

Policy Memo for Budget 2022-23

Using Direct Taxation to Reduce Inequality and Boost Revenue

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Submitted by

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About This Policy Memo

This note sets out RAPID's recommendations for reforming direct taxation to tackle rapidly rising inequality while at the same time strengthening domestic resource mobilization effort. Some of the proposed reform measures can be initiative in the 2022-23 fiscal year. These recommendations have been prepared based on research RAPID consultations with experts and former senior policy makers dealing with taxation related issues. RAPID would be keen to engage with the MoF and/or NBR to discuss and review these recommendations and other relevant issues.

Rationale for Reform

Bangladesh has achieved commendable socio-economic development over the past decade, and compared to many other countries at a similar stage of development, it achieved faster progress in various social and human development indicators such as health, education, poverty reduction, nutrition, demographic, and gender equality outcomes. In the face of the onset of the Covid-19 global pandemic the Bangladesh economy has shown tremendous resilience. However, despite the significant growth in the per capita income, the overall tax effort in the country has remained quite low (around 9 percent) and much smaller than that of in many other competing countries. While the low tax-GDP ratio can stimulate growth giving higher spending capacity to the people as well as to business enterprises, rising income inequality in the county has become a major concern. The income share of the richest 5% of the population increased from around 17 percent in the 1990s to 30 percent in 2016, while the same share for the bottom 5% declined from an already paltry 1.03 percent to just 0.23 percent.

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

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

State of Income Tax in Bangladesh

Bangladesh is highly dependent on indirect taxation for revenue mobilisation with two-thirds of its tax revenue coming from indirect tax. Although the revenue from income taxation has increased in absolute terms, it is rather striking that the income tax revenue-GDP ratio has declined considerably from a peak of 3.22 percent in FY14 to 2.62 percent in FY20.

The government did undertake different reform initiatives to boost direct tax revenues. These include enlarging the tax base by introducing the Taxpayer Identification Number (TIN); arranging an annual tax fair; cross-checking bank accounts, utility bills, and home rentals; and introducing a large taxpayer unit. Furthermore, a new income tax act has been introduced. However, some of these measures suffer from implementation challenges leading to less than satisfactory performance in the collection of direct tax.

State of personal income tax

- Currently, only five million people have a taxpayer identification number. This comes to just about 4.5 percent of the working-age population and 8.2 percent of the employed population. Bangladesh has an estimated potential income taxpayer population of more than 10 million.
- Of the people registered with a TIN, less than 40 percent or 1.9 million individuals submitted their tax returns in 2018–19.
- The key challenges of the personal income tax system in Bangladesh include the very narrow tax net and consequently uneven distribution of the income tax burden; lack of progress in digitalisation of the taxation system; lack of enforcement mechanism; large informal sector activities; lack of compliance; etc.

State of corporate income tax

- The corporate tax rate in Bangladesh is one of the highest in the region
- Widespread tax exemptions, incentives, and special provisions in the corporate tax system weaken the revenue potential.
- The total number of registered companies stood at 84,435 in 2018–19. However, only 27,680 (i.e. just about 33 percent) submitted tax returns.
- The number of registered companies in Bangladesh increased by 41 percent between FY14 and FY19, but the number of companies submitting returns increased by 27 percent, and tax collection increased by only 7.3 percent.
- The key challenges to streamlining the corporate tax system in Bangladesh include the very high tax rates, complexity in the tax system, narrow tax net, weak compliance, and widespread tax exemptions.

Policy Recommendations

In the above context, direct taxation currently has and will continue to offer tremendous potential to boost the tax revenue given the buoyant economy of Bangladesh, growing middle class, and rapid rise in income and wealth of affluent class. While there could be a long list of recommendations to streamline the direct tax system in the country, in this memo we just focus on some high priority ones.

High priority actions: The following recommendations in the upcoming budget can deliver some quick gains.

- The highest personal income tax rate was reduced from 30 percent to 25 percent in FY2021-22 in the context of the Covid-19 pandemic. However, since the economy has made a significant recovery from the pandemic induced economic shocks, and since the highest income tax rate is less likely to affect the lower- and middle-income people, consideration should be given in reinstating the highest personal income tax rate at 30 percent.
- Broadening the personal income tax net should be one clear policy direction in this year's Budget. It can be presented as an approach to address growing inequality. There are different approaches that the government could pursue when widening the tax net, and this Budget event could initiate a process of consultation and detailed policy design.
- Currently, formal sector employers collect only 10 per cent advance income tax of their employees but this can be expanded further to collect all calculable income tax obligations from the specified employment.
- Although the tax authorities collect certain information from land registry offices, banks, and city corporations for certain types of income, the absence of an automated database for the third-party reporting system makes tax evasion easier as the audit system becomes inefficient due to the lack of data. Therefore, it is necessary to introduce an integrated third-party reporting system with an automated database to ensure more intense use of third-party information inside and outside the public sector.

Medium to long term actions: The following recommendations should be considered in the next few years to strengthen direct taxation in Bangladesh.

- In order to achieve the objective of increasing the number of individuals paying personal income tax, the government could explore a universal registration approach. Under this approach, incentives for individuals can be provided to register via a unique personal identification number that links tax registration and eligibility to other public services or cash benefit entitlements. A system of providing unique identification numbers to every individual can be initiated whenever they enter the working age. This option would support a 'soft hypothecation' approach to a wider tax net. Alternatively, the personal income tax be expanded by adopting a gradual and targeted registration approach. In this approach, the widening of the PIT base can be achieved through an employer-collected payroll tax. Initially, the tax authorities might focus on employees of relatively larger companies, but expand over time to include smaller companies and the self-employed. Geographic targeted approach can also be adopted – first, focusing on large cities and emerging growth centres, and then gradually extend to small towns.

- Given that the very high corporate tax rates, as well as the existence of several rates, it is imperative to rationalise the corporate tax structure. The number of tax rates can be brought down. For example, in India, there are only two corporate tax rates against six in Bangladesh.
- Reducing the marginal tax rates, in some cases, would provide incentives for self-compliance. A strong focus on expanding the tax net alone can generate significant revenue.
- Given the very narrow tax base, a small number of taxpayers disproportionately bear the burden of corporate income tax. Therefore, it is essential to broaden the corporate tax net by ensuring the registration of the businesses and expanding it to the informal sector. The taxation system with due compliance can help formalization of many informal business enterprises. This can eventually generate benefits to businesses (e.g., in terms for their accessing loans from the financial sector).
- An efficient tax audit system is essential to deal with many malpractices in the tax system. The audit selection is still done manually without any standard operating procedure. This widens the probability that the selection will be affected by subjective bias, and the revenue-risky cases won't get audited. To avoid such inefficiencies, the audit selection should be automated based on some specific criteria such as profession, income size, the volume of turnover, location of business of the taxpayer, etc. Furthermore, unnecessary harassment of taxpayers linked with tax audits should be avoided.
- Given the manual processes in place, very high degree of autonomy and discretionary powers of tax officials are important concerns of the existing tax payers discouraging potential tax payers filing for their return or disclosing their all incomes. Manual processes and discretionary powers tend to lead to malpractices and corruption. Therefore, the tax administration needs to fully adopt the information and communication technology to manage all core processes. In this regard, NBR can launch a centralised data processing centre that can provide multiple services for a variety of functions such as taxpayer registration, detection of stop filers, tax return processing, and payment and correspondence with taxpayers. Auditing system should be fully automated with any room for manual processes must be strictly limited.
- The tax breaks and exemptions, incentives, and special provisions reduce revenue collection by allowing many people to legitimately avoid paying taxes. Therefore, the widespread tax exemptions in Bangladesh should be eliminated and this can be complemented with lowering of tax rates. Tax exemptions might not be required for foreign investment if the tax rate is low or reasonable.
- The improvement in taxpayer service might also help increase tax compliance. In this regard, several measures can be undertaken such as creating easily understandable forms with clear instructions, assistance, and information; introducing taxpayer education programmes; improving phone advice service and website instructions; initiating online payment; and assisting in filing returns and paying taxes, including the use of pre-populated tax returns.