RAPID Research and Policy Integration for Development

Policy Brief
January 2023

Using Direct Taxation to Reduce Inequality and Boost Revenue

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About this Policy Brief

This policy brief presents a set of policy recommendations for expanding and strengthening the direct taxation regime to boost revenue and tackle inequality in Bangladesh. The findings and recommendations are based on a RAPID research paper.

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Major recommendations for promoting direct taxation

i) Develop a roadmap and action plan of policy measures to achieve the new direct taxation target

ii) Broaden the income tax net, making it consistent with the economy's growth performance to be reflected in the number of taxpayers

iii) Increase the number of registered taxpayers

iv) Strengthen the capacity of the National Board of Revenue

v) Review and rationalize tax exemptions and incentives

vi) Introduce an automated and centralised audit system to encourage the taxpayers and boost their confidence

vii) Increase the non-taxable income floor and the highest personal income tax rate

viii) Deduct calculable tax obligations at the source

ix) Rationalise corporate tax rates

x) Notify the registered taxpayers to submit tax returns

Using Direct Taxation to Reduce Inequality and Boost Revenue

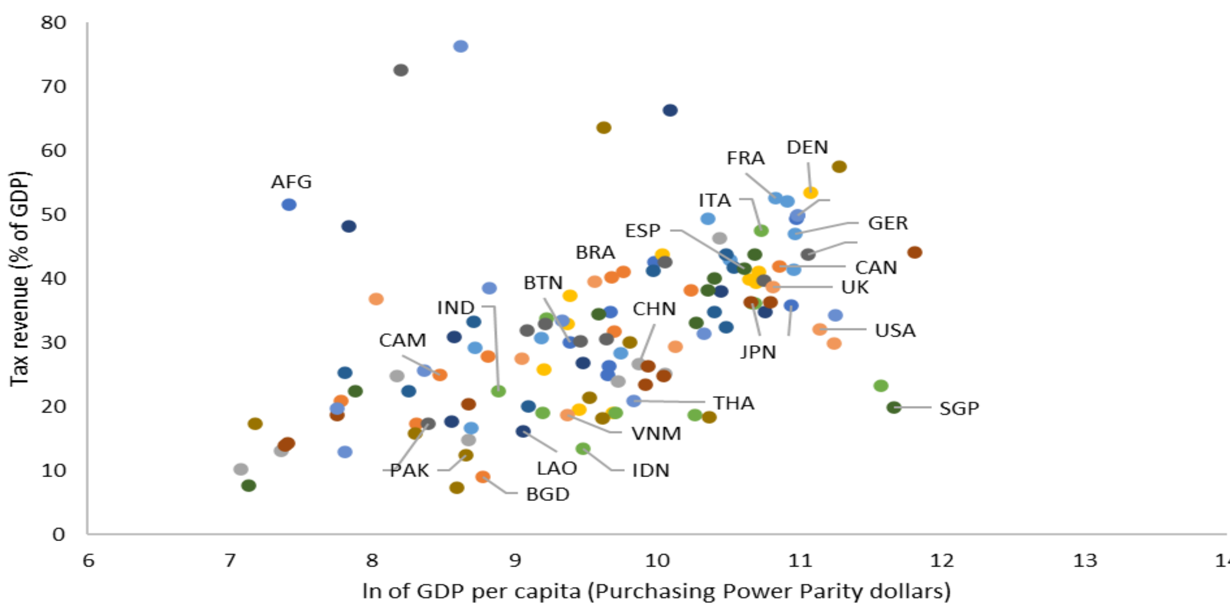
Background

Bangladesh has achieved commendable socio-economic development over the past decades. Compared to many other countries at a similar stage of development, it achieved faster progress in various social and human development indicators. In 2015, Bangladesh moved from a low-income to a lower-middle-income country as per the World Bank's classification of global economies and is now set to leave the groups of least developed countries (LDCs) in 2026. Even amid Covid-19 disruptions, it remained resilient by posting positive economic growth. Bangladesh's current development aspirations include attaining SDGs and becoming an upper-middle-income country by 2031.

The development transitions that the Bangladesh economy is going through would require catering to the ever-rising demand for public investment in, amongst others, energy, infrastructure, education, health, and social protection, along with their improved quality. Bangladesh's current public spending—about 15% of GDP—is much smaller than many comparator countries, such as Cambodia (24%), India (30%), Nepal (27%), the Philippines (25% for each), and Vietnam (22%).

Figure 1: The overall tax effort in Bangladesh remained low compared to many other countries at similar stage of development

Tax revenue and per capita GDP of global economies



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

Bangladesh's public spending is low due to the low tax effort: the tax-GDP ratio of 8% is among the lowest in the world. Consequently, Bangladesh's fiscal space is severely constrained for increased health, education, and social protection spending. There is robust evidence from cross-country studies that a tax-GDP ratio above 15% is crucial for stimulating and sustaining growth and achieving economic transformation.

Lack of additional public investment means the benefits of economic growth may not effectively trickle down. Furthermore, there is now a growing concern about rising inequality. The income share of the richest 5% of the population increased from around 17% in the 1990s to 30% (in 2016), while the same share for the bottom 5% declined from an already paltry 1.03% to just 0.23%.

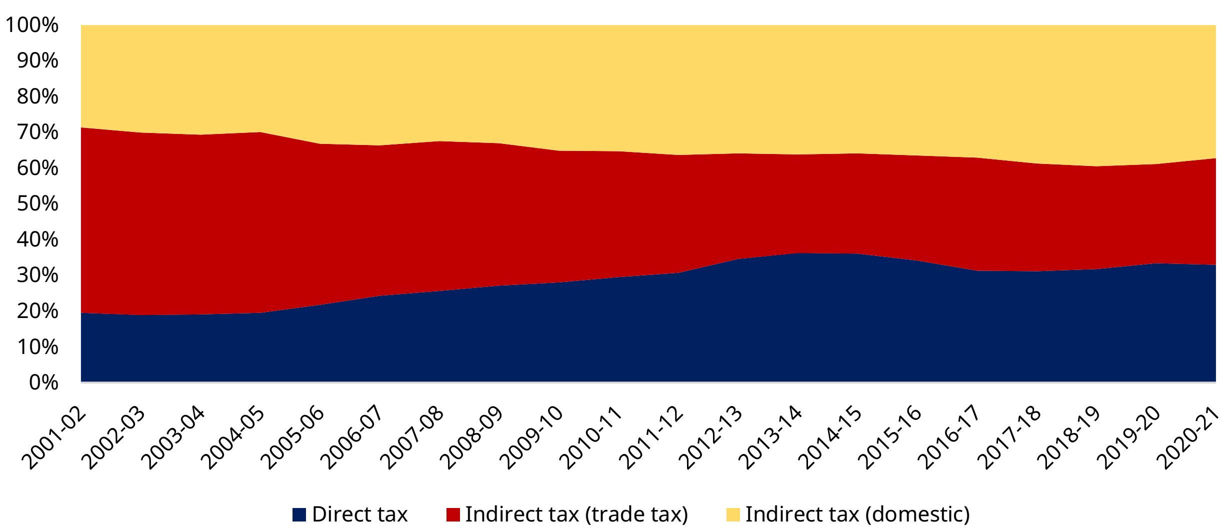
Given the above, the role of public finance policies (i.e., taxation and expenditure) cannot be overstated in materializing growth with equity, ensuring opportunities for all, and leaving no one behind. Additionally, equitable growth is critical for promoting social cohesion and stability, which can create a more conducive environment for economic growth in the long term.

There is thus a tremendous opportunity for more strategic use of the direct taxation system, which should be employed as an important policy instrument for boosting overall revenue generation and tackling inequality. Direct taxation generally helps build a more equitable society as its burden is borne by individuals and businesses based on their earned incomes, while indirect taxes shift the burden to the consumers. Most upper-middle-income and high-income countries overwhelmingly rely on direct taxation for public spending.

Recently, at a high-level public consultation (on 3 September 2022), the NBR set out its target to increase the share of direct tax to 70% of the total revenue from the currently 35%. It is a welcome initiative that should help achieve the objective of economic development with fairness. This will surely not be easy; nonetheless, it is the right policy direction. A concrete roadmap is needed to grow revenue from all sources and raise the significance of direct tax-based receipts.

Figure 2: Direct tax comprises around one-third of total tax revenue

Composition of direct and indirect tax revenue



Source: Authors' presentation using NBR data.

State of Direct Tax in Bangladesh

The revenue-GDP ratio stood at 9.3% in 2020-21, increasing from 8.4% in the previous year. The tax-GDP ratio was 7.6% of GDP in the same year, while the corresponding non-tax-GDP ratio was 1.7%. Since 2010-11, the total NBR revenue grew at an annual average rate of 13%. Two-thirds of the government revenue are generated from indirect taxes.

In 2020-21, around 7.6 million people held a taxpayer identification number (TIN), but only 2.4 million, or about one-third of all TIN-holders, submitted their returns. The average tax revenue per taxpayer was Tk. 1.1 lakh—down from 2.4 lakh in 2015-16. Only around 15,000 individuals paid a wealth surcharge. Some 29,000 companies submitted tax returns in 2020-21, out of a total of 2.73 lakh enrolled with the Registrar of Joint Stock Companies and Firms (RJSCF). The average corporate income tax yield reached above Tk. 200 lakh in 2020-21. Some corporate tax rates in Bangladesh are among the highest in the region, although the revenue collection as a proportion of GDP has been lacklustre. According to the Perspective Plan 2021, for Bangladesh to achieve its development aspirations, the tax-GDP ratio should rise from less than 9% to 17% by 2031 and then to about 22% by 2041. The same plan targets the direct tax-GDP ratio to rise from 2.6% to 7.1% in 2031 before rising further to 9.5% in 2041.

> *"The government's target of increasing the number of registered taxpayers to 10 million should be regarded as low-hanging fruit, and concerted efforts must be undertaken to achieve it within the shortest possible time."*

Policy Recommendations

Many important reform initiatives are underway to boost direct tax revenues. These include enlarging the tax net and introducing the requirement of providing evidence of tax return submission for accessing various government services. A new income tax act has also been introduced. However, implementation challenges lead to less satisfactory performance in collecting direct tax. Based on its recent analysis, RAPID provides the following recommendations to strengthen the direct taxation system in Bangladesh.

i) Develop a roadmap and action plan of policy measures to achieve the new direct taxation target. This plan should comprise short-to-medium and medium-to-long-term actions with clear implementation strategies and time-bound outcome indicators.

ii) Broaden the income tax net, making it consistent with the economy's growth performance to be reflected in the number of taxpayers. Using the BBS Household Income and Expenditure Survey data, RAPID's analysis suggests that if all eligible individuals paid their lawful taxes, the income tax revenue would rise to 3.1% of GDP from just around 1%.

iii) Increase the number of registered taxpayers. The government's target of increasing the number of registered taxpayers to 10 million should be regarded as low-hanging fruit, and concerted efforts must be undertaken to achieve it within the shortest possible time. A geographic targeting approach can be adapted to progress towards this objective – first, by focusing on large cities and emerging growth centres, then gradually extending to small towns. Informed interventions will be needed to identify potential taxpayers, e.g., by conducting socio-economic and enterprise (business) surveys in growth centres to understand income sources and devise appropriate assessment methods.

iv) Strengthening the capacity of the National Board of Revenue should be considered the key to success in direct tax mobilization. Rather than setting indiscriminate targets, the NBR's capacity constraints must be addressed. The constraining factors range from a shortage of human resources to the lack of training facilities and appropriate resourcing for adapting to digitalisation and automation and undertaking tax policy analysis.[1]

v) Review and rationalize tax exemptions and incentives. Tax breaks and exemptions, incentives, and special provisions reduce revenue collection. The need for these exemptions should be rigorously assessed. Exemptions once given, tend to be long-lasting, jeopardizing future revenue potential. There are estimates to suggest that the revenue-GDP ratio would be 2-3 percentage points higher in the absence of exemptions.

vi) Introduce an automated and centralised audit system to encourage the taxpayers and boost their confidence. An efficient tax audit system is essential to deal with many malpractices. Even if only about 10% of taxpayers are brought under the automated tax audit system, it is possible that all taxpayers should be audited at least once within a decade. It can reassure many taxpayers that they will not be mistreated or harassed.

vii) Increase the non-taxable income floor and the highest personal income tax rate. Currently, the tax exemption limit is Tk. 300,000. Given the inflation rate and cost of living, raising the tax eligibility floor should only be fair and equitable. The highest personal income tax rate was reduced from 30% to 25% in the wake of the Covid-19 pandemic. However, since the economy has now made a significant recovery, consideration should be given to reinstituting the highest rate at the pre-pandemic level. This can help raise the revenue from personal income tax by around 0.5% of GDP.

viii) Deduct calculable tax obligations at the source. Currently, the formal sector employers collect only 10% advance income tax of their employees at source (tax deducted at source - TDS), which generates 60% of the direct tax. Following examples of many other countries, employers may be asked to collect all calculable income tax obligations from the specific employment. The tax return could be linked to their employers' TDS collection for employees with the only source of income from their employment.

ix) Rationalise corporate tax rates. Due to high corporate tax rates, many businesses and traders try to evade taxes. There is thus room for rationalization. Other country examples may be considered to bring the number of rates down. There can also be scope for reducing the marginal tax rates.[2]

x) Notifying the registered taxpayers to submit tax returns. There is no mechanism to identify and prompt the taxpayers (individuals and businesses) who are not submitting the return. The registered taxpayers should be notified through an automated system. It can help improve the tax return rate.

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[1] There are estimates to show the administrative cost of collecting Tk. 100 as revenue was just Tk. 0.31 and the recruitment of additional 100 revenue officers can generate Tk. 15 billion in revenue.

[2] Recently, the government has taken some initiatives to rationalise corporate tax rates. The differential between RMG and non-RMG exports has been removed by reducing CIT on non-RMG sectors from 30% to 12%.

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