

## The political economy of taxation

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Industrial countries are experiencing protests of a kind usually seen in developing

countries where democratic institutions do not work well. In industrial countries citizens typically register their unhappiness by lobbying their constituency representatives and voting them out of power if they fail to deliver.

So, the experience of popular protests in the USA and Europe, which is showing signs of a contagion effect, is worrying political scientists. There is even a debate whether the market economy is under threat. I do not want to go into that debate here. My main point is to draw attention to an important message emerging from this experience that may have serious implications for Bangladesh. This relates to the political economy of taxation.

One key issue voiced by protestors in the USA is the unfairness of the tax system. This matter drew public attention when the US tycoon, Warren Buffet, one of the richest persons in the world, pointed out in a New York Times (NYT) op-ed of August 14, 2011 that he was paying a far smaller share of his income in taxes than the average tax paid by a wage earner. To his credit, he argued that this was unfair and the tax system that allows this outcome ought to be reformed. The tax burden in the US on the average wage earner has become even more contentious in an environment of economic depression with high unemployment, falling property values and slow growing average incomes.

Even in the case of a seemingly comprehensive tax system like that in the USA where tax compliance is very high and much of the tax revenues come from corporate and personal income taxes, tax laws that allow the rich to find ways to reduce their tax burden to a much lower rate than the average wage earner is indicative of the nature of political economy of

taxation globally. A political scientist would argue that this happens because those who represent the citizens in the parliament are typically the rich and the influential. Additionally campaign financing tends to be dominated by business people who get various concessions including tax advantages in return for their contributions.

Bangladeshi citizens will recognize that this strikes a similar chord in their country. Indeed the problem appears far more difficult and possibly much more unfair. In fiscal year (FY) 2011 Bangladesh collected a total of 10 per cent of gross domestic product (GDP) as tax revenues. Only 30 per cent of this revenue, which is 3.0 per cent of GDP, came from income taxes (personal and corporate). Of this, personal tax accounted for a mere 1.0 per cent of GDP and corporate profit tax for 2.0 per cent of GDP. This is a pitiable performance by any standards.

Low tax revenue has severely constrained the ability of the government to finance expenditures that provide benefits to the poor, including health, education, water supply and safety net programmes. It has also constrained the ability of the government to improve the infrastructure situation that is constraining economic growth and employment. Faced with citizen's growing unhappiness with the poor state of public services, the government has been providing open-ended subsidies on energy, fertiliser and food as well as operating a number of safety net schemes. The financing of these expenditures is done partly through the banking system. Deficit financing in turn is feeding on monetary expansion beyond prudent limits and thereby contributing to rapid inflation. In September 2011 the inflation rate climbed to 12 per cent, which is the highest level since December 1998.

Economists recognize that high inflation fed by public sector borrowings is the well known "inflation tax". This was fashionable in the 1950s when old-fashioned development economists argued that there was a trade-off between inflation and growth and higher inflation (beyond 5.0-6.0 per cent level) was necessary to finance economic growth. Subsequent experience of the Latin American countries with run-away inflation put this resource mobilization source in disrepute.

Bangladesh traditionally has avoided the inflation tax as a conscious instrument of resource mobilization and has tended to fight inflation quickly and with vigor. This has served Bangladesh well. So, it is a bit surprising that the government has allowed inflation to rise continuously over the past 24 months. The rapid growth of public borrowing over the past

seven months from the banking sector raises a concern whether the government, even if unwittingly, is falling into the pitfalls of using the inflation tax as an instrument of budget financing.

To a large part the government faces hard choices in the matter of resource mobilization. The range of options it has is as follows. First, and possibly the most attractive instrument from the economic point of view, is strengthening income taxes. Some efforts are underway to strengthen this through improvements in tax administration.

But improvements in tax administration will yield results only in the medium-to-long run. In the short term, the quickest way of getting more income tax revenues is by closing the various loopholes and exemptions. The biggest loophole is the virtual absence of capital gains tax on real estate transactions and on gains from stock markets. Similarly, the government can impose a proper property tax. A third action is to eliminate many of the unnecessary tax exemptions. All these actions can yield substantial tax revenues to the government, especially the first two. These taxes are more progressive than other taxes and as such more equitable.

Second, the government can raise resources by charging proper prices for publicly provided commercial goods and services. It is unfortunate that lack of prompt action has caused the energy subsidy bill alone to climb to \$4.0 billion in the current fiscal year. This is almost 40 per cent of total tax revenues and is clearly not sustainable. The government could target to cut this by 50 per cent through price adjustments. This is economically efficient because the closer prices are to their actual costs, the better will be the efficiency of use. With carefully designed targeted subsidies for the poor consumers, this can also be made equitable.

A third instrument is the use of deficit financing through foreign borrowing. There is considerable scope for this as presently Bangladesh has low foreign debt to GDP ratio (19 per cent only) and very low current account deficit. Bangladesh can mobilize higher levels of foreign capital from both official sources and from direct foreign investment. These foreign funding can be a major source of financing development projects in infrastructure and human development in a non-inflationary manner.

A fourth choice is deficit financing through private sector. Bangladesh presently mobilizes a

small amount of resources through various national savings schemes. The government can broaden this access to borrowing from the private sector by developing the Treasury (T)-bill market.

A final instrument is the use of the inflation tax, by borrowing resources from the Bangladesh Bank. In the short term, this is the easiest option. In the absence of an independent central bank, the Treasury has almost unlimited access to this instrument.

The actual use of instruments is guided partly by administrative considerations but mostly by political-economy factors. The low overall tax effort in Bangladesh in general and the dismal performance of income tax collection partly reflect weak tax administration, but to a large extent it shows the political influence of the rich taxpayers in policymaking. It is therefore not surprising that some of the largest source of income for the rich, capital gains on real estate and stocks, are virtually outside the tax net.

Additionally, there is no well-established property tax system. Any proposal to correct these loopholes therefore meets with stiff resistance and gets swept under the rug in the political debate and decision making. Modernizing and broadening the income tax base in order to include all forms of income in the tax base, irrespective of the source of income, and introducing a well developed property tax system are arguably two of the most important political economy challenges for fiscal reforms.

Regarding subsidies and prices of fuel oil and electricity, the political dilemma is the prospect of facing street protests. Other developing countries have addressed this problem by making more frequent and automatic adjustments to fuel and energy prices and also providing targeted subsidies. Delaying price adjustments to an extent that the subsidy level reaches a crisis level is a recipe for disaster and must be avoided.

Foreign borrowing in a prudent manner is a good instrument. The problem here is two-fold. First, the global environment for official assistance is tough, both in terms of availability and strict standards of performance demanded by donor countries/agencies. The ongoing debate with the financing of the Padma Bridge is a very good example of the political limitations that the Bangladesh government faces in deploying this instrument. Second, regarding private foreign investment, the performance standards are similarly challenging in terms of

economic policies, institutions and good governance. Bangladesh faces substantial challenges in each of these areas, which explains the limited use of this instrument.

Concerning borrowing from the private sector, this is often used by the Treasury through sale of T-bills to selected commercial banks and through various saving schemes. The Treasury prefers t-bills as it is less expensive in terms of interest cost as compared with saving schemes. One problem however is the lack of secondary market for T-bills. Commercial banks also are reluctant to hold more t-bills than they need as a part of their statutory liquidity requirement owing to low interest offered in t-bill auctions. If a truly open market for t-bill emerges, it is likely that the cost of borrowing will rise that will constrain the use of this instrument.

This leaves the last instrument: borrowing from the Bangladesh Bank. This is the easiest instrument from an administrative point of view. Its use is usually constrained by the policy objectives of keeping inflation and the balance of payments under control. But the recent experience with the liberal use of this instrument is worrisome. The inflation problem is the number one social problem facing Bangladesh today and if this is not addressed quickly this could have severe socio-political consequences for the country.

Bangladesh tax policy is at a cross road. While there have been some positive developments in terms of higher tax collections and improvements in tax administration, the reform efforts are half hearted. There are serious problems with the efficiency and equity of the tax system. The absence of a modern income tax system that taxes income, irrespective of the source of income, and a well developed property tax system has serious adverse implications for both tax yields and equity.

As against this major policy gap in taxation, a strategy to use inflation tax as an active instrument of resource mobilization is fraught with severe downside risk that is best avoided. Instituting a modern income tax system that is broad-based with minimum exemptions is the highest fiscal reform priority. This is necessary both to increase the tax yield as well as to enhance the equity aspects of taxation. Fiscal policy must be coordinated with monetary policy to ensure that the effect of the budget on inflation is as low as possible.

Citizens in turn must be willing to pay their fair share of taxes based on the ability to pay

principle. This is akin to an unwritten social contract. Economic development without equity can be socially de-stabilizing. If citizens of advanced industrial economies with well functioning democratic institutions can take to the street to vent their frustrations and anger against inequitable policies, these difficulties can multiply manifold in low income economies like Bangladesh where democratic institutions are still evolving.

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