Adequacy of fiscal policy – a critical challenge

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By *Dr. Sadiq Ahmed*

Bangladesh has made tremendous development progress over the past several years and now aspires to reach upper middle-income status by the World Bank's income grouping criteria by fiscal year (FY) 2030-31. It also aspires to eliminate extreme poverty by the same deadline. Bangladesh faces many challenges in achieving these laudable aspirations, including large increases in public and private investment rates; huge increases in social spending including on health, education and social protection; and substantial improvements in governance and institutions. These challenges are well-known and also embedded in several recent government strategy documents including the seventh Five Year Plan.

A critical policy challenge in this regard is the adequacy of fiscal policy. While there is no conclusive evidence in the economics literature regarding the optimal size of a government and the associated levels of taxation and public spending, the inadequacy of fiscal policy for securing the government's development objectives can be illustrated by the facts that the tax revenue as a share of gross domestic product (GDP) is amongst the lowest in the world, and social spending as a share of GDP is low by international standards and grossly inadequate relative to development needs.

Nobody in the government debates these concerns. Indeed, the 7th Plan is remarkably frank and explicit about these policy challenges. The government adopted a Tax Modernization Plan in 2011. Every year, the national budget sets ambitious revenue targets to strengthen the government's revenue mobilization as per the Tax Modernization Plan. The outcomes, however, are much less than satisfactory. A major constraint is that the tax policy is not grounded in securing major shifts in the tax structure that not only will increase the tax/ GDP ratio but also allow a modernization of the tax structure that is consistent with the multiple objectives of sustained increases in tax revenues, preserving tax equity considerations and imposing minimum loses to efficiency and investment incentives.

The government is now preparing for the next national budget for FY2017-18. This will be the third budget under the 7th Five Year Plan. Can the government break from the past and adopt a tax policy that will enable some radical shifts in the tax structure over the medium term? The objective of this write-up is to provide some inputs to this debate. Its contention is that despite past progress, the Bangladesh tax structure resembles that of a low-income economy and has not graduated to the tax structure of even a low middle-income country, even though it achieved that status in FY2014-15. The policy reforms that are needed have been debated and discussed but not implemented.

The recent trend of tax/GDP ratio is shown in Figure 1. The structure of taxation is illustrated in Figure 2. The Figures show that over the past seven years (FY2009-FY2016) the tax improvement effort has made only modest progress. Total tax collection as a share of GDP increased during FY2009 and FY2012, but has remained basically stagnant since then at around 9.0 per cent of GDP. For all the years since FY2012, the tax target has been missed. The structure of taxation has improved modestly. There has been some improvement in the role of income taxation and domestic production/consumption taxation while the reliance on international trade taxation has declined. The increased role of domestic production/consumption taxation reflects the growing importance of the value-added tax (VAT) in revenue generation. This is a positive development; yet the productivity of the VAT has been stagnant since FY2011 (Figure 3).

A useful way of assessing the tax performance and the associated tax structure is to compare the Bangladesh experience with other countries. Using data from International Financial Statistics of the International Monetary Fund (IMF) for the years 1996-2001, Gordon and Lie summarize the results of the international tax structure by income groups as illustrated in Table 1. The income groups were selected from the World Bank classification of low income (below $745); lower middle income ($746-2975); upper middle income ($2979-9205); and upper income (greater than $9206) prevailing during 1996-2001.

This is a very powerful table and tells a remarkably instructive story about the international experience with the modernization of the tax structure as income grows and development proceeds. The main messages are:

First, the tax/GDP ratio tends to increase with income growth. The main policy implication is that the structure of taxation should be such that it responds well to income growth. In other words, the tax structure must be buoyant with respect to the expansion of economic activities as reflected by the level of GDP.

Second, as development proceeds, the share of income taxes grows. Indeed developed countries raise more than 50 per cent of their revenues from income taxes. The rationale for this based on the need to have a tax structure that meets three desirable principles of taxation: the ability to pay; equity principles of taxation; and the buoyancy argument.

Third, developed and upper middle income countries rely much more on personal income taxes relative to corporate taxes. Thus, developed countries obtain as much as 45 per cent of their total tax revenues from personal income taxes; corporate taxes account for less than 10 per cent of total tax collections. The rationale here is that unduly high taxation of corporate sector would tend to reduce investment incentives and lead to capital flight, which would hurt growth.

Fourth, as development proceeds, the role of international trade taxes tend to disappear. Thus, it accounts for less than 1.0 per cent of total tax revenues for high income countries and around 5.0 per cent for upper middle-income countries.   Even lower middle-income countries get less than 10 per cent of their tax revenues from international trade taxes. The rationale for this is the result that trade taxes tend to distort resource allocation, hurting exports and breeding inefficiency of domestic production.

Finally, reliance on consumption taxes, primarily the value-added tax (VAT), has gained universal acceptance as an important instrument for both developing and developed countries.

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Tax reforms: More revenue with equity

Sadiq Ahmed concluding his two-part write-up on ‘Modernising Bangladesh’s tax structure’

The tax performance of Bangladesh fares rather poorly, relevant international evidence shows. The most telling weakness is that the Bangladesh tax effort (9.0 per cent of gross domestic product or GDP) is substantially below the average for even low-income economies (14 per cent of GDP). Regarding the tax structure, despite recent progress, there are many shortcomings. Bangladesh continues to rely very heavily on international trade taxes (27 per cent) as compared with less than 9.0 per cent for all developing countries. Even the low-income countries on average get some 16 per cent of their revenues from international trade taxes, which is nearly 60 per cent lower than in Bangladesh. This heavy reliance of Bangladesh on international trade taxes is a seriously negative policy development and indicates the distortionary effect of the tax structure.

The improvement in the performance of income taxes is a positive development. It is now roughly comparable with the average for low-income economies. But there is still a major concern. Some 67 per cent of income taxes come from the corporate sector. This is high even by low-income country standard (average of 54 per cent) and much higher than upper middle-income and high-income countries. The expansion of income tax revenues has mostly come from an aggressive pursuit of corporate income taxes. Some sectors like telecoms are required to pay a hefty 41 per cent profit tax rate. This relative heavy taxation of the corporate sector goes against the grain of international evidence that high corporate tax rates might discourage investments including foreign direct investment (FDI). It also discourages the entry of new firms from the informal economy to a formal economy.

A major issue of the tax structure is the very low yield from personal income taxes (1.0 per cent of GDP). Very few people pay personal income taxes. Bangladesh does not have a universal income tax base owing to exemptions of many sources of taxation and the very low taxation of capital gains. The poor performance of personal income taxation is one of the primary reasons for the low tax buoyancy in Bangladesh, which has constrained the overall tax performance. Sadly, this also speaks volumes about the inequitable nature of the tax structure. Income inequality has grown substantially in Bangladesh, but the collection of personal income taxes have not increased much.

Finally, as was noted in the first part of this write-up (FE, March 11), the productivity of value added tax (VAT) has been stagnant owing to many exemptions and inadequate coverage. This is yet another factor that explains the low buoyancy of the Bangladesh tax structure.

POLICY MESSAGES: This brief review provides some powerful policy messages for modernizing the tax structure starting with the FY2017-18 national budget, with a view to increasing revenue while improving equity and reducing the adverse effects on incentives and resource allocation. The main policy messages are:

First, the tax structure of Bangladesh lacks buoyancy and must be improved by increasing the reliance on buoyant revenue sources. These include the personal income taxes and the VAT.

Second, the productivity of VAT must be enhanced. The VAT productivity improvement plan has been on the cards for a while. Much progress has been made in strengthening the VAT infrastructure including the drafting of a new VAT law, computerization and improvements in VAT administrative system. But the implementation of the new VAT law has not yet happened. This must be a top priority for the FY2017-18 Budget. The government has to take precaution that the implementation does not get politically hijacked by vested business interests as happened last year.

Third, it is high time the government made a serious effort to reform the income taxation regime. Several actions can be taken, including streamlining the corporate tax rate in a series of steps with a maximum rate of 35 per cent in FY2017-18, 30 per cent in FY2018-19 and 25 per cent in FY2019-20. As rates come down, exemptions and tax holidays for foreign direct investments (FDIs) or specific sectors must be eliminated over a well-defined period of time so that, by and large, all investors are required to pay taxes. Once the tax rates are lowered and made internationally attractive, exemptions will not be needed. Capital flight for taxation purposes will not be an issue because the investor will have to pay taxes in other countries as well.

Fourth, the personal income reform needs a substantial overhaul based on further research and analysis. Once again the required reform is to lower the marginal and average tax rates and to increase the tax base. Bangladesh can learn the lessons from other countries. The best approach to increasing the tax base is to provide incentives for voluntary compliance. Having large marginal tax rates and putting pressure on those who pay is a recipe for disaster. It is like killing the goose which lays the golden egg. Many tax-payers will find ways to escape the tax net by entering into collusive behaviour with the tax collectors as presently. The tax system must be based on the principle of universal income and self-assessment with productive and selective audits. It must be fully digitized wherever possible with no interface between the tax-payer and tax collector, except when subject to audits. The tax system must be simple with low compliance cost. Indeed, the simpler the system and lower the tax rates, the most likely there will be voluntary compliance and less the scope for tax harassment and corruption.

One example of a bad feature of the present tax design that discourages tax filing and leads to harassment and corruption is the requirement to file a wealth statement based on balancing of income and expenditure along with the tax return. Many tax-payers find this requirement onerous and it discourages them from filing taxes because of the fear that this will lead them to various forms of harassment. This also encroaches on the privacy of a citizen. While the government has the right to tax the income, it is debatable whether citizens should be required to explain how they spend their money. The value of this dubious requirement in terms of tax collection is negligible and, on a net basis, negative because it discourages tax filing. Importantly, there is a common perception that this feature creates incentives for income tax officers to harass tax-payers and extract a bribe. As an example, income tax collections and compliance in the USA are very high with no such requirement to submit a wealth statement based on a matching of income-expenditure.

Fifth, to support long-term economic growth and exports Bangladesh must reform its trade policy. Making trade policy subservient to the needs of revenue mobilization is a serious policy debacle that must be addressed as soon as possible, preferably with the forthcoming budget. A combination of income and VAT reforms will help address the revenue losses from the reduction of trade protection through tariffs and para tariffs that have mushroomed in Bangladesh in recent years primarily to mobilize revenues.

Finally, time has come to introduce a proper property tax system in Bangladesh. This can be a win-win by enabling fiscal decentralization to the urban local government institutions (LGIs) as well as mobilizing additional revenues. The potential revenue role of a well-designed property tax system can be gauged from the fact that in many developed countries it accounts for as much as 2.0 per cent of GDP. In Bangladesh the revenue yield is less than 0.2 per cent of GDP.