates to the differences in the tax rates applied to different taxable entities and taxable income categories. For achieving tax harmonization, simplification in tax administration and avoidance of possible double taxation, the existing tax rates applied to different taxable entities under personal income tax need to be unified and appropriately integrated. We recommend the following reform changes with respect to the personal income tax rates.

a. Apply the same graduated tax rate schedule to individuals, proprietorships and partnerships (whether the latter are registered with the NBR or not) -- changing the current starting rate from 15 percent to 20 percent and merging the current first two rates of 15 percent and 20 percent into 20 percent, as recommended by the IMF, for the taxable income brackets starting with Tk 55,001 and ending with Tk 160,000; and 25 percent for all remaining taxable income -- as are being currently applied to individuals and proprietorships. According to the IMF, because of the basic high exemption of a net taxable income from tax, the merger of the two first rates into 20 percent will ensure a more progressive and desirable personal income taxation structure starting with a zero rate on the first Tk 55,000 (when IMF made the recommendation, it was Tk 50,000) and gradually and progressively rising to an average 5 percent when the total income is Tk 80,000, 10 percent when the total income is Tk 105,000 and asymtotically rising toward 25 percent at a very high income level.[27]

b. Introduce a system of 100 percent credit offered to partners of registered firms while assessing their tax liabilities for the proportionate individual shares of any taxes paid by the firms. (The proportionate individual shares of taxes paid by a registered partnership firm would be determined on the basis of individual shares in the paid-up capital of the firm or actual distribution of the firm profits among them.)

c. Withdraw the tax rate rebates of five percent and ten percent currently offered on the basis of production performance and applied to the owners of small and cottage industries located in less developed and least developed areas.

d. Lower the current flat tax rate of 25 percent applied to non-resident tax payers to 20 percent.

e. Lower the current 15 to 20 percent rates being applied to capital gains under personal income tax to respectively 7.5 to ten percent.

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27 See IMF, *Bangladesh: Reform of Direct Taxation*, March 1994, pp. 19-20.

f. Review the presumptive or flat tax rates, being applied in certain cases which are administratively difficult to tax under the normal tax rates, for possible revision to make them more consistent with the normal rate schedule and realistic appraisal of the income situation of such taxable entities. It seems that these entities generally remain grossly undertaxed compared to other individuals. (Presumptive basis tax is applied to non-corporate business units that do not maintain acceptable books of accounts and to individuals with income from professions. Flat tax rates are applied in the case of owners of bus or truck transport businesses.) Presumptive tax rates should be kept at a tolerably high level and these should be offered as an option to the normal rates, which the taxpayers should be allowed to use in case they can produce acceptable accounts of their income.

5.4 Recommendations (a) and (b) are meant for tax harmonization, greater tax progressivity and avoidance of double taxation. Recommendation © is for simplification of tax administration and avoidance of unnecessary special tax concessions. Providing special tax concessions to encourage location of small and cottage industries in underdeveloped regions is not a sound economic policy, as argued before. Recommendation (d) is consistent with the need for maintaining tax harmonization and making no discrimination against non-resident foreign investors. Recommendation (e) is made for the sake of tax harmonization and avoidance of any discouragement to investment. Also, capital gains in nominal terms (i.e., without taking into account the effects of general inflation over time on the nominal value of such property or assets) may not always be gains in real terms, when the general inflation effects are duly taken into account. As such, capital gains need to be taxed more lightly than normal income. Currently capital gains continue to be taxed at 15 percent to 20 percent rates depending on the holding period of assets. These rates are too high, compared with the normal income tax rates. These rates remain high apparently because these were not adjusted commensurately with the recent lowering of the normal income tax rates. (The rationale for recommendation (f) has already been noted in the same paragraph.)

5.C Issues and Recommendations Relating to Special Tax Exemptions and Deductions

5.5 Issues of significance that relate to special tax concessions under personal and non-corporate business taxation are:

a. Tax treatment, of dividend income, which now provides limited exemptions;

b. Tax treatment, of interest income, which now provides limited exemptions.

c. The provision for a limited investment tax credit;

d. No tax credit allowed for reinvestment of profits of non-corporate business units;

e. Tax treatment, of salary income, which allows special deductions.

f. Special exemptions provided to co-operative societies engaging in commercial activities;

g. Special tax exemptions provided for some farming activities;

h. Special tax exemptions and deductions offered on housing income;

I. Special exemptions provided for capital gains;

j. Special tax exemption offered on income from non-corporate export business; and

k. Special flat deduction allowed on agricultural income.

5.C.1 Tax Treatment of Dividend Income

5.6 We have noted before that because of dividend tax deductions at source at a rate of ten percent and because of difficulties tax payers face in proving that they do not have other dividend income to tax, the currently offered limited tax exemption for dividend income up to Tk 30,000 is not effectively available to the tax payers. In fact, as we have recommended in the context of corporate taxation, dividend income qualifies to be fully exempted from tax, in order to avoid double taxation as well as to provide some badly needed incentive to investment and development of the fledgling capital market of Bangladesh. Currently the tax law provides for full exemption of dividend income, received by foreign investors from firms in which they were invested if such dividends are received during the tax holiday period of those firms. Foreign investors also otherwise receive full tax exemption benefit on such income if it is reinvested in industries. The local investors are not entitled to these tax benefits. It appears then that the partial dividend exemption, if at all effective, is practically applied in the case of local investors. It will be quite appropriate to extend the same tax benefits as are enjoyed by the foreign investors to local investors. We would therefore recommend full exemption of dividend income from taxation. We have noted before that there would be a negligible revenue implication of the full tax exemption of dividend income.

5.C.2 Tax Treatment of Interest Income

5.7 Interest income is also capital income and it qualifies to be treated in the same way as dividend income. Currently interest income received on specified government securities such as government Savings Certificates and Defence Certificates is fully tax-exempt and that on debentures issued by public limited industrial companies is eligible for a partial tax exemption of Tk 20,000. We would recommend full tax exemption of this latter income. In so far as interest on bank deposits is concerned, full tax exemption of this interest is also desirable from the points of view of encouraging personal savings and some indirect contribution to the general operating profitability of the financial institutions. However, considering the sizeable immediate revenue reduction impact which full tax exemption of interest on bank deposits may have[28], it seems advisable that this interest remain subject to the ten percent tax deduction at source, as at present, and that the bank interest received by individuals should be exempted from further tax. Thus interest on bank deposits would be subjected to a partial tax, at a rate of ten percent, while interest received on the debentures of public industrial companies as well as that on specified government securities would remain fully tax-exempt. We do not recommend tax exemption on interest on other securities and so recommend continuation of full tax on those because of revenue considerations.[29]

5.C.3 Investment Tax Credit

5.8 Investment in newly floated shares of public limited industrial companies is partially exempted from income tax, up to 20 percent of the total personal gross income subject to a maximum of Tk 100,000. Investment in specified government securities like government Savings Certificates and Defence Certificates, which was also given the same tax treatment was recently taken out from the investment tax credit benefit fold. The withdrawal of this benefit was done to provide an additional incentive for equity investment by small savers. If dividend income is fully tax-exempted, there would remain no justification for also exempting investment from income tax, even partially. Small savers will invest in shares in industrial companies primarily on expectation of acceptable future dividends on such investments. We would, therefore, recommend the abolition of the current limited income tax credit for investment made in newly floated shares of public limited companies.

5.C.4 Tax Credit for Reinvestment by Non-Corporate Industrial Businesses

5.9 At present there is no credit offered for income tax paid on reinvested industrial profits. In the context of corporate tax reform, we have recommended 50 percent credit on the tax on reinvested profits. The same proposed tax treatment should be extended to reinvested profits of non-corporate firms also.

5.C.5 Tax Treatment of Salary Income

5.10 Although before independence of Bangladesh, salary income of government employees used to be subjected to tax, at independence, this income began to be treated as tax-paid, while salary income of other organizations, including public sector corporations, remained taxable. This has created an anomalous situation, one that seems to have been a source of inequity in the tax system

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28 During FYs 1992/93 and 1993/94, income tax deduction at source on bank deposits respectively amounted to Tk 157.5 million and Tk 1,888.2 million, which were respectively 1.6 and 1.9 percent of total income tax collection during these two years.

29 During 1992/93 and 1993/94, income tax deduction at source on interest on securities was respectively Tk 70.7 million and Tk 546.4 million..

and a possible cause for some genuine erosion of the tax base. There is no acceptable rationale for keeping the salary incomes of government employees outside the purview of income taxation. Income tax can be easily reimposed on this income after an appropriate commensurate upward adjustment of the before-tax incomes to ensure that the after-tax (take-home) incomes remain unchanged. This required adjustment of the salary levels should not be a difficult task on the part of the Government and will not require any additional mobilization of government revenue as additional salary will be exactly matched by the additional income tax to be raised from them, which will be deducted at source. This initial adjustment will thus simply be an exercise of book keeping or accounts adjustment without involving any real change in the existing levels of government revenue or expenditure. The extra revenue earned in the form of income tax from government employees is simply all spent in the form of extra salary the Government is required to pay to its employees.

5.11 Bringing the salary incomes of government employees back under income taxation would, on the other hand, result in a definite improvement of the personal income tax system. The resulting advantages to follow from this reform are as follows:

a. Possible occurrences of discriminatory tax treatments between government employees, on one hand, and non-government employees and other tax-paying individuals on the other hand, at the same and different income levels will be removed. The reform will thus contribute toward greater horizontal and vertical equity of the tax system;

b. The chances of tax evasion by government officials will be reduced. The existing tax treatment of the salary incomes of government employees requires them to submit tax returns and pay tax as soon as their total income including any income from other sources exceeds the initial tax exemption amount, Tk 55,000, in a year. However, incomes earned by government employees from other sources, even when they become taxable, seemingly go unreported to the tax authority. Bringing these officials back into the income tax net will hopefully plug in part, if not all the loopholes created by present separate treatment of government officials' salary incomes.

c. The Government can also utilize the opportunity to introduce any desirable changes in the government employees's salaries at different levels, while undergoing the exercise of adjusting their pre-tax incomes in such a manner that they are left neither worse off nor better off than before after deduction of income tax on salaries at source -- without, of course, taking into account the additional changes introduced deliberately.

5.12 In order to undertake this tax reform measure, the Government should appoint a committee to work out the revised salary levels of government employees. This work should be done carefully to assign appropriate values to the benefits provided in kind to the employees so that their taxable incomes are properly recognized just as such incomes of other tax payers are recognized by the tax law. The committee should be sufficiently represented by people knowledgeable about the tax law.

5.C.6 House Rent and Transport Allowances

5.13 The law allows certain tax-exempt perquisites to tax-paying salary income earners, like a housing accommodation benefit of up to 50 percent of the earners' basic salary level, subject to a maximum of Tk 72,000 and transport benefits currently in the amounts of Tk 3,000 to 6,600, depending on the type of transport owned and/or used. These tax-free allowances, in addition to the initial exemption up to Tk 55,000, are not tenable on the equity ground. These allowances should either be discontinued, or if still continued in the case of employees of non-government organizations, should be continued uniformly for all tax-paying individuals. Uniformity in tax treatment is required for ensuring equity in the tax system.

5.C.7 Other Special Exemptions or Deductions

5.14 In the context of corporate tax reform, we recommend abolition of the special income tax exemption to export activities. Similarly under non-corporate firm or personal income taxation, special tax exemptions such as those for income from exports, some farming activities, co-operative societies, to capital gains and some special tax exemption allowed in the case of rental income earned on newly constructed houses should also be discontinued. There is no need for providing any special exemptions to capital gains in addition to our recommended tax rate reduction for capital gains. (Capital gains on real assets are provided full exemption, if such gains are reinvested within a certain period; capital gains earned on the stocks and shares except bonus shares of the stock market are completely tax-exempt; capital gains earned on the sale of landed property five miles beyond municipal areas are fully tax-exempt.) Special tax exemption of the formerly taxable imputed income of owner-occupied houses, introduced last year, has been a retrograde step as it adds to the inequity of the tax system. Taxation of such income should be restored. Special tax exemptions are generally to be avoided, as they create efficiency distortions, are inequitable, and often encourage tax evasion and avoidance.

5.15 The flat 20 percent business deduction allowed in the case of rental income from houses given on lease and the 50 percent business deduction allowed in the case of farm (gross) incomes should be subjected to review for their possible appropriate revision. The deduction on rental income has been increased to 25 percent by this year's budget, subject to production of production of sufficient proof of the expenses allowed (on account of maintenance, repair, collection and this year budget's newly added item, cost incurred on services employed in the house). The deductions may be, on scrutiny, found to be too liberal. Too liberal deductions are inequitable and they erode the tax base.

5.D Other Tax Reform Issues

5.16 Tax administration issues dominate the other reform issues. Most of the recommendations made to improve tax administration in the context of corporate taxation would also apply to the case of non-corporate income taxation. Evasion and avoidance of tax on personal and non-corporate business incomes seem rampant. It is widely believed that tax evasion takes place with the connivance of, or collusion with, tax officials. Sizeable taxable incomes go untapped also because sufficient survey efforts to unearth hidden incomes have not been undertaken. A recent survey effort to investigate the taxable ncome of car owners was reportedly cancelled while it was under way. Many owners of houses go without paying tax on their rental incomes, either because they do not report such incomes to the income tax authority or under-report their true incomes by resorting to false lease documents. Periodical surveys of rental incomes in urban areas, with sufficient coverage of different residential areas in each urban center, can be valuable guides to judge the levels of incomes and detect any misdeclaration of incomes by the taxpayers. Also, much needs to be done, in addition to what has been done in this year's budget as noted in Chapter 3, to prevent the number of pending tax assessment cases from growing and to reduce the time tax assessment cases remain pending. To a certain extent, shortage of tax officials and their lack of training also account for administrative inefficiency. In addition, tax officials should be held to greater accountability.

5.17 Administration of the non-corporate income taxes needs to be greatly improved. To this end, the National Board of Revenue should chalk out a carefully worked out plan. The plan should incorporate well-designed targets of performance for tax officials as well as sufficient punitive actions for poor performance and the resort to corrupt practices.

5.18 One other issue, which was briefly referred to earlier, relates to the provision, introduced by last year's Budget and Finance Act, that funds brought from abroad through the official channel by non-resident Bangladesh nationals will be exempted from income tax only if such funds are invested directly in new industry or in stocks and shares or government bonds or securities. The Metropolitan Chamber of Commerce and Industry has recently and rightly made a representation to the NBR to the effect that this new provision contradicted the relevant corresponding provision of the Income Tax Ordinance, 1984 and also an earlier instruction issued in this regard by the NBR, which have hitherto kept such remittances from abroad from being included under taxable income. The new provision creates unnecessary confusion. It suggests that unless such remittances are invested in the way the Government wants, these would be subjected to tax. Funds earned abroad and brought in by residents during a given tax year can be legitimately included in taxable income. However, funds earned abroad while resident abroad and brought in later or funds sent by non-resident Bangladesh nationals should not be treated as taxable income. These are simply capital funds and not income. The new provision, if put into effect, will adversely affect the remittances sent by Bangladesh nationals, which constitute an important part of the total foreign exchange earned and received by Bangladesh. The new provision should, therefore, be withdrawn.

5.19 The Bangladesh Tax Lawyers' Association has resented the introduction, again last year, of a new provision which requires tax payers submitting tax returns on the self-assessment basis to pay a minimum tax of Tk 1,800, regardless of the amount of their net taxable income. The minimum tax on self-assessment basis has been reduced to Tk 1,200 by this year's budget. However, the minimum tax is defensible as a presumptive levy in the same way as a presumptive tax (with a minimum at Tk 2,000) has been in force for taxpayers coming from businesses who maintain no acceptable books of accounts and people from professional groups. The idea of the presumptive levy is that of "either pay the minimum tax under self assessment and go with the possibility that you will not be subjected to further assessment by the tax officials or face assessment by the tax officials". The first option, with such a low minimum tax of only Tk 100 per month currently, is likely to be viewed by many taxpayers as a much better one than the latter option, which often requires them to undergo a grueling experience. In fact, the self assessment basis is offered to the taxpayers as an advantage and those who benefit from taking advantage of this basis can be legitimately asked to pay a price for it. The very idea of the presumptive levy is that this basis should be replaced by tax assessment on the basis of the tax payer's actual income only when the tax payer is able to satisfactorily prove that the tax levied does not correspond to his actual income. In Bangladesh, tax evasion is suspected to be massive among small businesses and self-employed people and the presumptive levy with a minimum tax of Tk 2,000 has made little dent into the massive tax evasion by these classes of people. On this ground, there is, therefore, a strong case for reviewing the levels of the minimum taxes being currently used for their possible upward revision. A presumptive tax on personal income has been successful in raising substantial tax revenue in some countries, most notably in Colombia.

5.20 As with corporate taxation, taxpayers usually face enormous delays in assessment of tax returns by tax officials and in resolution of appeals on assessments lodged with the appellate authorities. As noted under discussion of the corporate tax system, the Government's reduction of the period of pending tax cases to two years by this year's budget is not sufficient. There is no time limit specified for resolution of tax dispute appeals with the general appellate division. The Government has done a good job this year by reducing the tax assessed by tax officials to be paid first before filing the first appeal to 15 percent of assessed tax or of tax payable on the income admitted by the taxpayer, whichever is higher and waiving the requirement that the minimum tax be paid before filing an appeal against the orders of Income Tax Tribunal to High Court and against the orders of the High Court to Supreme Court. The Government should now take concrete steps to further expedite the tax assessment process and specify a time target to ensure quick resolution of tax appeal cases. Because of a huge backlog of pending tax cases, the Government is unable to raise in time a lot of revenue.

6. REFORM ISSUES AND OPTIONS: VALUE ADDED TAX

6.A Introduction

6.1 The value added tax (VAT) was introduced in Bangladesh, as in many other developing countries, as a fundamental tax reform measure, to raise more revenue as well as to reduce economic distortions caused by the previous more narrow-based cascade-type excise taxes. The essential merits of the VAT are that it is a consumption-based tax, and, in its purest form, it is fully trade-neutral and thus has no trade policy-created protection effects on domestic production activities. It is precisely due to this latter merit of this tax system, it is available to the Government as an important viable alternative revenue instrument to press ahead with tariff reform entailing tariff reductions and restructuring. With a uniform rate and broad-enough coverage of goods and services, the VAT also causes least distortion to relative prices of such goods and services and hence least discriminates between different economic activities. As the tax can be made quite broad-based, it is capable of raising good government revenue with a low rate. The tax is also elastic over time -- the revenue grows with the same tax rate -- as the economy grows in real terms as well as when prices of goods and services rise. These virtues of this tax have led many countries in both developed and developing parts of the world to introduce it in their tax systems. The VAT now exists in over 50 countries of the world. In Bangladesh, the VAT, including supplementary duties, accounted for 41 percent of total tax revenue during the third year of its introduction, FY 94. In FY 95 revised estimates, the revenue contribution from the VAT system increased to 42.53 percent. During these two years, the remaining excise taxes which were collected on two domestic goods and one service item accounted for respectively 1.65 and 1.62 percent of total tax. (See Table 5-A of Chapter 3).

6.2 In Chapter 3, we observed that although the VAT system which includes supplementary duties brought in more revenue, this increase was more highly concentrated in the revenue from the VAT collected on imports. The revenue increase was much lower in the case of the VAT collected on domestic goods and services. This was seen as a reflection of particularly unsatisfactory coverage of domestic goods and services. The revenue contribution of the VAT and its two main components, those on domestic goods and services and on imports, can be seen again in the information presented in Table 9.

6.3 The Table shows two things. First, the revenue increase due to the VAT has not, after all, been impressive as a percent of the GDP. This increase was a little lower than half of a percentage point in the first year (1991/92) of the VAT, while it was a little over another half of a percentage point the following year. Compare this to the 1.4 percentage point revenue increase in Indonesia as percent of GDP in the first year of introduction of the VAT and a further 1.1 percentage point increase during next three years. However, in four years in Indonesia, the VAT, together with supplementary duties, was only successful in raising revenue which was equivalent to 3.5 percent of GDP.[30] In Bangladesh, the VAT, together with supplementary duties, accounted for 3.77 percent of GDP in the second year of its introduction. From this point of view, the revenue contribution of VAT in Bangladesh is not bad. However, in Indonesia, the relative burden of the overall tax on international trade and transactions, including the VAT on imports, is very low, only 5.5 percent

30 See World Bank, *Lessons of Tax Reform*, p. 32.

Table 9: Revenues from VAT and Related Taxes or Original Taxes as Percent of GDP

Year/Description	1990/91	1991/92	1992/93	1993/94 Revised
Total Revenue from VAT, Supplemetary Duties & Excise or Original Replaced Taxes	3.05	3.52	4.12	4.00
Revenue from VAT, Sup. Duties on Imports or Original Sales Tax	0.96	1.43	1.86	1.84
Revenue from VAT, Sup. Duties & Excise (Domestic Part) or Original Replaced Taxes	2.09	2.09	2.26	2.16

Source: National Board of Revenue

during 1992 (See Table 4 of Chapter 2), which suggests that Indonesia was successful in broadening the tax base on domestic goods and services and raising enough revenue from this base to reduce the relative burden on trade taxes. In Bangladesh, the revenue dependence on the trade taxes, including the VAT on imports, continues to be overwhelming, as much as half of the total tax revenue in FYs 93 and 94. The relative dependence on trade taxes has rather increased after the introduction of the VAT, since the VAT, together with supplementary duties, on imports raises more revenue than the VAT, together with supplementary duties, on domestic goods and services (See Table 5-A of Chapter 3).

6.4 Second, revenue due to the VAT, including supplemetary duties, on domestic goods and services, did not increase as percent of GDP in the first year of its introduction, FY 92, compared to the revenue that was raised during the previous year by the taxes which the VAT replaced. During the following year, revenue from the same tax base through the VAT registered an increase by only 0.17 percent of GDP. Revenue from the VAT on imports, on the other hand, increased appreciably by 0.47 percent of GDP in the first year and by another 0.43 percent in the second year. In FY 94, however, the revenue contributions from the VAT system on both the bases marked a fall as percent of GDP, but it was a marginal fall in the case of VAT on imports, while it was, a steeper, 0.1 percent fall in the case of VAT on domestic goods and services.

6.5 Another feature of the VAT coverage of domestic goods, including supplementary duties (SDs) on them, is a high concentration of the revenue collected from a few products such as cigarettes, gas, other petroleum products, sugar, medicine, mild steel products, and edible oil. During 1992/93, these seven products accounted for 86.0 percent of the total VAT and SD revenue on all domestic goods. In so far as the VAT alone was concerned, the seven products brought in 69.7 percent of the total VAT, excluding the SDs, on all domestic goods. As regards the SD part, two products, cigarettes and gas, brought in almost the whole, 98.6 percent, of the SD revenue from domestic products. In so far as the VAT and SDs on domestic services were concerned, telephones, telex and fax services, insurance service, hotels and restaurants, and cinemas were the most prominent revenue raisers, accounting for 87.5 percent of the total VAT and SD revenue on domestic services. (See Table 10).

6.6 The above documentation demonstrates that the little buoyancy in tax revenue that was brought about due to the introduction of the VAT was made possible almost entirely due to a better VAT coverage of imports. Little improvement was made in the VAT coverage of domestic goods and services. A major purpose of the VAT as an instrument to broaden the domestic goods and services tax base has, therefore, not yet materialized. The key reform issues in relation to the VAT,

Table 10: Structure of VAT and SDs on Domestic Goods and Services : FY 1992/93
(Absolute figures in Tk million)

VAT & SDs/Indiv. Categories	VAT Revenue	Percent of Total VAT Revenue	Revenue from SDs	Percent of Total SD Revenue	Total VAT & SD Revenue	Percent of Total VAT & SD Rev.
Domestic Goods	6,902.64	100.00	9,603.49	100.00	16,603.39	100.00
Cigarettes	1,587.98	23.01	6,103.66	63.56	7,691.64	46.33
Gas	906.72	13.14	3,364.99	35.04	4,271.71	25.73
Petroleum products	631.48	9.15	0.00	0.00	631.48	3.80
Sugar	582.59	8.44	0.00	0.00	582.59	3.51
Medicine	520.40	7.54	0.00	0.00	520.40	3.13
M.S. products	309.34	4.48	0.00	0.00	309.34	1.86
Edible oil	270.79	3.92	0.00	0.00	270.79	1.63
Total of seven goods	4,809.30	69.67	9,468.65	98.60	14,277.95	85.99
Domestic Services	1,323.84	100.00	204.69	100.00	1,423.84	100.00
Telephone, telex, fax	760.21	57.42	0.00	0.00	760.21	53.39
Insurance	212.67	16.06	0.00	0.00	212.67	14.94
Hotels & restaurants	138.18	10.44	36.97	18.06	156.24	10.97
Cinemas	36.17	2.73	163.65	79.95	116.12	8.16
Total of four services	1,147.23	86.66	200.62	98.01	1,245.24	87.46

Source: NBR

therefore, precisely relate to the questions of how to broaden this tax base under VAT by (1) considering possible expansion of the VAT scope from the manufacturing stage to the wholesale and retail trades, (2) limiting the current extensive VAT exemptions of goods and services, and (3) addressing deficiencies in tax administration. For ~~a new and complicated~~ tax-like VAT, it is but natural to think that tax administration problems have been particularly acute. Other related issues concern (1) the basic VAT rate applied, (2) the rates and coverage of the supplementary duties, (3) the point of levy of the tax to maintain uniformity and neutrality in tax treatment, and (4) the threshold at which the VAT is imposed.

6.B Extending the VAT to Wholesale and Retail Trade

6.7 The VAT should cover all stages of production and the trade sector up to the retail level. Confining the VAT to the manufacturing level can induce vertically integrated firms having distribution chains to resort to tax avoidance behavior by shifting profit centers downstream and encourage vertical firm integrations for tax avoidance purpose. Covering the wholesale and not retail stages is also inherently unsatisfactory, not only because otherwise, total value added before consumption will not be taxed, but also because it is not always easy to pinpoint particular transactions as "wholesale" or "retail" and defining wholesale margins creates inevitable problems of equity and scope for corruption by tax officials. Not covering the trade sector under VAT, not only erodes the essential merit of the VAT as a consumption tax but it also leaves uneven cascading effects of the tax on ultimate consumers as well as producers using domestically produced industrial inputs. The IMF May report notes that the coverage of the trade sector would substantially increase the VAT base and also automatically resolve a number of administrative problems that have resulted from the exemption. Because of the exempt status of the traders, the VAT on imports subsequently purchased by domestic manufacturers results in a cascading of the import VAT on the VAT on the manufacturer's output. In practice, the administration adopts a procedure through which the manufacturer can receive credit for the import VAT on the basis of a copy of the bill of entry. However, the IMF report notes that this procedure is unsatisfactory as it can be abused through use of the same bill of entry for multiple credits.[31]

6.8 Given the inadequacies in the existing tax administration and the general characteristics and sizes of individual establishments of wholesale and retail trades in Bangladesh, it is probably not feasible or appropriate right at this point to consider the extension of the VAT to wholesale and retail of produced or manufactured products. However, the fact remains that without covering the latter activities, the tax will remain narrowly based and probably with a higher than desirable tax rate with more distortionary economic effects. Experience in other developing countries which have introduced this tax suggests that extension of the VAT to the retail level yields better results in terms of revenue as well as tax base broadening with use of a low-enough tax rate. In Indonesia, the tax was extended to wholesale and service activities in four years after its initial introduction. In Senegal also, the tax was extended to the wholesale and retail levels at a later stage. Thailand and the Philippines also cover the tax base up to the retail level. The standard VAT rate applied in Indonesia and the Philippines is 10 percent and it is 7 percent in Thailand, below 10 to 10 percent in several other developing countries and 12.5 percent in Pakistan.[32]

6.9 In the service sector, Bangladesh already covers a number of items under the VAT net at the retail level. The VAT on several of these services, such as hotels and restaurants, cinema houses, construction firms, advertising firms, indenting firms, motor garages, sweetmeat shops, money exchangers, and printing presses, brings in significant amounts of revenue. The tax administration of many of the services is, however, admittedly unsatisfactory. Still, improvement in tax administration is a continuous, not a one-shot, process. The VAT started in the first place with a weak administrative base. The National Board of Revenue needs to introduce necessary improvements in the administration to extend the VAT coverage to the retail level for virtually all goods and services, except primary goods and some basic food items which weigh importantly in the consumption of the poor. The extension should be considered in the near future -- say, in one or two years. The threshold

31 See Heeden, Brondolo and Firestone, Bangladesh: *Toward Improving Income and Value Added Tax Administration*, op. cit., p.3.

32 See Tait, Alan A. (ed.), *Value-Added Tax: Administrative and Policy Issues*, International Monetary Fund, October 1991, pp. 2-3.

point for levying the VAT should be an appropriate size of establishment, commensurate with administrative capacity, and not according to the types of goods and services (with the exceptions already noted) or places of such establishments or activities. Last year's budget has decided to extend the VAT to wholesale and retail levels on a voluntary basis, that is the business units at such levels have been offered the option of registering for VAT payment in order for them to be able to take advantage of the crediting facilities available under VAT. However, there has been reportedly no response from private firms to this offer. It, therefore, appears that voluntary VAT registration will not work. Therefore, to begin with on a trial basis, the NBR should take the VAT to the retail level for a specified list of products.

6.C Reducing the Exemptions

6.10 VAT exemptions of goods are placed under the following categories: (1) primary unprocessed agricultural, forestry, fishery and livestock products -- both at import and domestic production stages, (2) semi-processed or processed food products, not canned or packaged, at both import and domestic production stages, (3) manufactured goods both at import and domestic production stages, (4) manufactured goods at the domestic production stage, not at the import stage, and (5) goods at the import stage only, including capital machinery and spare parts which are fully duty-exempt or eligible for duties at concessionary rates and certain agricultural equipment and their parts. Small and cottage industries are also exempt from the VAT. The threshold at which the VAT becomes leviable is defined in terms of Tk 300,000 of capital and Tk 1.5 million of turnover, except for certain industries which are covered under the VAT regardless of their sizes. In addition, there are service items which are exempt from the tax. There is a clear need for rationalizing these exemptions for improving the revenue yield, reducing inequities in tax treatment, and simplifying and improving tax administration.

6.11 Exemption of primary agricultural, forestry, livestock and fishery products from VAT rests on practical grounds as their taxation is not generally administratively feasible. However, in some cases, imposition of a VAT on primary agricultural inputs, in combination with VAT on outputs, would be economically more efficient (would involve less economic efficiency losses) and be administratively more feasible and desirable. A good example is a VAT on cotton along with a VAT on textile yarn products. As discussed later, Bangladesh's current exemption of domestic textile products from VAT, while imported textile inputs and outputs are being covered under VAT with the exception of cotton, is creating significant undesirable revenue losses for the Government as well as causing significant economic efficiency losses.

6.12 Agricultural products bear, if any, little indirect VAT burden *via* the VAT on their inputs, which are manufactured products, first because such input content may not be sizeable, and second, as in Bangladesh, because some of the vital inputs to agriculture may be exempt from VAT. Currently fertilizer and pesticides remain exempted from VAT. In fact, the Government controls the domestic price of fertilizer and deliberately keeps it at a subsidized level. Currently the ex-factory price of urea is below 50 percent of the export parity price. This policy of VAT exemption of fertilizer and pesticides and subsidization of fertilizer is an economically unsound and counter-productive policy as such a policy does not pay off in the long run. An irrational pricing policy unrelated to costs is bound to break down in the form of lower production in the future or other perverse effects which will adversely affect the farmers themselves. In its tax strategies, the government often gives undue importance to social considerations forgetting that in practice price controls may not lead to commensurate price reductions at retail level and may thus lead to little benefit to the ultimate target groups -- consumers or users of the goods. This is more likely to be the case, when the goods are sold in a monopolistic or oligopolistic market controlled by a limited number of dealers. Likewise, the Government tax exemptions are often not desirable as the lower Government revenue in the future enables the Government to undertake less developmental activities. The exemption of fertilizer and pesticides from VAT should be withdrawn.

6.13 In so far as the VAT exemption of domestically produced agricultural irrigation equipment such as pumps and tubewells is concerned, such exemption is justified as these are capital goods. Such exemption should be general and not limited to domestic production only, as otherwise the VAT exemption ceases to be trade-neutral. However, in stead of straight away providing exemption, it would be more appropriate to zero rate VAT on such goods, just as exports are zero-rated. The advantage of zero rating lies in the fact that under this system, the tax concession has less scope for abuse than when a straight exemption is provided. Zero rating leaves the items first taxable at existing rates but allows the users of such items to get crediting for the tax against VAT on them and/or refund of the tax, the latter as in the case of export products. This way, the users of the capital goods are assured of zero-rated VAT on such goods. The shift to zero rating from the current practice of granting straight exemption could be done by simple amendments to Sections 3(2) and 2(w) of the VAT Act.[33] The IMF has also recommended withdrawal of currently maintained VAT exemptions of capital goods. It has not, however, mentioned about its zero rating. As Tait notes in another IMF document, "In what might be called the 'pure' VAT, the tax paid on all capital purchases should be allowed as a credit at once and, if a net repayment is established, the tax should be refunded immediately. This ensures that the tax is on consumption and should encourage investment."[34] In a developing economy such as Bangladesh in its current nascent stage of industrialization, it would be quite appropriate to zero rate VAT on all capital goods, not just those which are duty-exempt or eligible for concessionary duties, on the simple ground that the VAT would significantly raise investment cost and slow down the industrialization efforts of the country. Zero rating of VAT on capital goods is, therefore, justified. And, this zero rating should be extended to domestic production of such goods and not limited, as the current exemption is, to imports only. However, the current VAT exemption or its substitution by zero rating on spare parts, which are current inputs, is not at all justified and hence it should be discontinued.

6.14 VAT exemption of processed foods when these are not canned or packaged can also be justified on equity and, in some cases, administrative grounds. Some canned or packaged foods are also exempt. These are: breads, milk (including canned condensed and powdered milk), milk foods such as butter, ghee, cheese, etc., and mustard oil. Exemption of these foods, when packaged or

33 I am grateful to Mr. E R C Mouat, ODA VAT Advisor with the NBR for bringing this point to my attention.

34 Tait, Alan A., "VAT Policy Issues: Structure, Regressivity, Inflation, and Exports", in Tait, (ed.), *Value-Added Tax: Administrative and Policy Issues*, op. cit.

canned, from VAT can hardly be justified as these are not poor men's foods.

6.15 Besides some processed foods, a number of other manufactured products are currently exempt from VAT, both at import and domestic production stages. All VAT exemptions of manufactured products should be withdrawn, excluding some foods, which count heavily in poor people's diet such as rice and wheat, and excluding machinery products which qualify to be treated, and can be clearly identified, as capital goods. A partial list of such goods is provided at Table 11.

Table 11: Partial List of Manufactured Goods Exempted from VAT on both Import and Domestic Production

H. S. Code	Description	H. S. Code	Description
1514: relevant codes	Mustard oil	4801.0000	Newsprint, in rolls and sheets
1905: relevant codes	Breads, "bun" breads, and similar breads	4901-4903: relevant codes	Books, booklets, newspapers, magazines, periodicals
2301- 2306, 2308 and 2309: relevant codes	Various food industry residues and waste; and animal fodder	5303.1020	Jute cuttings
		6402.2000	Plastic and rubber sandals
2402.2000	Cigarettes containing manually made tobacco[35]	7317.0090	Nails
2501.0090	Salt of all descriptions	7615: relevant codes	Aluminium and Aluminium-made kitchen & household articles; and sanitary ware and parts thereof
2835.2500	Dicalcium phosphate		
3002-3006: relevant codes	Pharmaceutical birth control goods	8424.8110	Hand sprayers for agricultural purposes
3101-3105: relevant codes	Chemical fertilizer	9019.2010	Oxygen therapy and artificial respiration apparatus
3808: relevant codes	Agricultural insecticides, herbicides, fungicides, disinfectants, etc. and raw materials; and rat killing insecticides and the like and raw materials	9021.5000	Heart pacemakers
		9021.9000	Heart valves
		9405.5010	Hurricane lamps
		9608.1000	Ballpoint pens
3924: relevant codes	Plastic (except melamine) products	9609.1000	Wooden pencils
4014.1000	Sheath contraceptives		

Source: First Schedule under *Excise and Salt Act, 1944* and SRO dated 10 June 1993 of NBR.

If the Government thinks that exemption of some goods from any tax including VAT is desirable on social or other considerations, such as for goods like birth control contraceptives and instruments, books, newspapers and periodicals, and pace makers and heart valves, the Government should provide a subsidy to compensate the targeted groups for the tax rather than provide the tax exemption in the first place. Although the latter method may be preferable on administrative grounds, it is inequitable since the straight tax exemption benefits the rich as well.

35 Subject to an excise duty.

6.16 Among the manufactured products, which are exempted from VAT at the domestic production stage and not at the import point, the most noteworthy are textile products other than jute textiles. Domestic textile yarn and fabrics are covered instead by specific low excise duties, which were in place prior to the VAT introduction. The Government initially intended to include the textile sector under VAT coverage and with that end in view, it withdrew the existing excise duties on them. However, during the 1991/92 parliamentary budget discussions, the Government decided in favor of keeping the textile products outside the VAT coverage. To retrieve part of the revenue loss from non-coverage of domestic textile products from VAT, the Government increased the customs duty on imported cotton from five percent to ten percent during 1991/92. Subsequently the duty was dropped. Domestic textile sector remained without being covered by any explicit tax for one year. Then the budget for 1992/93 imposed a 2.5 percent excise duty on textile yarn and fabrics. But this also was abandoned later and replaced by the original even lower and more inefficient specific excise duties of pre-VAT times.

6.17 The cotton and silk spinning and weaving parts of the textile sector currently enjoy a specially favored tax situation. There is no customs duty on imported cotton, silk cocoons and raw silk, which remain also VAT-free as primary products. The customs duty on imported cotton and silk yarns was reduced in FY 95 to 7.5 percent, from previous year's 15 percent. Besides customs duty, imported cotton yarn is subject to VAT. Imported mixed cotton-synthetic yarn is also subject to a customs duty of 7.5 percent and the VAT. Synthetic and woollen parts of this sector receive varying tax treatment. Imported synthetic fibers are subject to a customs duty of 7.5 percent and the VAT. Customs duty on nylon chips used in synthetic textiles has been reduced to zero last year from lprevious year's 7.5 percent, but the VAT on them remains. Imported synthetic yarn faces a customs duty of 22.5 percent and the VAT. Raw wool is subject to a customs duty of 15 percent and no VAT. Imported woollen yarn faces a customs duty of 7.5 percent and the VAT. The textile industry now also has to pay considerably lower duties on imported dyes and spare parts than previously. (See Table 12).

6.18 In this generally lower tax situation being enjoyed by the domestic textile products than ever before, their VAT exemption would seem all the more unwarranted. Moreover, the differentiated tax treatments of different textile products, combined with the exemption of the domestic products from VAT result in very different discriminatory cascaded tax burdens for the different products, a consequence which is economically not at all desirable for a sound growth of the textile sector as a whole.

6.19 Domestic textiles is a large sector. This sector, excluding jute, readymade garments and knitwear, which mostly cater to the export market, but including textile dyeing and finishing, accounted for some 19 percent of total manufacturing value-added at factor cost in 1986/87 benchmark manufacturing data estimated by Zaid Bakht in 1991.[36] In the enlarged Census of Manufacturing Industries (CMI) of 1988/89 of the Bangladesh Bureau of Statistics (BBS), where nearly 24,000 industrial establishments have been covered compared to a coverage of only about 5,000 of the 1987/88 Census, the domestic textile sector as specified above accounted for 12.7 percent of total manufacturing gross value added in 1988/89. Keeping such a large industry sector

36 See his *Time Series Estimates of Value Added at 4-digit Industry Level: 1980/81 -89//90*; Draft, July 1991.

outside the VAT purview has created a highly undesirable tax situation which is not only economically anomalous, inefficient and inequitable, it has also deprived the Government of an immediate substantial revenue as well as of a dynamically important source of tax revenue.

Table 12: Current (FY 96) Customs Duties and VAT Status on Textile Products and Inputs

Product or Input	HS Code	Customs Duty (%)	VAT (%)
Cotton, silk cocoons and raw silk	5201, 5001	0	0
Synthetic fibers	3908109	7.5	15 on imports 0 on domestic production
Nylon chips		0	15
Raw wool	51011000	15	0
Cotton, silk and mixed cotton-synthetic yarns	52050607, 5004, 520624	7.5	15 on imports 0 on domestic production
Synthetic and polyester yarn	5402209	22.5	15 on imports 0 on domestic production
Woollen yarn	51071	7.5	15 on imports 0 on domestic production
Textile fabrics, various kinds	Various codes	Various rates	15 on imports 0 on domestic production

Source: NBR, *Bangladesh Operative Tariff Schedule 1994-95*. September, 1994 and 1995/96 budget changes.

6.20 The intended purpose of introducing the VAT reform was to raise an additional revenue through mainly broadening the tax base by covering the previously untapped or lightly taxed sectors and parts of the economy and shifting and spreading to them the burden of additional taxation and thus lay the foundations of an elastic broad-based and cascade-free tax system, which would impart greater equity and efficiency to the tax system. The non-inclusion of the domestic textile products under VAT has created the following specific effects:

- First, the VAT on the imported textile inputs, except raw cotton, silk cocoon and raw silk, and on imported outputs and not on their domestic production has made the VAT non-trade-neutral. It works as an additional protective levy on imports.

- Second, the tax creates uneven cascaded VAT burdens on downstream industries since no VAT is collected at the downstream stage and since, because of this, no credit is obtained for the VAT paid on the imported inputs, except for the export textile products for which there is provision for full crediting of the VAT paid on used inputs. The uneven VAT-caused tax burdens of different textile products result from different proportions of VAT-embodied inputs used in their production, as well as from the differentiated VAT treatment of imported textile inputs. In the current tax milieu faced by different parts of the textile industry, cotton spinning faces a virtually zero tax situation.

- Third and most important, the Government remains deprived of a substantial potential revenue. The current excise duties on textile products raise a small revenue. In 1992/93, the revenue from excise duties from these products was Tk 144.2 million, which was equivalent to only about 2.1 percent of the total VAT collected from domestic products (not services) during that year. At the time of VAT introduction, the NBR estimated the revenue loss from non-inclusion of textile products under VAT at Tk 820 million for 1991/92. This means that excise duties raise not even one fifth of the potentially available revenue from the textile sector through the VAT.

- Also the specific excise duties -- Tk 1.5 per kilogram of textile yarn and Tk 0.50 per square meter of textile fabric -- are inelastic; i.e., the revenue does not go up with price increases of textile products. The differentiated excise duties are also inefficient as they create uneven tax burdens for the products and add to the cascaded effects of the VATs which are paid on the imported inputs. The excise duties are on yarn and grey fabrics. Other textile sector operations such as printing, dyeing, manufacturing of tapes and braids, and other downstream ancillary textile industries remain directly uncovered by any tax now; they bear uneven cascaded burdens: (1) of the VATs on imported textile inputs, and/or (2) of the VATs on imported outputs, and (3) of the excises on domestic yarn and grey fabrics.

6.21 The implications of the non-inclusion of the domestic textile sector in the VAT coverage and of alternative tax regimes were examined in some detail by this author in 1992 at the behest of the World Bank. The paper concluded that keeping this large industry sector outside the VAT range could hardly be justified on any ground including the generally weak state of the industry.[37] Special tax exemptions of specific industries should always be avoided. Perceived structural weaknesses, if any, of any industry should not be addressed by tax concessions, as such special industry-specific tax concessions are inefficient and inequitable as they discriminate between industry sectors and between products and stages within a particular industry sector and as such tax concessions create scope for abuse and foster vested interests. The Government should withdraw the VAT exemption.

6.22 Other domestically processed/manufactured products explicitly exempted from VAT and not already mentioned above, include certain domestic foundry and engineering workshop products such as raw materials and spare parts of irrigation pumps and hand tubewells, weights and measures, and certain parts of haulers. These exemptions are hardly justified.

6.23 It appears that many other domestically manufactured products escape VAT under the cottage industry umbrella, especially after a more liberal VAT threshold was defined this year. SRO 13 - Law/ 94/ 93-VAT dated 9 June 1994, subsequently amended, lists some 30 four-digit specific products which are not allowed to be eligible for the cottage industry status. All other industries are eligible for the cottage industry status, which also get exempted from the 2 percent turnover tax. The

37 See *Potential Impact of a VAT-included and Alternative Tax Regimes on Domestic Textile Industries*, Dhaka, 04 August, 1992.

so-called cottage industries, according to the IMF May report to the Government, are known to enjoy substantial competitive advantages in comparison with other enterprises operating in the same sectors. Their products, once sold to the trade sector, carry a much lower VAT burden than the same products of larger enterprises. In several economic sectors, the cottage industries have been able to obtain major shares of the markets. The industries and industrial establishments which are currently being exempted under the cottage industry criterion should be published by the NBR and subjected to further review. For, the provision is suspected to have been abused under political or other pressures from special interests, which has led to VAT exemption of industries and/or of specific industrial establishments such as PVC pipes, which is not really justified under the cottage industry criterion. The blanket provision that any industry not included in a specified list of exclusions can qualify to be treated as a cottage industry also seems to have encouraged development of certain industries on a VAT-exempt small scale basis -- just as the development of handloom and semi-mechanized weaving units in the past occurred because of certain excise tax concessions offered on the basis of the number of looms installed in weaving units. It seems that it would be administratively more expedient to control the abuses of the cottage industry status if the NBR maintains a positive list of industrial items and establishments which are granted the cottage industry status rather than through the current practice of maintaining a negative list of industries which are not so exempt.

6.24 There is also a need for reviewing the current liberal VAT threshold being applied in terms of both capital investment and turnover. The turnover has been doubled last year from Tk 0.75 million to Tk 1.5 million. The IMF May report to the Government noted that even the threshold at Tk 0.75 million, which is equivalent to nearly US$ 20,000 was high enough, which limits the increase in taxpayers to a manageable number. It is not clear whether the current suddenly doubled turnover is really justified in terms of net marginal VAT collection lost compared to the marginal savings in tax administration cost. If, on close scrutiny, it is found that the threshold has been defined at an excessively liberal level, it should be appropriately cut back. Also, there does not seem to be any good reason to apply both a capital cap and a turnover limit to define the VAT threshold below which the turnover tax at 2 percent would apply rather than the VAT. In fact, as the very level of turnover tax collection seems to suggest -- during 1992/93 turnover tax collection was only a paltry sum of Tk 6.1 million -- that the turnover tax has been a means of avoiding any worthwhile tax liability under the VAT.

6.25 Deviations adopted from standard VAT procedures in specific product or service category cases have also caused anomalies in VAT treatment among products and services and generally eroded the VAT base. In the case of domestically produced edible oil, in stead of calculating the VAT on the sale value with credit provided for the input VAT, the VAT is calculated on the basis of a predetermined value added to sales value ratio in the industry without providing for any credit for the input VAT. This practice has reportedly been adopted to remove a perceived disadvantage the industry faces from the application of standard VAT procedures. The IMF May report notes that for enterprises in the construction sector, a reduced rate of 4.5 percent without credit for invoiced VAT has been introduced, also on the basis of an averaged value added computation for the sector. The IMF report observes that the new procedure is an obstacle to turnkey projects because it is more advantageous to have the inputs charged immediately to the purchaser of the project. Such deviations from the set VAT procedures are economically inefficient and inequitable and hence should be avoided.

6.26 Some erosion of the domestic VAT base has occurred in another way -- another kind of deviation from the VAT procedures -- through setting official tariff values (on which the VAT is to be calculated), instead of employing the usual method of calculating VAT based on pre-VAT ex-factory price that is taken for VAT calculation. These official tariff values are taken at lower than actual pre-VAT ex-factory prices of products, thus providing another form of VAT concession to some industrial products. Currently the products which are being provided such concessions include sugar, paper, bricks, razor blades, and diesel engines. Sugar, paper and diesel engines are produced solely by public enterprises. Such tax concessions are clearly unwarranted and should be removed.

6.27 VAT exemption is provided to certain goods on their imports only, which are ostensibly not being produced domestically, such as homeopathic, biochemic, ayurvedic and unani medicines, certain other medicines, radio-cassette recorders (two-in-ones) brought in by Bangladeshi passengers under baggage rules (one only carried by one passenger), and gold bullion carried under baggage rules. These VAT exemptions are also unjustified, and should be eliminated.

6.28 There is also a provision that the NBR can provide VAT exemption to public sector domestic production of natural gas, petroleum oil and petroleum products under special production sharing arrangements with foreign companies. The rationale of this provision is also unclear. If such production sharing arrangements are made in the private sector, the VAT exemption would be clearly unacceptable. For maintaining uniformity of tax treatment, it is necessary that no distinction be made in tax treatment between the private and public sectors.

6.29 The VAT should also ideally cover most services to the point where their coverage is effectively worth administering. Currently certain important services are excluded from the VAT coverage. One of the most notable among them is electricity consumption. Electricity is currently subject to a low specific duty, at a rate of Tk 0.15 per kilowatt hour of electricity consumed. This tax has low revenue productivity, is not sufficiently elastic and has a cascading effect on the productive system. Electricity should be brought under the VAT net. This tax will fall on consumption and will not add to those business units which are already covered by VAT. Transport services, fares and freight charges, should also be covered by VAT. Again, this coverage will not add to the final tax burden of businesses which are already VAT-covered. However, the VAT will have some cascading tax effect on businesses which are currently not VAT-covered. This way, the units which get explicit VAT exemption will share some tax burden, which is probably not undesirable. The banking services, but not insurance services, are also currently VAT-exempt. Instead, the savings accounts are currently subject to an inappropriate excise duty. Banking services should remain exempt from any tax, since this will affect private saving and would also further strain the already financial unsoundness of the banking system and adversely affect bank disbursements for investment.

6.30 During last year's budget, the Government has drastically reduced the number of manufactured items subject to supplementary duties (SDs) in addition to VAT at the standard rate. It has dropped 341 items from a total of 426 while adding some new items to keep a total of 131 items under the SD list at present. This drastic reduction of the SD list raises a question as to whether the Government's tax designs are not at times made on less than rational considerations. Even a cursory look at the old and new lists of goods subject to SDs would seem to confirm this apprehension. Many products, which can be legitimately categorized as luxury goods, have now been kept outside the SD levy. Some examples of such goods are coffee, caramel, butter, jelly, jam, soft drinks, perfumes, wall papers, motor tires, carpets, electric blankets, tiles, marble stones, mosaic slabs, etc. The NBR should closely reexamine the current SD-exempt list and at the same time it should review the widely varying SD rates being applied, which currently range from 5 percent to 350 percent. In some cases, the rates, on reexamination would be found to be either too low or too high. For example, a rate of 150 percent on gas leaves too little funds at the gas companies for new investments and modernization.[38] These rates need to be reviewed for possible rationalization. For administrative and possibly equity reasons, it will be desirable to use a fewer number of SD rates than are applied now.

6.31 The basis adopted for computing SDs on imports is not in line with that used for computing SDs on domestic products. In the former case, SD is computed on the basis of value of imports assessable for customs duty purposes in the same way as customs duty is computed -- which means that SD is computed on the basis of duty-assessable import value exclusive of any customs duty. VAT is calculated on the import value inclusive of both customs duty and SD, if any. In the latter case, SD is computed on the basis of ex-factory sales value, net of any tax. VAT is calculated on the basis of ex-factory sales value including SD, if any. The basis adopted in both cases is anomalous, if SD, which is essentially part of the VAT system, is to be trade-neutral. The current basis in effect negates in part the protection to domestic production activities, which are subject to SDs, accorded through customs duties. This is because ex-factory sales value of domestic products net of any tax is comparable to the duty-included value of imports of comparable products. SD is currently levied as a *de facto* excise on domestic products. To offset its disprotective effect on domestic products, it is necessary that SD on imports is computed on the basis of customs duty-inclusive value of imports. This correction should be done, which will not only remove the current distortion in the the trade-neutral character of the tax, but will also raise additional revenue from both SDs and VAT on imports. Note, however, a caveat even in this approach.

6.32 The above correction will not lead to the fully desirable situation. Through this approach, where the SDs on domestic products and services are used as *de facto* excises on them and since there is no crediting available for the SDs on imports or on domestic products and services for the users and consumers of such products, SDs create uneven cascading effects and also cease to be a consumption-based tax. Businesses are affected by SDs paid on some inputs, including importantly gas, where the SD is payable at a very high rate. The proper way to compute SD on both domestic products and services and imports, which also entails a change in the current basis of computation

38 It appears that in this particular case, the high SD rate on gas has been used as a device to bring the consumer price of gas, at least in part, into line with its economic price, which is defined as the present discounted value of its opportunity cost in terms of the price of the equivalent alternative fuel when the known gas reserve in Bangladesh gets completely depleted (which is called the" depletion allowance") plus the long-run marginal cost of extraction, transmission and distribution of gas -- and as a device to syphon off the surplus profit from the government-owned gas companies as government revenue. However, this process can make gas operations unattractive to private companies to invest in this sector. It will be best to explicitly correct the gas price in the first place and subject it to the normal VAT rate.

of VAT as well, is as follows:

On domestic items: Both VAT and SD = Sales value before VAT and SD <u>times</u> the combined VAT and SD rates

On imported items: Both VAT and SD = (Assessable value of imports <u>plus</u> customs duty) <u>times</u> the combined VAT and SD rates

Adoption of this basis will entail a loss in presently collected revenue from VAT on goods which are also subject to SDs and a gain in presently collected revenue from SDs. It is not readily clear what will be the net revenue effect. This basis should be adopted, with adjustment of the SD rates, if required not to affect Government revenue. And it should incorporate crediting arrangement for SD as for VAT.

6.33 A final policy issue relates to the rate of the turnover tax which is applied to the small industrial and service establishments having turnovers below the threshold level. As the IMF May report observes, the current rate of 2 percent is low to counterbalance the advantage of VAT exemption. We endorse the IMF recommendation that this rate be reconsidered with a view to increasing it to 4 percent.

6.D VAT Administration Issues

6.34 The VAT is a tax system with crediting mechanisms built into it, for all VAT payers, for VAT paid on intermediate and service inputs used by them and as such it is a more difficult and less easily understood tax for effective administration and compliance. On the other hand, once the concept is brought home to the taxpayers, it can establish itself as a business-friendly tax or, to put it differently since all taxes are disliked by taxpayers, it can turn out to be a less disliked tax than many other taxes. In other words, the VAT is liable to have greater voluntary tax compliance than other taxes. However, too many exemptions and exceptions from the tax and weak tax administration can erode this potential virtue.

6.35 The tax has been imposed on an already weak existing administrative base, which did not have any past experience in administering a broad-based system of domestic sales tax and it could not wait for sufficient orientation and training of its staff. Quite naturally, the administration of this tax has remained deficient. Most of the deficiencies of the VAT administration have been well articulated in a recent article by Mr. Saiful Islam, Member of the NBR in charge of VAT administration. Some of his observations are summarized as follows.

a. The field staff is largely untrained and uninitiated; this has been a major administrative hurdle and the main source of irritation for both the taxing authority and the taxpaying business people.

b. Confusion about the VAT concept and its Act and Rules has prevailed since its introduction.

c. The field offices are not yet adequately equipped for proper supervision of the application of the VAT Rules.

d. The NBR has not yet been able to train all its staff or to build its tax auditing capability -- which are vital for effective VAT enforcement.

e. In less than three years of introduction of the tax, the administration has had to deal with situations created by forces within the tax administering staff and pressure groups from outside which could have threatened the tax system itself.

f. Effective VAT collection could not as yet be commenced from some sectors, such as land development and construction due to legal and administrative problems as well as due to undue pressures being faced from interest groups. These two sub-sectors have remained out of the VAT net even after two years of enactment of the law covering them.

g. Due to disarray in customs valuation, distortions were created in the computations of VAT at the import stage which showed up vividly in the protection effects of the import tax regime and domestic VAT on edible oil refining, shipbreaking and production of mild steel products.

h. Administrative problems have been compounded by the absence of a proper personnel management policy which has resulted in an unprecedented shortage of trained staff and officers at the most vital points of the administration -- a situation which was not foreseen three years ago.[39]

6.36 The IMF May report to the Government noted that in 1992, more than half of registered VAT taxpayers failed to submit tax returns. It also noted that despite the large number of tax officials relative to taxpayers (compared to international standards), work backlogs are common throughout the tax administration. This can be traced to fundamental shortcomings in tax administration's organizational structure, work procedures, and data processing systems.

6.37 Among the efforts made, or which are in the cards, to improve the administration are the following.

a. The NBR is considering gradual elimination of the VAT exemptions to create a better tax environment for tax compliance.

b. It is thinking of introducing some simplification and improvisation in administering the

39 See Khan, Saiful Islam, "The Value Added Tax: Bangladesh Experience", in *Fiscal Frontiers*, a journal of Bangladesh Customs and Excise Administration, December 1994.

VAT on small businesses by introducing a system of "arbitration" for them.

c. The NBR has recently started addressing the problems of valuation at the import stage.

d. Other important recent administrative efforts have been to (1) increase the number of field collectorates and reorganize them to create greater tax evasion-preventive and auditing capabilities, with a focus on VAT taxable units in the service sector of Dhaka metropolitan area to develop a model for other areas, and (2) establish a proper base for VAT assessment in the cases of land development and construction.

e. The administration is also thinking of gradual elimination of the turnover tax and bringing the small and cottage units under the VAT net.

f. The administration is also aware of the need for developing the auditing capacity in the system.

g. There is also reportedly a plan to install a computerized system in the NBR to administer the VAT under a UNDP technical assistance program.

6.38 Future programs to improve the VAT administration need to focus on the following elements:

a. Putting a fully operational computerized system in place.

b. Training the staff adequately and recruiting additional required specialist staff.

c. Eliminating all exemptions by industry or service categories and obliging all potential taxpayers to register under VAT unless they get exemption by way of the defined tax threshold in terms of business size.

d. Demanding proper invoicing and bookkeeping from the VAT registered units.

e. Introducing proper arrangements to identify non-filers (those who do not file to avoid the tax) and stop-filers (those who stop filing returns to avoid or delay paying the tax).

f. Instituting appropriate arrangements to ensure prompt VAT refunds where such refunds cannot be adjusted by the VAT payers.

g. Ensuring broad audit coverage.

6.39 Putting a fully operational computerized system in place, which is absent at present, is a key element in VAT administration. It is hard to think of efficiently administering the VAT system without a computerized system. Advantages to be reaped from the use of computer technology include (1) faster processing of tax returns, (2) greater and swifter detection of tax delinquents and stop-filers,

(3) greater cross-check and self-enforcing mechanisms through comparisons of taxpayers' tax returns and inter-department exchanges of information within the NBR, and (4) speedier and more reliable compilation of relevant tax and other related data. A properly designed and operated master file system is an effective and essential tool in many tax applications, including the VAT. Assistance from the computer system is the most effective and quickest way to detect stop-filers and delinquent taxpayers. Collection has to rely largely on computers because there is no known manual system that can process the vast numbers of tax returns required and detect non-filers and delinquent accounts promptly and reliably. Most European countries and many in Latin America rely heavily on computers for collecting VAT. In Bangladesh, the VAT system was designed with assistance from the IMF; its introduction was to be accompanied by a fully operational computerized system. A UNDP technical assistance program was there to help with the computerization program. However, this program has been only partially implemented to date. As the IMF report notes, computers have been introduced in only three collectorate offices and their use has been limited to registration activities. Additional systems need to be developed for returns and payments processing, revenue accounting, audit support and management information. The Duty Exemption and Drawback Office (DEDO), which is entrusted with the important function of promptly settling and clearing tax refunds to the exporters, was also supposed to be supported by a fully operational computerized system. However, this program also remains to be implemented due to a current lack of technical staff. The NBR should take appropriate actions to swiftly implement all such computer programs which are essential to ensure efficient VAT administration.

6.39 The IMF May report has made a number of specific recommendations to improve VAT administration, which are essentially related to the above recommendations of ours. Their recommendations which we particularly endorse are as outlined below:

a. Simplify the forms and procedures for filing tax returns.

b. Adopt a uniform taxpayer identification numbering system on the basis of the income tax numbering system.

c. Expand the audit coverage of larger firms.

d. Improve training of operational staff in VAT enforcement and audit methods.

e. Establish a tax recovery unit.

6.E Summary of Recommendations

6.38 Recommendations relating to the VAT system including supplementary duties, which have been made and are spread in this chapter with detailed justifications, are consolidated and summarized below with brief justifications. The recommendations relate to VAT policy issues and its administration. Those in the former category in turn mainly relate to the VAT exemptions and concessions.

6.E.1 Recommendations Relating to VAT Policy Issues

1. Extend, within the next couple of years, the VAT to the trade sector up to the retail stage, covering all goods and services except primary agricultural goods and basic foods which weigh importantly in the consumption of the poor, combining this extension with a reduction in the present standard VAT rate of 15 percent to, say, 12.5 percent in one phase and 10 percent in a second phase. Considering the present administrative limitations and characteristics of wholesale and retail trades in Bangladesh, a specified list of products could be immediately brought under the VAT up to the retail level on a trial basis. To facilitate introduction of this reform, it would be expedient for the Government to seek technical assistance from the IMF. As argued before, the current VAT exemption of the trade sector has led to distortive cascading effects of the VAT on the trading sector and other undesirable economic effects, and the non-coverage of trades has made the tax less of a fully consumption-based one.

2. Withdraw the VAT exemption of current manufactured agricultural inputs like chemical fertilizer and pesticides. Since the agricultural sector remains completely exempt from the VAT, there is little economic rationale for VAT exemption of the current manufactured inputs used in agriculture such as fertilizer and pesticides, while the capital inputs like irrigation pumps and tubewells and other agricultural implements should continue to remain VAT-exempt. The VAT exemption of fertilizer little benefits the farmers in the form of a reduced fertilizer price since the fertilizer market is not yet a fully competitive one. [40]

3. Remove the VAT exemption of canned or packaged foods which are not generally consumed by the poor such as butter, cheese, ghee and mustard oil.

4. Remove the VAT exemption, at both import and domestic production levels, of other processed or manufactured goods, except those which are clearly identifiable as capital goods. A partial list of such goods has been provided in Table 11 of this report. Such exemptions have no economic rationale.

5. Withdraw the VAT exemption on domestically produced textile products. The exemption of this sector has substantially narrowed the VAT base, unduly depriving the Government of a substantial revenue, has created serious distortionary cascading effects of the VATs on imported textile inputs on domestic products, and, with the VAT on imported textile inputs and products and not on domestic production of such goods, has made the tax

40 The author recognizes that this recommendation may be a politically sensitive one, especially when fertilizer is being heavily subsidized by the Government. As argued before, the subsidization has, however, been a wrong policy which has been hurting the long-term interests of the farmers themselves. The VAT, if imposed on such inputs, will have, if any, a small cascading burden on the farmers -- which is not unwelcome in the event that the agricultural sector remains VAT-exempt.

non-trade-neutral and creates additional undesirable protection for the sector. The argument that this exemption is defensible on the ground that the sector is not in an economically healthy state is not tenable. The current specific excise duties on textile yarn and fabrics are a poor substitute for the VAT as they raise a small revenue, are inelastic and create distortive cascading effects.

6. Withdraw the VAT exemption of other products at domestic production stage, such as raw materials and spare parts of agricultural implements and weights and measures.

7. Withdraw VAT exemptions applied to some products at import stage only, such as homeopathic, biochemic, ayurvedic and unani medicines, some other medicines, radio-cassette recorders brought in by Bangladeshi nationals under baggage rules, and gold bullion. Such exemptions are unjustified.

8. Remove the current exemption from VAT of any industry on cottage industry ground. This exemption has created scope for extensive VAT exemptions and has significantly narrowed the domestic VAT base. It is unduly discriminating between so-called cottage firms and larger firms -- the former firms have, according to IMF May report, substantial competitive advantages in comparison with the latter ones operating in the same sectors. Currently the industries enjoying the cottage industry status are exempt from both VAT and the turnover tax.

9. Review the current apparently too liberal VAT threshold of Tk 1.5 million for an appropriate cut back in this level. Remove the simultaneous application of the VAT threshold in terms of capital size of a firm.

10. Eliminate deviations from the standard VAT procedures applied to specific products or services in assessing the VAT such as in the cases of edible oil, sugar, paper, bricks, razor blades, diesel engines and construction. Such deviations introduce inter-industry distortions in VAT burdens, create economic efficiency losses and are inequitable.

11. Eliminate VAT exemption being allowed to public sector production of gas, and other petroleum products under production sharing arrangement with foreign companies. The exemption is economically unjustified and it creates an undesirable distinction in tax treatment of private and public sector enterprises..

12. Extend the VAT to electricity, replacing the current low and inefficient specific duty of Tk 0.15 per kilowatt hour of electricity consumption. This will not hurt businesses as the VAT will be either creditable or refundable for domestic market-oriented and export firms.

13. Also bring services other than electricity, notably transport services, freight and fares under the VAT net. If businesses use such services, they also get credit for VAT paid on them.

14. Introduce or reintroduce supplementary duties on luxury and semi-luxury products and services at appropriate rates. Many such products currently remain outside the SD net, after many products were dropped from the SD list through the FY 95 Budget. A transparent rationale should be established for putting on an SD and for its level.

15. Reduce the present wide dispersion in the SD rates applied and reduce their number.

16. Remove the current anomaly in SD assessment of imports and domestic products appropriately changing the basis of assessment, as noted in paragraphs 6.31 or 6.32, to make the base comparable in both cases. The presently applied method of assessment erodes the protection provided to domestic production of goods subject to SDs. Also, to avoid cascading effects of SDs on business firms using such products or services, provide for crediting arrangement for SDs as in the case of VAT.

17. Reconsider, as the IMF recommends, the current low, 2 percent, turnover tax rate to raise it to 4 percent.

6.E.2 Recommendations Relating to VAT Administration

6.39 It should be noted that the efficiency of a tax administration depends also on how well the tax system has been designed. Too many exemptions, concessions or exceptions to the standard rates and procedures complicate tax administration. From this point of view, the recommendations made with respect to the VAT policy issues, if accepted and implemented by the Government, will also significantly improve administration of this tax system. Recommendations which relate directly to administration issues are noted as follows:

1. Put a fully operational computerized system in place to identify tax delinquents (who do not file tax returns or even register for VAT or pay less tax than is due) and stop-filers (who stop filing tax returns to avoid or delay tax payment), speedily process and cross-check tax returns and facilitate other administrative operations, including importantly tax refund operations which are handled by the Duty Exemption and Drawback Office (DEDO). The VAT refund operations should be transferred to the VAT and Excise Wing of the NBR.

2. Institute appropriate training programs to adequately train the VAT staff and recruit required specialist staff. Adequately train, as the IMF recommends, particularly the operational staff in VAT enforcement and audit methods.

3. Eliminate all exemptions by industry or service categories and oblige all potential taxpayers to register under VAT unless they get exemption by way of the defined tax threshold in terms of business size.

4. Demand proper invoicing and bookkeeping from the VAT registered units.

5. Institute also other measures (in addition to a satisfactorily operational computer system) such as formation of an appropriate inspection and investigation team and undertaking appropriate surveys to identify tax delinquents.

6. Institute appropriate arrangements to ensure prompt VAT refunds, where refunds are due after crediting adjustment, if any.

7. Ensure broad audit coverage, and expand, as the IMF recommends, particularly the audit coverage of larger firms.

8. In addition, the following IMF recommendations not covered above are endorsed:

   a. Simplify the forms and procedures of filing tax returns.

   b. Adopt a uniform taxpayer identification numbering system on the basis of the income tax numbering system.

   c. Establish a separate tax recovery unit.

7. REFORM ISSUES AND OPTIONS: IMPORT TARIFFS

7.A Introduction

7.1 As typical of a developing country in early stages of development, imports are traditionally used as a convenient major source of government revenue and the taxes on imports -- those which are not matched by taxes on domestic production -- also serve as protection to domestic production activities. As shown in Chapter 3, Bangladesh continues to depend very heavily on import taxes for its revenue, despite a recent program of tariff reform, incorporating substantial reductions in customs duties on numerous import items. As shown in Tables 5-A and 5-B of that chapter, such taxes accounted for about half of Bangladesh's total tax revenue during FYs 93 and 94 and 53.3 percent in the revised estimates of FY 95 -- of which VAT, which is mostly trade-neutral accounted for around 18 percent of total tax revenue during these years. Customs duties alone accounted for over 30 percent of total tax revenue. There has been only some gradual reduction in the contribution of customs duties to total tax revenue in recent years, but in the revised estimates of FY 95, this contribution increased again to 33 percent. In addition to customs duties and VAT, imports are subject to two other levies: an import LCA (letter of credit authorization) or import permit (IP)fee and an advance income tax, each at a rate of 2.5 percent of import value. The LCA/IPfee is not matched by any tax on domestic products; it thus adds to customs duties as a protective tariff on imports. In so far as advance income tax is concerned, it is a levy which is adjustable against future income tax liabilities of the importers. To the extent such adjustment does not in fact take place, this levy also turns out to be protective in effect. As shown in Table 13, during FY 93, these two levies accounted for 7.7 percent of total import tax collection, while customs duties accounted for 57.8

Table 13: Import Tax Receipts, FY 1991/92- 94/95 (up to Dec 94)
(Billion taka and percent of total)

Revenue Source	1990/91		1991/92		1992/93		1993/94		Jul Dec 94	
	Revenue	% of Total	Revenue	% of Total	Revenue	% of Total	Revenue	% of Total	Revenue	% of Total
Customs duty(a)	29.74	73.6	25.92	63.5	25.27	57.8	27.59	57.0	16.29	55.7
VAT(b)	7.98	19.7	11.96	29.3	14.89	34.1	16.42	33.9	9.86	33.7
Supp. duty	-	-	0.22	0.5	0.21	0.5	0.64	1.3	0.72	2.5
LCA fee	1.2	3.0	1.21	3.0	1.55	3.5	1.69	3.5	1.09	3.7
Adv. inc. tax	1.5	3.7	1.48	3.6	1.83	4.2	2.04	4.2	1.30	4.4
Total receipts	40.42	100	40.79	100	43.69	100	48.38	100	29.26	100
Assessed value of imports	107.49		106.17		107.26		113.26		75.78	
Cus. duty as % of assd. imp. value	27.7		24.4		23.6		24.36		21.50	
Tot. receipts as% of assd. imp. val.	37.6		38.4		40.7		42.7		38.6	

Notes: (a) FY 1990/91 includes development surcharge and regulatory duty. (b) Sales tax in FY 1990/91.
Source: World Bank, *Bangladesh: From Stabilization to Growth*, March 17, 1994, p. 63 and NBR.

percent of such revenue and the VAT and SDs on imports provided the remaining part. Officially fixed "tariff values", if higher than actual invoice values of imports and if used for assessment of taxes on imports, also serve as an additional revenue and protective instrument.

7.2 Import tax reform issues, as earlier indicated, fundamentally concern rationalizing them with a view to liberalizing imports, reducing and rationalizing protection for domestic activities, and streamlining tax administration. The overwhelming need is to reduce the current high relative dependence on the protective levies, primarily customs duties, and rationalize them around a moderate level of nominal protection to maintain a fairly even structure of effective protection for domestic activities with a moderate mean rate of such protection. The net effect of these reforms will most likely be revenue reducing, which will have to be compensated by increased domestic taxation and, in part, by upward adjustment, where found possible and appropriate, of supplementary duties on imports as well as on same domestic products. One issue relates to the tax instrument to be used for protective purposes. For the sake of transparency and avoidance of tariff anomalies, it is important that customs duties alone are used as this instrument and all others are eliminated or phased out.

7.B Recent Progress Made in Tariff Reform

7.3 As briefly noted in the last chapter, import tariffs have been considerably restructured in recent years. The dimensions of tariff reform are gauged in terms of several criteria such as (1) a reduction in the maximum operative customs duty rate, (2) a reduction in the scale of the cascading nature of the tariff structure, (3) a reduction in the number of tariff rates used, (4) a decrease in user-defined tariff distinctions, (5) a decrease in tariff distinctions within a commodity group, particularly having the same tariff code, say at the four-digit level, (6) elimination of non-tariff levies on imports having a protective effect, or neutralizing such levies by commensurate domestic taxation, (7) cessation of the use of official tariff values, which may be higher or lower than actual import costs, for assessment of import taxes, and (8) removal of discrepancy in the bases used for assessment of VAT and supplementary duties on imports and on domestic products. The key summary criteria to judge a real shift to tariff rationalization are lowering of the maximum tariff rate to a moderate level and a move toward uniformity in the tariff rates, closer to the mean rate. It is such a tariff structure which can ensure a tolerable level, and a fairly even structure, of effective protection for domestic activities, thus causing no serious bias against export activities. The compelling reasons for tariff reform (and reform of trade policy involving quantitative import restrictions) are that:

a. Protective tariff and trade policy, by affecting effective rates of protection, distorts pre-tax rates of return on investments -- creates an anti-export bias as well as differential incentives for domestic market-oriented activities -- and thus misallocates resources;

b. Such a policy affects the competitiveness of export activities by raising the prices of domestically produced goods used as inputs for export production and by raising the cost of imported inputs through inadequate offsets received on the tariffs on such inputs; and

c. It distorts (overvalues) the exchange rate thus further hurting export activities.

7.4 The Government's present export promotion strategy, which still retains substantial protection for import-substitution activities and purports to compensate exporters through special bonded warehouse or duty drawback facilities and provides only partial compensation for the protection element embodied in domestically produced goods used as inputs in export production, is failing to produce enough export diversification and growth. In the ultimate analysis, there is no viable option left for the Government except to accelerate the process of trade liberalization through tariff and trade policy reform, which has been carried only to a limited extent to date. True, further trade liberalization may adversely affect some of the domestic industries. However, if trade liberalization is combined with appropriate exchange rate devaluation, the lost protection due to trade liberalization could be retrieved in substantial part. Furthermore, industries unable to compete with a more liberalized trade situation are essentially suffering from structural problems. Such problems can be more efficiently handled through appropriately designed restructuring assistance policy. Or, in case industries are too inefficient to be helped by any workable restructuring policy, it would nevertheless be more sensible to pursue the liberalization policy and let highly inefficient industries exit from the market. A policy of keeping high protection for certain industries would only serve to perpetuate the inefficiency of such industries, penalize Bangladesh companies with an internatiuonal comparative advantage, delay a surge in Bangladeshi workers and in general harm the longterm growth potential of the economy. An assessment of recent progress made in tariff reform is provided below.

7.5 Tariff reform was begun in earnest in FY 92 when the VAT was first introduced. The very introduction of the VAT was in itself a significant reform change of the overall import taxes and at the same time became an important instrument to help tariff reform. One World Bank study estimates that the replacement of the previous import-discriminating multiple-rate sales taxes (and cascade-type domestic excise taxes) by a trade-neutral uniform VAT on both imports and domestic products meant up to 20 percent reduction in nominal protection levels.[41] It also provided the Government with an alternative revenue instrument to press ahead with further tariff reduction with less concern for revenue lost. It enabled the Government to introduce or raise supplementary duties on both imports and domestic products compensating for lowered customs duties on imports. The following tariff reform changes have been effected during recent years.

a. The top customs duty (CD) rate has been brought down to 60 percent in FY 95 and 50 percent during the current year from 400 percent in FY 91, 350 percent in FY 92, 300 percent in FYs 93 and 94. Before making what appears to be a radical shift in FY 95, the Government drastically lowered the CD rates on many import items which were above 100 percent duty rate during FY 93 and above 75 percent duty rate during FY 94.

b. The number of import items under zero CD rate was reduced from 393 eight-digit items in FY 90 to 309 eight-digit items in FY 94. However, since FY 95 following introduction of full CD exemption on some additional industrial inputs and machinery items, the number of fully CD-exempted items increased dramatically to 1,218 in FY 95 -- even

41 Kamil Yilmaz and Sona Varma, *Trade Policy Reform in Bangladesh*, Draft, World Bank, March 27, 1995, p. 9.

when compared to the situation in FY 90.[42] This situation has turned still worse during the current year with more goods put under the zero rate.

c. Notwithstanding the development as reported under (b), a considerable compression in the CD rates has been effected due to moderation of the top duty rate. The number of operative general CD rates used including the zero rate has also been considerably and progressively reduced, from 18 in FY 91 to five non-zero rates in FY 95 and six during the current year with 7.5 percent as the first standard non-zero rate. Previously, lower non-zero rates of 5 and 2.5 percent were also used -- 5 percent in FY 92 and both 5 percent and 2.5 percent before FY 92. However, in addition to the five non-zero general rates applicable at present, some concessionary rates are applied for items imported under Bangkok, Bhutan and Generalized System of Trade Preferences (GSTP) agreements, under baggage rules and for some other reasons where some non-standard CD rates apply.

7.6 As a result of the tariff restructuring, the average duty rate as a percent of assessed import value has gone down to 21.5 percent in FY 95 from 27.7 percent in FY 91. During the same period, however, the total import tax as percent of assessed import value has rather gone up a little, from 37.6 percent to 38.6 percent. The FY 95 rate reflects a more substantial reduction over the previous year's peak overall average import tax rate of 42.7 percent (Table 13). The decline in the average CD rate contributes to a decline in the average level of nominal protection for domestic import-substitution activities. Other import taxes, however, also contribute to nominal protection. During FY 91, several import levies, such as development surcharge, regulatory duty, sales tax (after adjustment with domestic excise tax), LCA/IP fee and advance income tax (not refunded after adjustment with final income tax liability), also provided protection. During subsequent years, some of these levies were dropped but the LCA/IP fee, advance income tax (not refunded) and unilateral VAT on imports not matched by domestic taxation (such as that on textile yarn and fabrics) are still additive to the CD rate as protective import levies. As estimated by the World Bank and Excise Tax and Customs (ETAC) project of the NBR, recent efforts for tariff reform, including VAT introduction, have resulted in a substantial decline in the average nominal protection rate. The import-weighted average protection rate has declined by half, from 42 percent in FY 91 to 21.5 percent, in FY 95, while the unweighted mean protection rate declined to a near third, from 89 percent to 30 percent, over the same period. (The import-weighted mean of CDs is a better measure than the unweighted one since the latter is an arithmetic average of all CDs regardless of whether any items are imported or not.) These and several other effects of the tariff reform carried out in recent years are summarized in Table 14.

7.7 As the table shows, the substantial progress in tariff liberalization in terms of a decline in the nominal protection rate has, however, not been accompanied by a decline in the coefficient of variation in the nominal protection rate. The coefficient of variation declined in FY 93, from the increased level of FY 92, and then slightly rose again in FY 94, and then rose further in FY 95. This

42 World Bank, *Trade Policy Reform*, op. cit., Appendix Table 1.

Table 14: Some Effects of Tariff Reforms, FY 91-94
(Percent, unless otherwise noted)

Description	FY 91	FY 92	FY 93	FY 94	FY 95
Nominal Protection Rate (% of assd. import value): (a)					
Unweighted mean	89	59	50	39	30
Coefficient of variation	59	68	62	63	74
Import-weighted mean (b)	42	40	30	28	21
Number of ad valorem customs duty rates	16	18	15	12	6
Number of HS-8 codes with:					
Customs duty rate = zero	313	349	340	309	1212
Customs duty rate = 100%	2489	2352	769	40	0
Customs duty rate above 100%	268	241	46	17	0
Customs duty rate = 75%	0	207	1529	636	0
Customs duty rate above 75%	2763	2567	815	57	0
Customs duty rate = 60%	574	2863	1996	1699	905
Customs duty rate above 60%	2763	2774	2344	693	0
Total import tax rate (% of assd. import value): (c)					
Unweighted mean	91	84	72	58	40.5
Coefficient of variation	59	57	53	60	not estd.
Import-weighted mean (b)	44	59	45	43	35.5
Percentage share of customs revenue from goods with: (b, d)					
Customs duty = Zero-15%	8.7	13	19.1	21.9	29.4
Customs duty = 16-29%	29	11.9	0	0	0
Customs duty = 30-60%	35	50.4	63.2	68.1	70.6
Customs duty = 75-100%	6.4	16.8	16.9	9.6	0
Customs duty above 100%	20.9	7.8	0.8	0.5	0

Notes: (a) FY 91 includes customs duty, development surcharge, LCA fee, advance income tax (not refunded), and sales tax minus domestic excise (est.). For other years, sales tax is replaced by the protective impact of the VAT (for textiles),, and allowance is made for the negative impact of supplementary duty.
(b) FY 91 is weighted by CY 91 imports. FY 92 is weighted by FY 92 imports, FYs 93 and 94 imports are weighted by FY 93 imports.
(c) Ad valorem rated imports (i.e., excluding specific rated petroleum imports before FY 95).

Sources: 1. World Bank, *Bangladesh: From Stabilization to Growth*, March 17, 1994, Table 2.1, p. 61
2. -------------, *Trade Policy Reform in Bangladesh*, Draft, March 27, 1995, Appendix Table
3. ETAC project, NBR and estimates by author

suggests that dispersion in protection rates has widened leading to a wider variation in effective protection rates.[43] (More on this later.)

7.8 Considerable compression in tariff rates has been effected, progressively over the years, in terms of both a reduction in the number of ad valorem CD rates used and a lowering of the top operative CD rate. In the latter case, the number of eight-digit import items, with rates above both 75 percent and 60 percent CD rates during FY 91, was as large as 2,763 -- i.e., 29.8 percent of the total. This number was reduced over the years to zero last year, while 909 items which were subject to the 60 percent duty rate were shifted to the 50 percent top duty rate this year -- which means that no item is now subject to a duty rate above 50 percent. At the same time, specific duty rates, which were being applied to some products, were eliminated, except only on monetary and nonmonetary gold.

7.9 Table 14 also shows that some 70 percent of customs revenue is now being collected in the 30-60 percent CD range, while the remainder is collected in the zero-15 percent CD range. While the relative collection has marginally increased in the higher duty range compared with previous two years, the increase in this collection in the lower duty range has been significantly more pronounced. Since total CD collection has not recorded much decline in spite of tariff restructuring, the distribution of CD collection suggests that the Government's revenue concern has been largely protected. It also suggests, as the World Bank notes, that the tariff reform program was influenced by revenue concern and where imports were sizeable, tariffs were not significantly changed.[44]

7.10 There has nevertheless been considerable import liberalization in terms of coverage of imports made in the low to moderate duty ranges. As values of imports assessed for duty purposes by the NBR during FYs 93 and 94 and in the first six months of FY 95 show (not shown in the table), the share of imports made under the CD range 0-15 percent has been approximately 60 percent, even excluding imports under back to back Letter of Credit arrangements, which also come duty free. The remaining about 40 percent of imports came under the CD range of 30-60 percent. However, no significant shift took place in imports in the lower duty range during these two and a half years.

7.11 Import liberalization has been further carried forward by the current year's, FY 96, budget. The top customs duty rate, as already mentioned has been reduced further to 50 percent and reductions in numerous tariff rates, especially on raw materials and intermediate goods and some more capital items have been made. The duty rate on some 1,028 industrial and other inputs has been reduced from 30 to 22.5 percent. In addition, lower tariffs on many other items have been further

43 One might contend that the coefficient of variation may not fully faithfully reflect the change in dispersion in protection rates, since the coefficient depends on the movement of both the standard deviation and the mean. When the decline in the mean is faster than in the standard deviation, the coefficient of variation, which is standard deviation divided by the mean, can increase even when there is a decline in the standard deviation, which may in fact reflect a decline in the dispersion of protection. In the current case, this has reportedly happened. Therefore, the conclusion that dispersion in nominal protection rates has increased is not incontrovertible. However, the retention of a great deal of cascading in the tariff structure, with lower tariffs on raw materials and intermediate products and higher tariffs on final outputs, may, indeed have left a high dispersion in effective protection rates. (See discussion later in the text).

44 World Bank's 1994 country economic report, <u>op. cit.</u>, p. 63.

reduced. On several items, as already noted above, duties have been completely withdrawn. However, these changes appear to have further widened tariff dispersion, with consequent deterioration in the dispersion in the resulting incentive effects (effective protection rates) on various domestic products.

7.C Further Reform Issues of Import Tariffs

7.12 Although good progress has been made in reduction of the average economy-wide nominal protection rate, the reform of the import taxes remains deficient in a number of important ways as follows:

a. The top tariff rate, and the effective protection rate it leads to, is still too high. The Government's phased tariff reduction plan envisages reduction of the top rate consistently with the need for reducing the effective protection to a low level comparable with international levels. Most successful developing countries in East Asia and Latin America have reduced their top tariff rates to 15-30 percent levels. Sri Lanka has brought down its highest tariff rate to 35 percent. Bangladesh should accelerate its tariff reduction to such levels. It should be able to soon achieve this goal without substantial revenue loss. Since the average import-weighted nominal protection rate is now about 20 percent, the highest duty rate of 25 percent should be achievable without any significant net revenue loss if it is accompanied by a further compression in the tariff rates which would involve reducing the number of zero tariff items and an adjustment upward of the low tariff rates on many items.

b. Indeed, the tariff reform goal should be to bring about a fair degree of uniformity in the various tariff rates used. The current structure of tariffs is highly discriminatory in terms of the protection it provides various sectors and products. With zero duty on many input items and low tariffs on intermediate-stage products and high tariffs on outputs, a cascaded tariff structure results. This generally leads to high effective protection rates and usually to a wide variation in such incentives. "Effective protection", as distinguished from "nominal protection", is a meaningful and proper measure of protection to an industry. Trade and tariff policy-created effective protection is usually the most important incentive industries receive.[45] (More on this later.)

c. The current taxes on imports also suffer from the shortcoming that instruments other than the customs duty are still being retained. These continue to play, or can play, the same protective role as customs duties. Tariff reform requires elimination of these other levies, notably the 2.5 percent LCA/IP fee and the official tariff values used in assessment of import taxes. The Finance Minister has announced in this year's budget that the LCA/IP fee will be in the tariff rate in a phased manner. Some progress in this direction has been made by the budget by removing this

45 "Nominal protection" of a product is defined as the extent its domestic price is raised over its world (border) price, which is generally done by a tariff on the comparable import item. However, since nominal protection to a product can be offset or eroded by nominal protections to its raw materials and intermediate inputs, it is "effective protection", given by the net result of nominal protections to both output and inputs, which really matters as an incentive.

fee on: (1) all zero-duty imports, (2) all agricultural seeds, (3) feed and medicines for poutry and livestocks, (4) machinery used in agricuture, poultry and livestocks, and (5) some inputs of textile industries including cotton yarn. However, this kind of exemption of the LCA/IP fee on sporadic cases and especially involving goods where the duty is zero or low does not really mark any progress in rationalization of the tariff structure, but rather further widens the dispersion in this structure with more adverse effects on the dispersion in the resuting effective protection rates. To rationalize the tariff structure, it is necessary that the LCA/IP fee is removed from all goods without delay with appropriate adjustment in the tariff rates.

d. The World Bank documented that the use of tariff values raised protection beyond levels that were ostensibly suggested by the existing customs duty levels.[46] The Government has, in November 1994, introduced a modification of the voluntary preshipment inspection mechanism in place, which now enables importers to have certified values of imports made by a recognized offshore agency prevail over the official tariff values. This is a step toward import tax reform. However, since official tariff values can work in both directions -- in raising protection or lowering it depending on whether the tariff values are higher or lower than the actual import values -- and since importers may not always care to have separate values assessed by an offshore agent as long as it is on a voluntary basis and particularly as they now have to pay the assessment costs, it is advisable that the tariff values be removed altogether as an instrument for customs assessment purposes. To protect Government revenue, it should rather think in terms of introducing a compulsory system of preshipment inspection for import valuation purposes, the cost of which should entirely be borne by the Government, as the World Bank recommended in its second industrial sector adjustment credit (ISAC-2) program with the Government.

e. User-defined tariff distinctions and those within similar product categories are still being retained. These distinctions should be completely abolished. All concessionary duty rates currently being used -- except probably those reached under Bangkok, Bhutan and Generalized System of Trade Preferences (GSTP) agreements, and except those provided for export activities -- should be eliminated. These include concessionary duties for capital goods if they are destined for underdeveloped regions of the country, imports under baggage rules, capital machinery for textile industries, certain agricultural and pharmaceutical industry inputs, and certain electrical items.

f. Some items have VAT collected on imports but not on domestic production, including importantly textile products. This unilateral collection of VAT causes a distortion in the tariff structure, providing protection to domestic production of such items beyond levels suggested by customs duties. It is essential that the VAT exemptions provided on such domestic production be withdrawn. (See arguments for VAT replacement of low excise duties on textile products in the last chapter.)

g. There also remains an anomaly in the basis adopted for assessment of supplementary duties on imports and domestic products, as mentioned in the last chapter. This anomaly also

46 See World Bank's 1994 country economic report, op.cit.

needs to be removed so that customs duties alone will be the only instrument to protect domestic industries. This will make the level of protection on various products more transparent.

h. Finally and not least, the remaining trade-related quantitative restrictions on imports of some 40 four-digit items -- which include grey and finished textile fabrics, sugar, salt, films, some electronics, engineering and metal products, and some transport equipment -- should be withdrawn without further delay. This is an essential element of needed tariff reform. These restrictions are providing excessive, arbitrary and precisely undeterminable levels of protection to these industries.

7.13 Currently capital machinery and equipment and, along with such machinery and equipment, spare parts up to 10 percent of the value of machinery are eligible for a general concessionary duty of 7.5 percent. A further concession of 2.5 percent is made for such machinery and equipment if these are for industries located in underdeveloped regions. Export-oriented industrial firms are eligible for a further 2.5 percent duty concession on such machinery, which means that such machinery pays 5 percent duty for industries located in developed regions and 2.5 percent duty for industries located in underveloped regions. One hundred percent export industries are eligible for full duty exemption. These duty concessions for export industries should be rationalized by according duty exemption on a pro-rata basis rather than providing a fixed duty concession and eliminating the concession based on location of industries. As previously argued in the context of income taxes, offering special tax concessions on regional consideration is not a good economic policy.

7.14 As can be observed from Table 15, significant differences still exist at the sectoral level in nominal customs duties and hence in nominal protection. In terms of import-weighted mean (FY 94 imports were used as weights), which is more meaningful than unweighted mean, the following intersectoral and subsectoral differences in average customs duties can be observed:

a. The average customs duty on manufactured products is 26.2 percent, which is double that on agricultural goods, while that on mining sector goods is about 40 percent higher than that on manufactured products. On the other hand, the intersectoral and intrasectoral variation in duties, represented by coefficient of variation in the customs duties, is much higher in mining and manufacturing sectors than in agricultural sector.

b. Of the manufactured products, consumer goods receive the highest average duty protection at 33.8 percent, followed by intermediate goods at 29.4 percent, and capital goods at a moderate 14.4 percent. Intragroup differences in the duty protections received by capital and intermediate goods are considerably higher than in the case of consumer goods. One reason why the intragroup differences in duties is so much higher is that part of such goods come at special concessionary duty rates including zero duty rate.

Table 15: Intersectoral and Intrasectoral Differences in FY 95 Average Customs Duties
(In percent)

Sector/Subsector/ Goods group	Unwtd.Mean	Coeff. of Var.	Import-wtd. Mean	Sector/Subsector/ Goods group	Unwtd. Mean	Coeff. of Var.	Imp-wtd. Mean
1 Agriculture	31.9	53.1	13.3	351 Industrial chem.	19.7	61.9	17.5
2 Mining	12.9	80.2	36.6	352 Other chemicals	26.1	63.2	18.6
3 Manufacturing	25.8	74.9	26.2	353 Petrol. refining	47.4	36.1	57.6
-11 Consumer goods	42	42.9	33.8	354 Petrol., coal prod	23.2	48.7	10.5
-12 Intermed. goods	23	67.6	29.4	355 Rubber prods.	29.3	63.9	30.7
-13 Capital goods	14.1	102.5	14.4	356 Plastic prods. nec.	24.8	71.2	33.37
-311 Food manufg.	38.4	37.8	39.7	361 Ceramic prods.	25.8	99.7	27.2
-313 Beverages	44.5	47.9	56	362 Glass, glass prod.	37.1	59	43.4
-314 Tobacco	47.1	11.1	46.6	369 Other nonmet. mineral products	23.3	77.3	15.7
-321 Textiles	44.9	43.3	21	371 Iron, steel, metal products	29.1	47.4	23.3
-322 Wearing apparel	57.8	10.6	58.2	372 Nonferrous metal products	22.2	60.1	17.4
-323 Leather products	31.3	28.6	35.7	381 Metal prods. nec.	21.7	86.3	25.4
-324 Footwear	56.4	17.3	39.4	382 Nonelec. mach.	13	112.6	13.9
-331 Wood, cork, prods.	21.1	67.9	11.6	383 Elec. machinery	17.9	91.9	18
-332 Wooden furn., fixt.	45	0	45.1	384 Transport equip.	26.4	70.4	21.9
-341 Paper products	37.9	38.4	40.8	385 Scientific equip.	17	93.1	15.2
-342 Printing, publish.	23.7	87.2	13.9	390 Other manufg.	37	40.9	30.8

Source: ETAC project, NBR

c. A wide dispersion can be observed in the average duty rates at the three-digit manufacturing subsector level. Beverages, tobacco, wearing apparel, refined petroleum products, glass and glass products, and paper products continue to receive duty protection higher than 40 percent. Even higher nominal protection is received by these products if the effect of the LCA/IP fee is added and the extensive use of tariff values is considered. Food products, footwear, leather products, plastic products, and also textiles, if the effect of unilateral VAT is added, receive average duty protection of more than 30 percent. On the other hand, many other products receive average levels of duty protection in the range of 20-30 percent, while several other industry subsectors such as wood, cork and their products, printed and published materials, chemical products, certain nonmetallic mineral products, nonferrous metal products, machinery receive lower than 20 percent duty protection.

d. Note also the wide spread in the variance coefficients of the duty averages at the subsectoral level. High variance coefficients found in the case of many of the subsectors signify wide differences being maintained in the treatment of specific production activities in these subsectors in terms of duty protection provided to each production activity.

7.15 Along with tariff differences at sectoral and subsectoral level, which are also contributing to a cascading structure of tariffs according to the nature of products -- primary, intermediate or final -- or the stage of production where such products are produced or used, a serious problem with the current tariffs is deliberate incorporation of significant cascaded tariff distinctions for raw materials and intermediate inputs and final outputs. There are numerous product chains, where the CD rate currently maintained is 50 percent on final products and 45 or 30 percent or lower rates on their major inputs. Similarly CD structures of 45 percent for outputs and 30 or 22.5 percent or lower rates for inputs, 30 percent for outputs and 22.5 or 15 percent or lower rates for inputs, and 15 percent for outputs and zero percent for inputs are common. These cascades are being maintained without realizing how serious the distortions these tariff distinctions introduce into the structure of incentives -- through effective protection -- to domestic activities. Examples of the variations in incentives -- as a result of variations in effective protection rates -- caused by cascaded tariffs are provided in the Annex. Some of the consequences of the cascading tariff structures to incentives for various activities can be summarized as follows:

a. The effective protection rate (EPR) is higher than the nominal protection rate (NPR) on final products. The difference in the EPR and the NPR becomes greater as the the absolute level of the NPR on final products increases and as the difference between the NPR on the final product and that on inputs increases, given in a free trade situation, the same ratio of value added to the value of the final product.

b. The same difference in cascading tariff rates (e.g., 50 percent on output and 35 percent on inputs as opposed to 45 percent on output and 30 percent on inputs) can lead to very different EPRs depending upon how much value added is created by the activity. The differences in the incentives are higher, the lower is the value added proportion.

c. Even very low nominal tariffs on outputs can yield very high EPRs with a constant percentage differential between the tariffs on outputs and inputs. Thus assembling activities and light manufacturing activities where value added is generally low, say between 1 percent to 20 percent, even a 15 percent tariff on output combined with zero tariff on inputs will result in very high EPRs -- in the range of 75 to 1,500 percent (See Annex Table ...).

7.16 While the general pattern of the tariff structure in Bangladesh is what has been described above, there have also been exceptions made to this general pattern. There are product cases where tariffs on final outputs are the same or fairly similar to those being maintained on major inputs of such products. Some examples of such product cases are electric compounds, paper board, washing soap (not toilet soap), hand and edge tools, nails, and hand pumps. Existence of such examples in the tariff structure does suggest that it should not be a very difficult task for the policy makers to proceed toward a uniform pattern of tariffs, which is indeed the most desirable pattern to maintain. It would also contribute to the "level playing field" among domestic manufacturers.

7.17 Another but most undesirable pattern -- providing the obverse result of the cascaded tariff system -- that can also be observed is product cases where tariffs, including LCA/IP fee, on final outputs are lower than those on their major inputs. Some examples of such cases, which could be readily identified, are shown in Table 16. These include bicycles (25 percent tariff on bicycles and 47.5 percent tariff on major inputs), printed books (zero tariff on with books and positive tariffs on paper and printing materials), certain pharmaceutical products (with lower tariffs on output and

Table 16: Some Examples of Tariff Anomalies with Lower Tariffs on Outputs than on Inputs: FY !995/96

Product, Input(s)	HS Code	CD (%)	Total Tariff(a) (%)	Product, Input(s)	HS Code	CD (%)	Total Tariff(a) (%)
Bicycles	8712	22.5	25.0	Diesel engines	84089000	0	0
-Cycle frame	871491	45.0	47.5	-Cast iron	72069000	15	17.5
-Cycle spoke	8714921	45.0	47.5				
-Cycle tyre	40115000	30.0	32.5				
				-Cast aluminium	76169020	45	47.5
Books	4901	0	0	-Cylinder head	84099190	30	32.5
-Paper	4802510	45.0	47.5	-Injector assembly	8409999	30	32.5
-Paper	480260	15.0	17.5				
-Printing ink	3215 10	45.0	47.5	Industrial machinery and spare parts	8456-8465 8433900	0-7.5 (mostly)	0-7.5 (mostly)
Medicines, some categ.	3004500	0	0	-Cast iron	7206900	15	17.5
-Pharm. ingredients	2936220	7.5-22.5	10.0-25.0	-Alumiminum scrap	7602	7.5	10
-Glucose syrup	17023091	45	47.5	-Rice hauller	84371	15	17.5
Antacid suspension	30042	7.5	10	-Bolts, nuts	73181600	45-50	47.5-52.5
-Aluminium hydroxide	28183	15	17.5	Electric motors	85013200	15	17.5
-Glucose syrup	17023091	45	47.5	-Cast iron housing	72069000	15	17.5
-Glass container	70109020	30	32.5	-Copper winding wire	85441100	45	47.5
Fertilizer	3100, 31021	<0	<0	-Silicon sheet	72251000	22.5	25
-Natural gas	271121	(b)	(b)	-Rotor	85030000	30	32.5
-Nitrogen	28043	15	17.5				
-Jute sacking	53101019	(c)	(c)				

Notes: (a) Including 2.5 % LCA/IP fee; (b) Domestic price/world price not known; (c) Higher than export price as includes VAT.

higher tariffs on inputs), fertilizer (with a negative tariff, i.e., government-directed lower than world price on output and positive tariffs on imported inputs), diesel engines, electric motors, and machinery and spare parts (much of which come duty free or at concessionary duty rates) which have lower duty rates on outputs than on their major inputs. These are undesirable tariff anomalies, which are generally cited by the manufacturers as the proper tariff anomalies. Such tariff anomalies need to be corrected. Note also that, in the table tariff rates shown are the regular ones in place. In some cases such as electric motors, diesel engines and industrial machinery and spare parts, the industries are allowed to import some of their materials at special concessionary duty rates (e.g., diesel manufacturers can import cylinder head and injector assembly at a concessionary duty rate of 7.5 percent, in place of the regular 30 percent rate, industrial machinery and parts makers can import bolts and nuts at the 7.5 percent duty rate instead of the 45 percent duty rate, and electric motor makers can import SECW (copper winding wire) and rotor at the same 7.5 percent duty rate in place of the 45 and 22.5 percent duty rates respectively applicable to them) when they import as industrial importers -- for which they need an import passbook with special rawmaterial entitlements. However, such special duty concessions do not appear to fully remove the overall tariff anomaly these industries face. Furthermore, special duty concessions allowed to specific groups of importers and not to all of them importing the same products are also not a desirable policy as this creates scope for abuse of the special concessions allowed and complicates customs administration and involves Government administration in determining import entitlements of particular groups. This is further import and industrial regulation rather than deregulation and movement toward a freer trade regime, which the Government's ongoing policy reforms should envisage.

7.18 In reforming taxes on imports, it is crucially important that the differences in incentives, in other words, differences in effective protection rates (EPRs), that result from such taxes, be kept in mind because EPRs provide signals that influence investors' choice of activity. (A 30 percent EPR means that value added is increased by 30 percent, which means that investors' profits are increased even more, since value added also includes, besides profits, wages and salaries paid on labor and employees and interest paid on borrowed capital). It is not widely appreciated that the cascaded structure of a tariff system can have as much, or more, impact on the pattern of incentives as the level of tariffs. Proceeding toward a uniform and moderate protection-creating customs duty replacing the current multiple rate structure would, therefore, be a critical requirement of the ongoing tariff reform program in Bangladesh. In reforming trade taxes, the Government needs to focus primarily on the resulting incentive effects, i.e., EPR rates, that the proposed taxes will create. In the ongoing tariff reform program, the Government is reportedly planning to move toward a tariff restructuring with 45 percent tariff put on final consumer goods, 30 percent on intermediate inputs and 15 percent on raw materials, with a higher than 45 percent rate used sparsely for protective purposes[47] if recommended by the National Tariff Commission with sufficient justification. As we have observed, this tariff structure, if put into place, will be a very unsatisfactory one. The idea, therefore, should be eschewed in favor of a fairly uniform pattern of tariffs closely clustering around a moderate level. The most preferred pattern would, of course, be a straight single and moderate rate used for virtually all imports, such as is found in some oil-rich Middle East countries. However, some small variation in the tariff rates can be tolerable as these are unlikely to introduce serious distortions in incentives.

47 See Zahid Hussain, "Recent Reforms of Indirect Taxes in Bangladesh", in *Fiscal Frontiers*, op. cit.

7.D Summary of Recommendations on Import Tariffs

7.19 In light of the foregoing discussion, we may summarize our recommendations on import tariffs as follows:

a. Introduce a standard customs duty (CD) rate at 20 percent, with the lowest rate fixed at 15 percent and the highest rate put at 25 percent. This rate structure will have minimal, if any, adverse revenue effect, since the current average CD rate on imports assessed for duty purposes is about 20 percent. The ongoing tariff reform program should, therefore, proceed toward lowering the top CD rate to 25 percent. On luxury and semi-luxury goods, the tariff cut should be accompanied by commensurate raising of supplementary duties on them. This will protect the Government revenue, which is coming from high duty items.

b. Put the 15 percent tariff on all import items, which are currently granted a zero rate. Provide duty drawback on duties paid on imports used in export activities, and where bonded warehouse facilities are available, provide duty exemption on inputs imported into such bonded warehouses for export activities. Remove all current duty concessions provided on capital goods imports, except the duty drawback or exemption as available for export activities.

c. Remove all user-defined tariff distinctions and those between similar products, especially within a four digit HS code.

d. Remove the import LCA fee. In so far as the advance income tax is concerned, it is advisable that this levy on imports of capital goods be also removed, while it may be retained on other imports. This levy on capital goods imports is having an adverse effect on investment.

e. Phase out the use of tariff values for assessment of duties without any delay and introduce the preshipment inspection for valuation of imports for duty assessment on a compulsory basis. Make available the preshipment inspection service free of cost to the importers. The cost should be borne by the Government.

f. Use a similar comparable base for assessment of supplementary duties on both imports and domestic products, as noted in connection with the value added tax.

g. If the Government fears, and the business community feels, that the proposed tariff reform will be too drastic and will unduly erode protection to domestic activities, this reform plan should be accompanied by an appropriate devaluation of the Taka. In fact, every trade liberalization resulting from tariff and trade policy reform should put pressure on the exchange rate to depreciate. In such an event, it is quite sensible and indeed advisable to combine trade liberalizing reform efforts with an appropriate exchange rate adjustment. Just as a tariff provides protection to an import-substituting activity, and a subsidy provides a similar protection to an export activity, so an exchange rate adjustment also provides a similar protection to both import substituting and export activities. An exchange rate adjustment is a superior method of protecting domestic production activities, since it is nondiscriminatory between economic activities.

h. Finally, we recommend that all quantitative import restrictions which are still being retained for trade (i.e., protection) reasons be removed without further delay. The CD structure should alone be allowed to play the protective function and do so transparently. Quantitative restrictions are an anachronism, which are inefficient, inequitable, and untenable in the current global context.