# Saga of the new VAT Law: A comedy of unforced errors

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It was unprecedented. A major economic and revenue reform initiative that was tabled with the fiscal year (FY) 2017-18 Budget proposal in Parliament had to be aborted. After a few weeks of rancorous exchange in and out of Parliament, the FY2018 Budget was finally passed by it sans The VAT and Supplementary Duties Act 2012 (i.e. the new VAT Law). Never has a Budget proposal suffered such large-scale diminution. Traditionally, contents of the Budget proposal are agreed to and approved by the Cabinet of Ministers. Then the approval of Parliament, after some discussion, becomes a mere formality. Not this time. This episode confirms that good economics is not necessarily good politics.

What went wrong? Like unforced errors in tennis, where a player errs on his/her own volition (e.g. a service double fault), the entire episode comes out as entirely avoidable if the launch of the new Law was abandoned in the first place. In hindsight, it seems like the authorities were ill-prepared to face the heat when it came. And there was simply not enough political will to ramrod unpopular tax reforms with elections looming in the horizon.

As it turns out, the New VAT Law was one of the last commitments to the International Monetary Fund (IMF) which already completed disbursement of $904 million under the three-year Extended Credit Facility (ECF) signed in 2012. With technical support of the IMF, the National Board of Revenue (NBR) was able to draft a new Law that was expected to simplify tax administration and lower taxpayers' compliance costs, and it was designed to protect the poor and small businesses. In crafting the new Law it is unclear whether the drafters had their feet on Bangladesh soil (to sense the ground realities) or were merely engaged in an exercise of pulling together best practices from other lands. The Law was passed without much fanfare by Parliament in 2012. After long delays and several postponements, the Finance Minister had the final nod from cabinet to launch the reforms this fiscal year

alongside the budget proposals.

Paradoxically, contrary to the intent and design of the new Law, the perception of taxpayers turned out to be inimical to the core. Whether it was lack of comprehension about the reform measures, or poor communication strategy of NBR, or inadequate preparations, despite intense view exchange and consultations with key stakeholders, the launch of the new Law with the FY2018 Budget faced a firestorm of criticism which, as we know, culminated in the current fiasco. This could remain a sticking point in Bangladesh's commitment to the IMF for the nearly one billion dollar ECF disbursement that has already taken place.

In hindsight, we could and should have done better. First, the Law as it was supposed to be applied appeared quite complex to anyone who wished to know how it all worked. The fact is that it was not clear to even the most sophisticated economists. The main message was that there would be a uniform VAT rate of 15 per cent on all goods and services produced, traded, or sold. Although the principle was to tax value addition at every stage of processing – and manufacturing or service activity involves several stages of processing before the final product is delivered to the consumer – the general presumption was an increase in the VAT rate to 15 per cent, whereas in the past there were several products or activities that were taxed at a lower rate. The systemic change that was supposed to be introduced got misconstrued as a rate hike for all – large or small enterprises.

In the past, VAT application resorted to a truncated principle where, in many cases, a presumption was made about value addition (say 10 per cent) and a 15 per cent tax on that presumed value addition came to only 1.5 per cent. Instead of presumed value addition in any activity the new system would have required proper record keeping in all economic activities in order to apply a uniform rate of VAT. It might sound simple but when you realise that a swarm of VAT inspectors will descend on the economic landscape to examine books of accounts, the deterrent was insurmountable. The option of VAT online and assurance for keeping a distance between taxpayers and tax collectors as the new system promised was apparently not convincing enough to the relevant stakeholders who, as we now realise, were far more organised in their resistance to the tax reform. The business community, who would have actually been the agents of tax authorities for collecting VAT and transferring it to the NBR, felt this would become one more instrument of extortion by intrusive VAT inspectors. Whereas implementation of the new VAT Law was perhaps the most significant economic

(revenue) reform undertaken by this government, it appears that not enough effort was made to win hearts and minds within the business community by appeasing many of the misplaced concerns.

Second, it makes me wonder if all concerned in the framing of the new Law grasped the full implications of the Law. The IMF experts/consultants, who drafted it, knew they were reforming a truncated and much distorted VAT system that not only distorted business incentives but also resulted in gross under-mobilisation of VAT revenues. What they had perhaps failed to realise was that part of the VAT system – supplementary duties (SD) – was being largely applied as an instrument of industrial protection by violating the very principle of "trade neutrality" of the VAT system. Whereas SD under the VAT Law should have been applied equally on imports and import competing domestic production, the widely used method was to either apply on imports only or apply on imports at a much higher rate thus making SD an effective protection instrument.

Given the notable influence of the textile lobby, the entire slew of textile products were also exempt from domestic VAT while imports remained subject to 15 per cent VAT. The new Law as drafted and approved in Parliament was designed to make all VAT and SD 'trade neutral', with significant reduction and elimination of the SD regime. Together, the new Law represented not just a major domestic tax reform, but a significant rationalisation of the protection regime, from the current state of high protection to a drastic reduction in protection, all in one go. Was it doable?

In 2013, Policy Research Institute (PRI) research on the existing SD regime revealed (a) that SD was largely being used as an instrument of protection by violating the VAT principle of trade neutrality, and (b) that the new Law contained a scheme of drastic reduction of protection through a radical scheme of SD rationalisation. Clearly, the new Law had failed to grasp the political economy undercurrents of the proposed reform. In the circumstances, I argued that only a phased reduction of the protection structure (at least in three phases) was feasible.

The lesson we draw from the experience of developing countries is that first-best options seldom work. We need to live with the second-best or third-best solutions. However, what the budget proposal did was to completely forfeit one-half of the Law by cutting out the SD

component of the reform package, leaving a truncated new Law in place. In the end, even the truncated Law had to be aborted. As for any future VAT reform, it is back to the drawing board.

Finally, part of the blame must rest on bad timing. Historical and cross-country experience strongly suggests that major reforms have to be implemented early in a government's tenure – and certainly not prior to an election looming in the horizon. Although the proposed Budget is usually a done deal, this time the Finance Minister faced an uphill battle in and out of Parliament to see the Budget through. When good economics meets difficult politics, something has got to give. That is what happened.