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Tax Expenditures in Bangladesh: An Introductory Analysis

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Abstract

In recent years, analysis of tax expenditures has received much attention in the literature of public policy, particularly in the developing and transition economies. This policy note attempts to introduce the concept and size of tax expenditures in the context of Bangladesh with special references to experiences of India and Pakistan. It shows that the amount of tax expenditures in Bangladesh is 2.52 per cent of GDP in FY05, in which expenditures in the direct taxes and indirect taxes are 0.28 per cent and 2.24 per cent, respectively. The note identifies that tax expenditure accounting is necessary to establish an efficient and effective tax system as well as fiscal accountability and transparency in the country, since tax expenditures are viewed as part of government expenditures. Thus, a detailed assessment of tax expenditures including an appropriate definition and a methodology for measuring 'tax expenditures' is essential along with restructuring the existing tax expenditure measures in Bangladesh.

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Tax Expenditures in Bangladesh: An Introductory Analysis

1. Introduction

In recent years, the study of tax expenditures has gained increased importance in the literature of public policy, particularly in developing and transition economies. Such studies are primarily concerned with reduction in tax liabilities resulting from various tax preferences such as preferential tax rates, exemptions, deductions, rebates, deferrals, credits, etc. These measures are often used as part of an efficient tax policy in order to achieve certain fiscal/social objectives, e.g., generating revenue at socially efficient and equitable level that minimizes its disincentive effects on economic activities, reducing pressure on public sector borrowing and substituting direct government expenditures (Cavalcanti and Li, 2000; Tanzi and Zee, 2000). These incentives may also be viewed as subsidy payments or government spending towards preferred taxpayers channelled through the existing tax system, besides direct expenditures of the government. Thus, it is necessary for a government to analyse tax expenditure accounting on a regular basis for maintaining efficiency, accountability and fiscal transparency of the country.

Tax expenditure measures are tax provisions, liabilities or concessions that fall outside a benchmark tax system. Tax expenditures may take a variety of forms such as tax exemptions, deductions, exclusions, allowances, credits, deferrals, relief, etc (OECD, 1996 and WB, 2003). Tax holidays and tax free zones are also examples of tax expenditures subject to specific periods and geographical areas (Swift 2006). Technically, tax expenditures may be defined as the gap between potential tax revenue, which does not contain tax provisions, and net tax revenue or tax revenue received. However, application of the definitions of tax expenditures differs among countries.

The establishment of an efficient and effective tax system by giving special attention to tax preferences plays an important role for a developing economy like Bangladesh, which faces constraints to requisite revenue generation due to lower domestic tax bases and increased integration with the world economy. The analysis of tax expenditure accounting is necessary broadly from two perspectives: first, it gives an indication about potential areas for further revenue generation; and second, it gives additional information about actual budget expenditures of the government that is not reflected in spending programme of the budget documents. This policy note attempts to analyze the concept and size of tax expenditures in the context of Bangladesh with special references to India and Pakistan for FY05.[1] It also finds the necessity to re-examine a few existing tax expenditure measures in Bangladesh.

2. Existing Tax Expenditure Measures in Bangladesh[2]

The tax system of Bangladesh includes several tax expenditure measures under the broad headings of direct taxes and indirect taxes. These provisions, introduced with the enactment of the tax law, have been subject to changes from time to time. The major policy objectives behind the tax expenditure measures in Bangladesh are to accelerate the process of industrialization, to attract foreign currency through increasing exports and foreign direct investment (FDI) and to ensure social security and welfare of low and modest income groups. Tax expenditure measures

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[1] Due to data unavailability, this note considers tax expenditures in Bangladesh only for FY05.

[2] This section is written with the help of various tax expenditure documents collected from the National Board of Revenue (NBR).

exist in sectors such as Public Services, Agriculture, Labour and Employment Affairs, Transport and Communication and Social Security and Welfare, etc.

2.1 Tax Expenditure Measures under Direct Taxes[3]

Various tax expenditure measures exist for corporate and personal income taxpayers under the existing income tax law. These are summarized below.

2.1.1 Corporate Income Tax

Tax holiday facility is allowed to newly set-up industrial undertakings, physical infrastructure facilities and tourism industry subject to certain specified conditions in order to promote industrialization and employment generation. Exemptions and deductions are applicable to incomes from firms in Export Processing Zone (EPZ), 50 per cent of income for export earnings, power generation companies, computer software businesses, agriculture-related industry, micro credit for NGOs, local government, welfare activities, etc. In particular, concessionary rate is allowed at the rate 20 per cent for those who do not enjoy tax holiday or accelerated depreciation, 15 per cent for textile and jute industries and 25 per cent for local authority, etc. Accelerated depreciation is allowed at the rate 100 per cent for new firms.

2.1.2 Personal Income Tax

Exemptions and deductions are admissible to individual incomes from agriculture-related activities, income of foreign technicians in EPZs, remuneration of diplomats and foreign employees of an embassy, income of an indigenous person of Hill Tracts region as individuals, income from specified savings instruments, etc. In addition, 15 per cent tax rebate is allowed on investment in provident fund, Deposit Pension Scheme (DPS), insurance, shares, bonds, etc.

2.2 Tax Expenditure Measures in Indirect Taxes[4]

Under the various acts of indirect taxes, exemptions and deductions are given in the area of customs duty, supplementary duty and Value-Added Tax (VAT).

2.2.1 Customs and Supplementary Duty

Exemptions are granted to local industrial units of a few specific sectors, viz. EPZ enterprises, power generation companies, poultry and dairy farms, etc. Concessionary rates are applicable to agro-processing, textile and leather industry, educational institutions, hospitals, privileged persons, etc. Incentives are also given to those sectors, which are complying with the international and bilateral agreements and conventions.

2.2.2 Value–Added Tax

Goods and services exempted from VAT include food and agricultural products, animal products, poultry sector, agriculture inputs, basic services for living, social welfare services, culture related services, finance and financial activities related services, transport services, personal services, etc.

3. Experiences from Neighbouring Countries

Since the structure of economies in all South Asian countries is similar, goals for various tax preferences in such economies do not vary greatly. In these countries, tax preferences are given in order to promote savings by individuals, to encourage investment by the private enterprises (both local and foreign investors) and to facilitate various infrastructure and social development. This

[3] The Income Tax Ordinance, 1984 and different Statutory Rules and Orders (SROs) issued on its behalf make provisions for a number of tax expenditure measures.

[4] Tax expenditure measures under indirect taxes are provided by the Customs Act, 1969, in the First and Second Schedule of the Value Added Tax Act, 1991 and different SROs.

policy note considers various tax preferences in FY05 that have been applied in India and Pakistan.[5]

3.1 Direct taxes

Under the existing laws, exemptions and deductions in India and Pakistan in the corporate sector are mainly pertaining to profits derived from development of infrastructure facilities, Special Economic Zones (SEZs), development of scientific research, religious and welfare activities, etc. Incentives and deductions for individual taxpayers are mainly related to income of senior citizens, investment in specified savings instruments, interest income on securities and deposit with banks, profits of cooperative societies, primary agricultural credit societies, etc.

The total cost of exemptions in direct taxes for FY05 amounts to PKR 4.6 billion in Pakistan and INR 710.7 billion in India, respectively, as shown in Table 1. In India, more than 80 per cent of the total estimated direct tax expenditures comes from the corporate income taxes in FY05.

Table 1: Tax Expenditures in India and Pakistan, FY05

Types of Tax	*Cost of Exemptions*					
	Pakistan			*India*		
	PKR in billion	*As % of tax revenue*	*As % of GDP*	*INR in billion*	*As % of tax revenue*	*As % of GDP*
Direct Taxes	*4.60*	*0.78*	*0.070*	*710.7*	*23.23*	*2.012*
Corporate income tax	-	-	-	578.5	18.91	1.638
Personal income tax	-	-	-	116.9	3.82	0.331
Co-operative sector related	-	-	-	15.3	0.50	0.043
Indirect Taxes	*20.27*	*3.44*	*0.311*	*875.8*	*28.62*	*2.48*
Sales tax	7.85	1.33	0.120	-	-	-
Customs duties	12.40	2.11	0.190	925.6	30.25	2.621
Excise duty	0.02	0.003	0.001	304.5	9.95	0.862
- Export credit related	-	-	-	*- 354.3*	-11.58	- 1.003
Total	*24.87*	*4.23*	*0.381*	*1586.6*	*51.85*	*4.492*

Source: "Annex – 12," India Budget Summary, FY07 and
"Annexure – 2," Pakistan Economic Survey, FY06

3.2 Indirect taxes

Preferences in customs duties arise mostly due to various national and international contractual obligations for trade liberalization. Major exemptions and concessions are applicable to small-scale industry, fertilizers, agricultural produce, pharmaceutical products, information technology related items, construction materials, import by the manufacturing industry, tourism-related projects, imports of energy sector products, exploration and production companies.

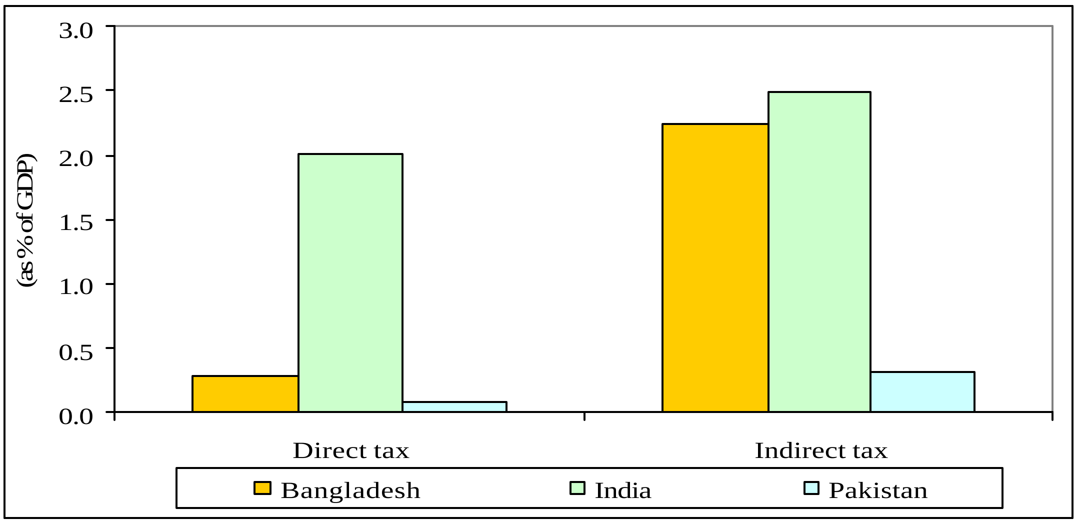
The total cost of exemptions in indirect taxes is INR 875.8 billion in India for FY05. Expenditures in customs duty amount to INR 925.6 billion, which is scaled down by the amount of INR 354.3 billion as being export credit related. Excise duty expenditures amount to INR 304.5 billion. On the other hand, in Pakistan, the total cost of exemptions in indirect taxes is PKR 20.27 billion in FY05, in which a major part is contained by expenditures in customs duties (PKR 12.4 billion), followed by exemptions in sales tax (PKR 7.85 billion). Thus, a total of PKR 24.87 billion and INR 1586.6 billion tax expenditures are estimated in Pakistan and India in FY05, respectively. The size of tax expenditures as a share of GDP and as per cent of total revenue earnings varies dramatically between these two countries. The size of tax expenditures in FY05 is

[5] Due to data unavailability for state or provincial governments, this note considers only tax expenditures of the Central Government in India and the Federal Government in Pakistan.

0.38 per cent of GDP in Pakistan, and 4.49 per cent of GDP in India. Besides, total expenditures in direct and indirect taxes are 0.78 percent and 3.44 percent of tax revenue, respectively, in Pakistan; in India, those are 23.23 percent and 28.62 percent of tax revenue, respectively.

The magnitude of tax expenditures in Bangladesh differs from its neighbouring countries. A comparative picture of tax expenditures as a share of GDP under the two broad headings of direct and indirect taxes among Bangladesh, India and Pakistan is depicted in Figure 1. It is clear from the figure that India incurs comparatively higher direct and indirect tax expenditures as a share of GDP than Bangladesh and Pakistan. It is also mentionable that both direct and indirect expenditures as per cent of GDP in Pakistan are much lower compared to those of Bangladesh and India. Although these three countries have a similar tax system, the unusually low tax expenditures in Pakistan compared to that of other two South Asian countries might be due to the methodology used to estimate tax expenditures, which would render them not very comparable.

Figure 1: Tax Expenditures as per cent of GDP, FY05



Sources: (i) Various tax expenditures documents collected from NBR and BB (2006); (ii) "Annex – 12," India Budget Summary, FY07 and (iii) "Annexure – 2," Pakistan Economic Survey, FY06.

4. A Critical Analysis of the Tax Expenditure Scenario in Bangladesh

The concept of tax expenditures is not new for many countries of the world. However, in Bangladesh, it has drawn attention of the policy-makers very recently. Among different exemptions or fiscal incentives, a total of 106 measures have been identified under the two broad headings of tax classifications, viz., direct taxes (55 measures) and indirect taxes (51 measures), as shown in Table 2.[6] The estimated total tax expenditures of Bangladesh in FY05 are BDT 93.45 billion, in which BDT 10.28 billion is direct tax expenditures and BDT 83.17 billion are indirect tax expenditures. Thus, indirect tax expenditures have contributed to higher revenue loss in the country (almost 89 per cent of total revenue loss). In this regard, it may be mentioned that the share of indirect taxes is almost 80 per cent of total revenue earnings in FY05. The size of tax expenditures is over 2.5 per cent of GDP and 31.25 per cent of total revenue in FY05.

[6] NBR has compiled the data collected from different field level offices for income tax and VAT at import stage. Due to primary data unavailability for VAT at domestic stage, tax expenditures have been estimated from secondary sources.

Table 2: Tax Expenditures by Type of Exemptions/Fiscal Incentives, FY05

Type of exemptions	*Number of measures*	*Revenue foregone*		
		In billion BDT	*In proportion of total revenue loss*	*as % of GDP*
Direct Taxes:	*55*	*10.28*	*0.11*	*0.28*
Tax holiday	1	2.67	0.26	0.07
Exemptions and deductions	15	2.79	0.27	0.08
Tax rate reductions	6	1.82	0.18	0.05
Deferrals	1	1.29	0.13	0.04
Tax credits	18	0.22	0.02	0.01
Others	14	1.49	0.15	0.04
Indirect Taxes:	*51*	*83.17*	*0.89*	*2.24*
Exemptions and deductions	51	83.17	0.89	2.25
Total	*106*	*93.45*	*1.00*	*2.52*

Source: Various tax expenditure documents collected from NBR and BB (2006).

The estimated tax expenditures in the direct tax category in FY05 account for 0.28 per cent of GDP and 3.44 per cent of total revenue collection in the country. Most of the measures in direct taxes are in the form of tax credits (18 measures), followed by exemptions and deductions (15 measures) and other categories (14 measures). However, in respect of tax expenditures, the highest expenditures are estimated in the 'exemptions and deductions' category, followed by tax holiday and tax rate reductions. Among the categories of taxes, tax expenditures in the corporate income tax category contribute more than 80 per cent of direct tax expenditures in FY05, which is about 0.22 per cent of GDP and 2.69 per cent of total revenue.

Table 3: Tax Expenditures by Ma in Categories of Taxes, FY05

Categories of taxes	*In billion Tk.*	*Proportion of total revenue loss*	*As % of total total revenue*	*As % of GDP*
Direct Taxes	*10.28*	*0.11*	*3.44*	*0.28*
Corporate Income Tax	8.26	0.09	2.76	0.22
Personal Income Tax	2.02	0.02	0.68	0.05
Indirect Taxes	*83.17*	*0.89*	*27.81*	*2.24*
Customs Duty	3.65	0.04	1.22	0.10
Value Added Tax (VAT)	76.87	0.82	25.70	2.07
VAT: Import Stage	*17.89*	*0.19*	*5.98*	*0.48*
VAT: Domestic Stage	*58.97*	*0.63*	*19.72*	*1.59*
Supplementary Duty	2.65	0.03	0.89	0.07
Total	*93.45*	*1.00*	*31.25*	*2.52*

Source: Various tax expenditure documents collected from NBR and BB (2006).

In the indirect tax category, the estimated tax expenditures are 2.24 per cent of GDP and 27.81 per cent of total revenue received in FY05, as shown in Table 3. All measures in indirect taxes are in the form of exemptions and deductions. Among the categories of indirect taxes, highest tax expenditures are estimated in VAT at the domestic stage (accounting for about 1.6 per cent of GDP and more than 60 per cent of total revenue loss), followed by VAT at the import stage (about 0.5 per cent of GDP) and customs duty (about 0.1 per cent of GDP).

Table 4: Category - wise Tax Revenue-Tax Expenditures Relation, FY05

Categories of taxes	*Tax Revenue (in billion BDT)*	*Tax expenditures (in billion BDT)*	*Tax expenditures as % of tax revenue*
Personal Income Tax	27.33	8.26	30.22
Corporate Income Tax	28.44	2.02	7.10
Customs Duty	79.10	3.65	4.61
VAT (Import Stage)	53.47	17.89	33.47
VAT (Domestic Stage)	51.11	58.97	115.38
Supplementary Duty	18.36	2.65	14.43

Source: Various tax expenditure documents collected from NBR and BB (2006).

An analysis of category-wise relation between tax revenue and tax expenditures suggests that tax expenditures in the category of VAT at the domestic stage is 115.4 per cent of the tax revenue received in that category in FY05, as shown in Table 4. The large amount of tax expenditures relative to tax revenue might be due to the widespread leakage as well as narrow tax base in VAT at the domestic stage.[7] This indicates that a significant amount of revenue generation is possible at the domestic stage of VAT as tax expenditures in that category is higher than tax revenue received in the same category. In addition, greater revenue mobilization through reducing tax expenditure measures is possible from personal income tax and VAT at the import stage as considerable amounts of tax expenditures compared to revenue earnings are estimated from both these categories of taxes.

A critical review of the direct tax expenditure measures suggests that income from a few welfare organizations operating with profit-driven motive can be considered for taxation. Exemptions on salaries of foreign technicians require a careful review and should be specifically defined since a large number of foreign technicians are now working in Bangladesh and many companies often fraudulently use this measure. Exemptions of income from poultry, fisheries, livestock, horticulture, etc. require further consideration as there has been widespread misuse of this provision. There are certain investments under special tax treatment where no question can be raised as to the sources of these investments if the taxpayer pays tax at a specified rate and tax is also exempted if the investment is made in specified industries within specified time-period. It seems that these provisions do not serve any socio-economic goal; rather they violate the principle of equity and encourage corruption-related activities. Such provisions need to be reconsidered in order to mobilize revenue and to bring transparency in the tax system.

Recently, there has been a debate both in the national and international bodies regarding tax holiday whether this facility should be abolished. Tax holiday facility in the corporate sector is given to promote investment in specific sectors or areas and to attract foreign direct investment (FDI). It has been observed that tax holiday facility has been misused widely and the opportunity cost of the incentive has been high compared to the objective for which it has been introduced. It is also argued that it violates the principle of equity and free flow of resources among alternative uses. Thus the tax holiday facility may be withdrawn as suggested by the Revenue Reform Commission (MoF, 2003) and replaced by either the existing accelerated depreciation allowances or a reduced tax rate with a lower rate in earlier years and gradual increase in the later.[8]

Most of the tax expenditures come from indirect taxes (89 per cent of total revenue loss); VAT alone accounted for 82 per cent of total revenue loss of the country in FY05. Thus, it is necessary

[7] The stylized facts or characteristics of Bangladesh tax structure have been identified and analysed in Ahsan (1995) and McCarten (2005).

[8] Some of the observations are also reflected in MoF (2003), Bangladesh Civil Service (Taxation) Association (2003) and IMF (2005).

to re-consider tax expenditure measures in the indirect taxes, particularly, in VAT, to formulate an effective tax system. Exemption areas in VAT are not very wide under the existing VAT Act. Yet, tax expenditures in Bangladesh are the highest in VAT in terms of both absolute revenue loss and percentage of revenue earnings. One reason behind this is that the scope of VAT is wider compared to other types of taxes. Yet, a review of the exemptions in VAT is necessary in order to find out areas where the exemptions may be minimized and thus to expand VAT net. Some of the exemptions in the VAT Act can be revised such as educational and training institutes running on commercial basis, renters on commercial basis of building and place, income of brokers including stock and securities, etc.

It has been estimated by NBR that in Bangladesh, tax expenditures are the highest for agriculture, fisheries and forestry sectors, followed by public services and labor and employment affairs (about 15 per cent, 12 per cent and 5 per cent of total direct tax expenditures, respectively). Thus, there is the possibility of mobilising revenue from these sectors through reducing the expenditure measures. It is also necessary to review the tax expenditure measures in the category of business taxes as revenue loss due to different measures in this category is estimated at about 58 per cent of total direct tax expenditures.

In addition to withdrawing different measures, new measures may also be introduced. For example, voluntary contributions to non-profit educational institutions and hospitals, charitable or religious organizations benefiting the public may be considered for some kinds of incentives in order to promote private charity. It may be mentioned that, in India, these types of donations by the corporate sector enjoy exemption amounting to 50 per cent.

Furthermore, developed country experiences suggest that tax credit generates greater revenue as compared to tax exemptions or allowances. Thus, tax credit can be considered as an alternative measure for tax exemptions or allowances in a few cases in order to mobilize greater revenues.

5. Concluding Remarks

This note analyses the concept and magnitude of tax expenditures and critically examines existing tax expenditure measures in Bangladesh. This paper also analyses the magnitude of tax expenditures in India and Pakistan to get a comparative picture among neighbouring countries. Total tax expenditures are about 31.3 per cent of revenue earnings and 2.5 per cent of GDP in Bangladesh for FY05. Major portion of the tax expenditures comes from indirect taxes, particularly VAT at domestic stage. In contrast, tax expenditures are about 4.5 per cent and 0.4 per cent of GDP for FY05 in India and Pakistan, respectively.

For a developing country like Bangladesh, domestic resource mobilization in the face of targeted socio-economic objectives is important in formulating an effective tax policy. It is also required to create an efficient tax system, which includes appropriate tax expenditure measures that serve social objectives as well as being economically feasible. Therefore, a critical review of the existing tax expenditure measures in Bangladesh is necessary in order to oversee a balance between these two goals. Our analysis has identified some avenues for possible expansion of tax base through restructuring the existing tax expenditure measures, especially in the categories of income tax and VAT. Along with restructuring the measures, the tax administration requires a comprehensive organizational reinvention that is capable of meeting the revenue needs of Bangladesh (McCarten, 2005). It is also important to set a definition and to develop a methodology for measuring the 'tax expenditures' in the context of Bangladesh.

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