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Bangladesh

An Agenda for Tax Reform

(In Three Volumes) Volume III: Direct Taxation: Policy and Administration
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BANGLADESH

CURRENCY EQUIVALENTS

The estimated value of the Bangladesh Taka (Tk) is fixed in relation to a basket of reference currencies, with the U.S. Dollar serving as the intervention currency.

1989

US\$1 = Tk 33
Tk 1 = US\$ 0.030

Weights and Measures

1 Crore = 10 million

FISCAL YEAR

July 1 -- June 30

BANGLADESH: AN AGENDA FOR TAX REFORM

VOLUME III

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Chapter 5: DIRECT TAXATION: PERSONAL AND COMPANY INCOME TAXES

I. INTRODUCTION

5.1 Direct taxation which is derived almost exclusively from income accounts for approximately one-fifth of tax revenue. Revenue arising from personal and company income accounts for 15 percent of total tax revenue or about 1.2 percent of GDP. It is estimated that more than three-quarters of this comes from company taxation. The tax is levied almost entirely on the non-agricultural sector which accounts for some 50 percent of GDP. Furthermore, tax concessions of various kinds, further described below, ensure that less than 0.5 percent of the population is liable for personal income tax.

5.2 Comparative data (see Table 5.1) show that the share in Bangladesh of income tax in total revenue is lower than in other Asian countries. Part of this can be explained by the level of per capita income and limited degree of urbanization in relation to comparator countries.

II. PERSONAL INCOME TAXATION

1. Basic Tax Rules

5.3 The Income Tax Ordinance of 1984 calls for a global income tax base, which combines income from all sources (both earned and unearned), and a graduated rate structure. If the global income of an individual falls below a filing threshold (called the exemption limit in Bangladesh and currently set at Tk 36,000), no tax liability arises. If global income exceeds that threshold, tax liability is calculated as follows. First, the graduated tax rates are applied to income.¹ The current rate structure has 5 brackets, starting at 10 percent for the first Tk 55,000 of taxable income, 20 percent for the second, and so on, to the top marginal rate of 50 percent. Second, one-third of income in excess of the filing threshold is calculated. The amount of tax due is the lower of the two figures.^{2, 3}

1/ Note that according to this method, the filing threshold itself does not enter into the calculation of tax liabilities. Since it only serves to signal that tax liabilities exist for individuals with global income exceeding the specified level, the mission has chosen to use the term "filing threshold" rather than a more conventional exemption limit.

2/ A flood relief surcharge at the rate of 6 percent of income tax payable under the Income Tax Ordinance of 1984 was introduced in September 1987 for the assessment year 1987/88.

3/ A surcharge of 6 percent of income tax payable was added under the Relief and Rehabilitation Surcharge and Levy Ordinance, 1987. The rate of surcharge was raised by 10 percent in 1988 and to 15 percent in 1989.

**Table 5.1: Comparative Characteristics of Income Taxation
(in Selected Asian Countries) a/**

	Share of Income Tax in Tax Revenue (Percent)	Income Tax - GDP Ratio (Percent)	Per Capita GNP (1981)	Degree of Urbanization b/
Bangladesh	15.4	1.2	140	12
Bangladesh (FY1982-FY1986)	14.6	1.2		
India	18.4	2.6	260	24
Pakistan	15.6	2.3	350	29
Thailand	19.8	2.6	770	13
Philippines	24.0	2.9	790	30

Source: Government Finance Statistics, International Financial Statistics,
and World Development Report, various issues.

a/ The figures refer to 10-year averages based on data from 1971 to 1981, except those in the second row.

b/ The percentage of urban to total population.

5.4 Global income, for tax purposes, excludes certain allowances, such as those for housing, transportation and entertainment,⁴ where each type of allowance is subject to a ceiling. Housing allowances, for instance, may not exceed Tk 30,000 per annum or 50 percent of basic salary, whichever is lower. (The amount received in excess of these limits is taxable.) The ceiling for transportation allowances depends on the type of transportation used and ranges from Tk 3,000 to a maximum of Tk 6,000 per annum. Entertainment allowances are currently limited to a ceiling of Tk 4,200 per annum. Individuals who do not receive explicit cash allowances of the types mentioned above are allowed to make appropriate adjustments to the actual salaries received.

2. Tax Incentives and Exclusions

5.5 There are major exceptions to the basic rules as set out in the preceding section. These exceptions appear to be motivated primarily by the desire to promote saving and capital market development, although custom and administrative considerations also play a role.

Investment Allowance

5.6 Up to a third⁵ of global income may be deducted from the tax base, provided the amount is invested in approved assets. A broad range of financial instruments is covered, among them life insurance premia for the taxpayer and family members, contributions to pension funds, new issues of shares in public limited companies, new debentures and stocks of approved companies, government securities and selected savings certificates.⁶

Interest and Dividends

5.7 Interest income received by individuals is subject to a Jamuna bridge surcharge of 4 percent introduced in October 1985 and a flood relief levy of 4 percent introduced in September 1987, the latter terminating on June 30, 1988. The flood relief levy also applies to dividends. However, neither the Jamuna bridge surcharge nor the flood relief levy applies to deposits with investment or finance companies or the provident fund of government employees. Only interest income exceeding Tk 15,000 need be included in global income for tax purposes; dividends are exempt from the latter when received by individuals, except that originating from private limited companies which are not converted to public limited companies within two years starting July 1987.

4/ When these allowances are provided in kind, the basic income will be adjusted upward for tax purpose. The adjustment formula is generally designed to understate the benefits, however.

5/ A limit of two lakhs taka per taxpayer on investment allowance was introduced in 1988/89 budget.

6/ Investment allowances for any given year are restricted to the net investment (the difference between the purchases and sales of financial assets) over the month ending 31

Capital Gains

5.8 Capital gains are subject to tax upon realization. The rates applicable are graduated and separated from other sources of income. The proceeds that are reinvested in approved assets, however, incur no tax liabilities.

Gifts and Inheritance

5.9 Taxes on inheritance and gifts, which had a separate schedule of graduated rates, were repealed in 1982 and 1985, respectively.

Charitable Contributions

5.10 Until June 1987, up to one-third of global income contributed to charities was deductible from the tax base. Since June 1987, the ceiling for charitable contributions has been merged with that for investment allowances discussed above.

Government Salaries

5.11 Salaries of government officials are treated as if taxes have already been withheld at source and are therefore subject to no further taxes.

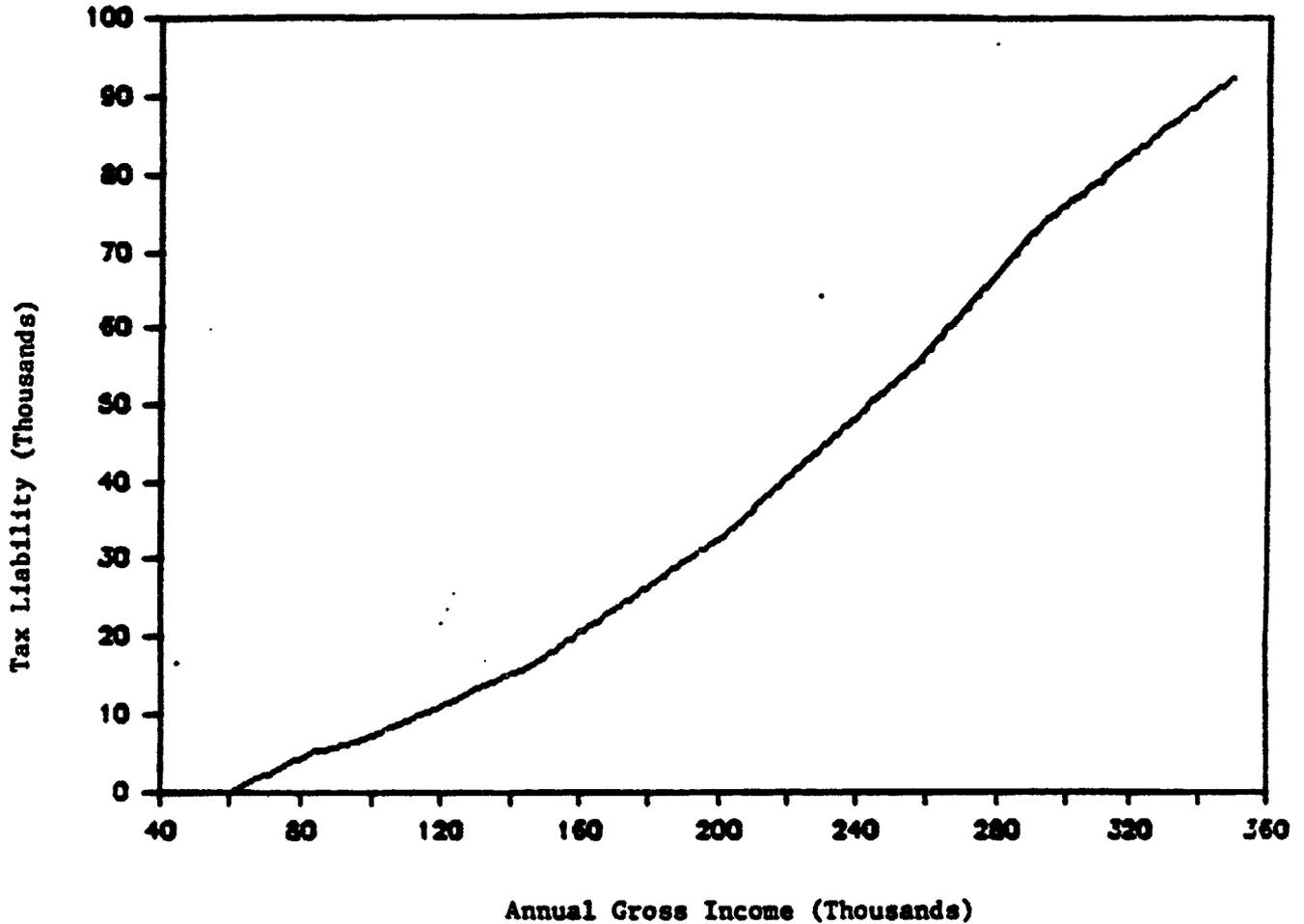
Income From Other Sources

5.12 Since, June 1987, income declared by individuals under the heading "other sources" is subject to a flat rate of 20 percent. If most (90 percent) of this income is reinvested within 2 years the tax rate is further reduced to 10 percent.

3. Tax Liability

5.13 A broad picture of the income tax liability of a salary earner may be constructed as follows. An individual with a basic salary of Tk 36,000 is entitled to a housing allowance of Tk 18,000 (50 of percent basic salary) and could claim a transportation allowance of Tk 6,000. This adds up to a gross income of Tk 60,000 (not including entertainment allowances). However, since housing and transport allowances are not included in gross income for tax purposes, no tax is due. Thus, no tax liability is due till income reaches almost 2½ times average family income. An individual with a basic salary of Tk 40,000 would, using the same allowances have a gross income of Tk 66,000. This elicits a tax liability of Tk 1,333.33 $[- \frac{1}{3} \times (40,000 - 36,000)]$, an average tax rate of 2 percent $[- \frac{1333.33}{66,000}]$ and a marginal tax rate of 22.2 percent $[\frac{1,333.33}{66,000 - 60,000}]$. For basic incomes higher than Tk 51,000, the tax due would be computed according to the graduated rate structure as this yields a lower tax liability than the one-third rule: thus, for a basic salary of Tk 55,000 (and gross income of Tk 88,500), the figures are Tk 5,500, 6.2 percent and 6.7 percent respectively. This is depicted in Figures 5.1 and 5.2. It will be seen that the one-third rule serves to limit tax liability at a basic salary of Tk 256,000 (gross income of just under Tk 292,000). At that income level, the total tax due and the average and marginal tax rates are Tk 73,300, 25.1 percent and 33-1/3 percent respectively.

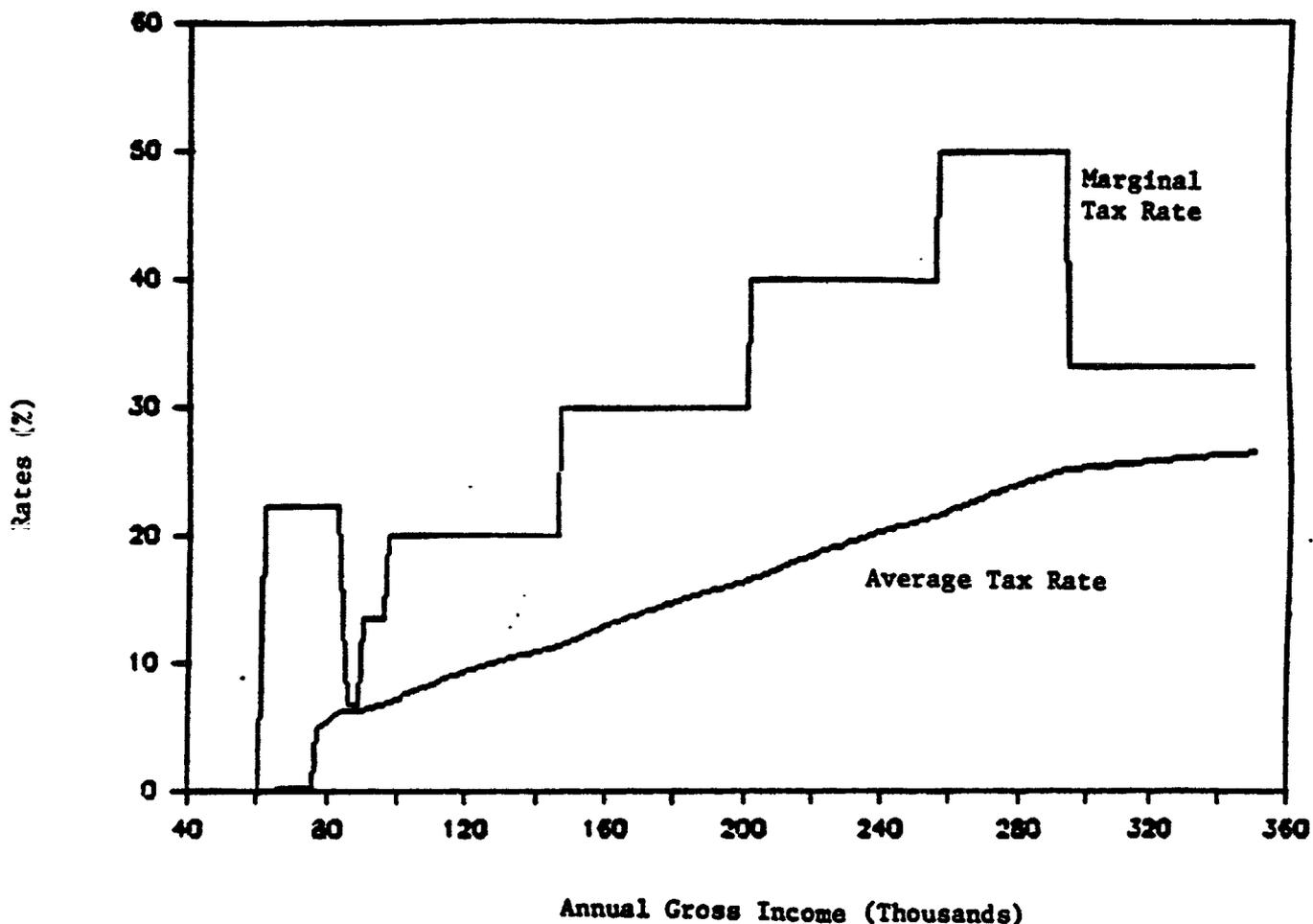
Figure 5.1: Income Tax Schedule: Existing System



Source: (a) Income Tax Ordinance, 1984
(b) Bangladesh Fiscal Statistics
(c) Annual Budget, various issues

Notes: 1. Rental and transport allowances are incorporated but not entertainment, investment and charity allowances.
2. Interest, dividends and civil services salaries are excluded.

**Figure 5.2: Average and Marginal Income Tax Rates:
Existing System**



Note: The jump in the marginal rate schedule over the approximate range Tk 62,000 to Tk 83,000 reflects the joint impact of the "one-third" tax liability rule (paragraph 5.3) and the income-related excludable allowances. Since the basic exemption is actually a filing threshold, the first effective marginal tax rate faced by the taxpayer is 22.2 percent as shown by the jump, rather than the 10 percent of the graduated rate structure (paragraph 5.3).

5.14 The above is suggestive of the tax burden of individuals that earn only salary income. The favorable treatment of interest and dividends implies that those with a combination of salary and capital income enjoy a lighter tax burden than is suggested by Figures 5.1 and 5.2, as the following example demonstrates. Consider two persons, A and B, with the same gross income of Tk 100,000 per annum. Suppose all of A's income is from salary and employment benefits while Tk 60,000 of B's income is from employment and the rest from investment income (Tk 15,000 in interest and Tk 25,000 in dividends). After excluding roughly Tk 37,000 as transport and rental expenses from his income, A pays a little over Tk 7,000 in income taxes, according to the graduated schedule. B pays only Tk 2,200, however, since the interest income is subject to an 8 percent levy, the dividend income to a 4 percent levy (see paragraph 5.3) and the remaining income of Tk 60,000 can be subdivided into Tk 24,000 for transport and housing allowances and Tk 36,000 of taxable income, which is at the filing threshold. Thus, persons with a higher proportion of capital income can face significantly lower tax burdens.

5.15 The tax burden can be further lowered if part of global income is invested in approved assets. Upto a third of total income may be so deducted; thus a taxpayer with a global income one-third in excess of another claiming no investment deductions pays the same tax as the latter. Taken in conjunction with the favorable treatment of capital income, this investment allowance can lead to striking differences in the average burden of taxation. To see this effect, compare the person A (with Tk 100,000 in income and Tk 7,000 tax liabilities as above) with person C who has Tk 200,000 in income. Suppose Tk 160,000 of C's income is from employment, the balance from interest (Tk 15,000) and dividends (Tk 25,000). If C takes Tk 36,000 as transport and rental deductions, virtually the same as A's, and, in addition, invests Tk 40,000 in approved assets, he then has only Tk 84,000 in taxable income. The amount of taxes due is Tk 11,300. The special levies on capital income amount as before to Tk 2200 - a total tax liability of Tk 13,500. Note that the average effective tax rate for A is 7 percent (Tk 7,000 divided by Tk 100,000) while that for C is only 6.7 percent (Tk 11,300 divided by Tk 200,000). The equity-enhancing effects of the mission's recommendations are illustrated in the context of the above examples in paragraph 5.53.

4. An Assessment of Personal Income Taxation

5.16 Personal income taxation as described above provides an environment that is exceptionally favorable to those best able to take advantage of its numerous concessions. While the comparatively light burden on wealthier taxpayers exerts little disincentive effects on their work and saving decisions, this result is achieved at the expense of revenue losses and adverse consequences for equity.

A. Filing Threshold

5.17 An unorthodox feature of personal income taxation is the use of a filing threshold, rather than a conventional tax exemption or relief. As indicated, individuals with incomes (excluding allowances) below Tk 36,000 are not required to file a tax return. Individuals with reported incomes (excluding allowances) within the range of Tk 36,000 to Tk 52,000 are governed by the one-third tax ceiling. Those with incomes above Tk 52,000, but below Tk 258,000 pay taxes according to the graduated rate schedule.

5.18 The filing threshold and the excludable allowances were shown to imply a marginal rate of 22 percent and not 10 percent for individuals with the lowest taxable incomes, i.e., incomes up to Tk 52,000 (excluding allowances). This implication causes concern on grounds of incentives and tax compliance. Individuals with income approaching the filing threshold, for example, might be sorely tempted to understate income to avoid the comparatively heavy initial tax burden. In certain cases, it is possible that the sudden increase in the marginal tax rate could have negative effects on incentives to do additional work.

B. Incentive Aspects

5.19 The filing threshold ensures that no tax liabilities are incurred until reported income is more than seven times per capita income. It was shown that for salaried persons no taxes are due until gross income (including allowances) is about 12 times per capita income. Furthermore, the average effective income tax rate cannot exceed one-third of total income as a result of the ceiling introduced in FY1985.

5.20 Similar provisions in other countries in a recent year (1987) were as follows. In India⁷ the basic exemption is currently about five times per capita income. The first marginal tax rate is 25 percent and the highest marginal of 50 percent is reached when annual income is 30 times per capita income, compared to 40 times in Bangladesh. In Pakistan,⁸ an individual incurs tax liabilities when his income exceeds 30,000 rupees or Tk 54,000, compared to Tk 62,000 for a salary earner in Bangladesh. Moreover, if the higher cost of living in Pakistan⁹ is taken into account, the real exemption in that country is worth Tk 45,000, or about three quarters of that in Bangladesh. Personal income taxation in Bangladesh is thus more favorable than in the other countries cited here even when only the basic tax rules apply. When the deductible investment allowance, the limit of which is set at one-third of total income, is taken into account, Bangladesh's tax system becomes far more generous than that of other countries in the region. While similar allowances are available in India and Pakistan, more stringent conditions are required in those countries. India, for example, sets the maximum allowable investment deduction in rupees, not as a fraction of total income, and qualified assets are more restricted, pertaining mainly to contributions to provident or pension funds. Pakistan is similar to Bangladesh in setting the ceiling for investment allowance at one-third of total income, but, unlike Bangladesh, it also has a ceiling in rupees, which is the binding constraint for high-income individuals. The list of assets approved for investment deduction in Pakistan is very similar to that of Bangladesh. There is, however, an important difference. In Bangladesh, many of the assets that are approved for investment deductions generate tax-free or effectively untaxed income,

7/ Per capita income in 1987: US\$260. Exchange rate: 12.36 Rupees/US\$.

8/ Per capita income in 1987: US\$380. Exchange rate: 15.36 Rupees/US\$.

9/ Based on preliminary 1985 estimates of the International Comparison Project, UN Statistical Office, New York.

as discussed further below. In Pakistan, these double allowances are largely avoided through taxation of the resulting investment income and through Zakat, a tax which is explained later.

5.21 Another major incentive is the special treatment granted to investment income including interest, dividends and capital gains. As indicated above, interest below an exemption limit (currently Tk 15,000) is not taxable except for the 8 percent levy. Only the amount exceeding this exemption is included in global income. Dividends are virtually tax-free. Since many of the assets generating capital income, including corporate debentures and stocks, also qualify for tax deductions, the returns to individuals are magnified by the tax system.

5.22 Consider an individual in the 30 percent tax bracket who purchases Tk 100's worth of corporate debentures with 15 percent pretax return. Since the purchase is tax deductible, the net of tax cost is Tk 70. With a 4 percent levy, the return as seen by the individual is Tk 14.4 for an investment of Tk 70 or about 21 percent, exceeding the stipulated rate of 15 percent. This implicit subsidy may be avoided either by eliminating the deduction when the asset is acquired or by taxing the return as part of global income. Suppose the individual, whose after-tax cost of the debenture is Tk 70, pays a 30 percent tax on the return. The after-tax yield is Tk 10.5, which implies a 15 percent rate of return on the (Tk 70) investment.

C. Revenue Aspects

5.23 An important implication of the liberal exemptions and deductions discussed above is the loss of revenue. So far no assessment has been made by the NBR regarding the tax expenditures of the various incentives available under personal income taxation. The overall impact may be inferred, however, from the net contribution of personal income taxes to total tax revenue.

5.24 At present, the amount of revenue collected from the personal income tax (PIT) is not known with precision. While income taxes paid by large companies are kept under a separate aggregate, small and medium-scale companies, referred to as "registered firms" for tax purposes, cannot be separated from individuals.¹⁰ The best estimates available for PIT collections, which are given in Table 5.2 below, include contributions made by registered firms and therefore exceed the revenue based on individual's income alone. The NBR reports however that there are few registered firms on the tax roll, and that their revenue contribution is small. In the absence of further statistical information, the mission was informed that it might not be seriously misleading to identify the figures in Table 5.2 with collections from the personal income tax.

10/ A "registered firm" has to be registered under Section III of the Income Tax Ordinance, 1984. No tax is payable on the first Tk 36,000 of its total income. The subsequent Tk 36,000, Tk 74,000 and Tk 74,000 of total income are taxed at 10 percent, 15 percent and 20 percent respectively; the balance is taxed at 25 percent.

**Table 5.2: Revenue Contribution of Personal Income Tax
(percentages)**

FY	Share in Total Income Tax	Share in Total Tax Revenue	Share in GDP
1981-82	33.2	6.8	0.6
1982-83	26.8	5.7	0.5
1983-84	27.3	5.4	0.4
1984-85	26.7	5.6	0.5
1985-86	26.7	5.7	0.5

Source: Data supplied by the NBR.

5.25 From Table 5.2, it is evident that the personal income tax makes a very limited contribution to domestic resource mobilization, accounting for less than six percent of total tax revenue in recent years. Personal income tax collection amounts to only one-half of one percent of GDP.

5.26 Of particular concern is the loss of revenue resulting from special exemptions given to investment income. The exemption for interest below Tk 15,000 (apart from the 8 percent levy) and the exemption of dividends (apart from the 4 percent levy) generally create revenue losses in three different ways. First, the income base is eroded directly by the exemption; for any given rate structure, the eroded tax base produces less revenue. Second, since the rate structure is graduated, the exemption of investment income puts taxpayers in brackets with lower marginal rates, further diminishing revenue collection. Third, the exemption limit for interest is difficult to enforce, since individuals may hold portfolios in which investment income from each source is below the limit. The splitting of bank accounts thus further diminishes the revenue base.

5.27 The extent of revenue loss caused by the favorable treatment of capital income is difficult to estimate from existing information. Some existing indicative evidence, however, suggests the following. On the basis of a random sample of tax returns furnished by the NBR, capital

income (interest, dividends and capital gains) is almost never reported, accounting for only 0.83 (four-fifth) of one percent of total reported income.¹¹ In a tax system in which a large proportion of the workforce has been ruled out by liberal exemptions and exclusion of government salaries, the share of capital income in the tax base can be expected to be relatively high. To indicate the potential shortfall, consider the share of capital income in other countries. In Thailand, for instance, taxes on interest income alone account for about 40 percent of personal income taxes. Since interest is taxed at a flat concessional rate, the share of interest income is likely to be higher than 40 percent of total reported income.

5.28 From the tax base considerably eroded by exemptions for capital income, more deductions can be made for investments in selected assets. These deductions further diminish the tax base and lessen the impact of rate graduation. From the same sample cited above, investment allowances represent the largest proportion of all deductions claimed, accounting for about 74 percent of the total. For every Tk 100 of reported income, about Tk 13 is written off as investment allowances. The sample of returns therefore shows a pattern in which little investment income is reported, and yet investment deductions are aggressively used.

D. Equity Aspects

5.29 Under current provisions, with liberal threshold and generous exclusions, individuals with considerable ability to pay are treated in the same way as those significantly worse off. In addition, "double allowance" of investment income subsidizes a source of income that accrues almost exclusively to the highest income groups. (As indicated above, double allowances occur when an investment is deductible and the yield is not taxable, as with purchases of public companies' shares.) Furthermore, high-income individuals can more fully utilize the double allowance, since the deduction limit for allowable investments, defined as a fixed proportion of income, is higher for them.

5. Recommendations

5.30 The mission's recommendations on reform of personal income tax policy are governed by the need to broaden the base of the tax in order to raise revenue, improve equity and remove anomalies that can adversely affect incentives and tax compliance. The proposals presented below are mutually reinforcing and therefore need to be viewed as a policy package. They could be introduced soon and would serve to enhance the role of personal income taxation in the tax system.

A. Include Employment-Related Allowances in the Tax Base and Replace the Current Filing Threshold by a Conventional Exemption Limit

5.31 At present housing, transport and entertainment allowances, whether received in cash or in kind, may be excluded from the income tax base. Furthermore, the jump in the marginal tax rate due to the filing threshold, noted in paragraph 5.18, has deleterious consequences for incentives and tax compliance.

11/ The sample consists of 172 personal income tax returns drawn randomly from the 1984/85 population.

5.32 Including allowances in the tax base would eliminate a major loophole under personal income taxation. However, to avoid undue hardship to those who would begin to pay taxes, as well as to eliminate an anomaly in the incentive structure noted above, it is proposed that the filing threshold of Tk 36,000 be converted into a conventional exemption limit.¹² This change implies that the graduated rate structure would apply to the excess of income over Tk 36,000. Thus, an individual with Tk 40,000 in income and benefits, would have a taxable income of Tk 4,000 [Tk 40,000 less Tk 36,000] and, a modest tax payment of Tk 400, implying an average tax rate of one percent and a marginal rate of ten percent. More generally individuals with gross income (inclusive of allowances) in the range of Tk 36,000 to Tk 90,000 may be required to pay taxes, depending on the individuals' circumstances.

5.33 The introduction of an exemption limit in place of a filing threshold, and the consequent definition of taxable income as being that in excess of the limit, would reduce revenue from taxpayers who primarily receive rental, investment or retirement income but who have no excludable allowances. However, the revenue gained by the curtailment of employment-related allowances is expected to more than offset this loss. It is estimated (see Appendix 5.1 for details) that this measure will eventually yield an extra Tk 150 million a year at 1986/87 prices, once the income tax administration is strengthened to deal with the new taxpayers brought within its purview.

5.34 It is proposed that the NBR retain the existing structure of marginal tax rates ranging from 10 percent to 50 percent.

5.35 The effects of these proposals are illustrated in Table 5.3. Panel II shows the use of a conventional exemption under the existing treatment of investment. As is evident, the impact of such a change is confined to the taxpayers who benefit from the existing double relief -- combination of employment allowances and the filing threshold. For other classes of taxpayers, there is little or no change in tax liabilities. Panel III of the table shows the effects of conventional exemption applied with new rules concerning investment as discussed below. Taken together, the new rules on exemptions and investment create a tax system that is more progressive and generates more revenue.

5.36 It will be recognized that the replacement of the filing threshold by an exemption limit reduces the marginal tax rate for those with excludable allowances coming into the tax net from 22.2 percent (as a result of the existing one-third rule) to 10 percent, thereby improving incentives for tax compliance. For that reason, the one-third rule would not play an important role in the reformed system. However, if it were retained, it would serve to limit the tax liability of those with gross incomes exceeding Tk 294,000. Under these assumptions, the total tax liability, together with the marginal and average rates of taxation under the new system, are shown in Figures 5.3 and 5.4 respectively.

5.37 At seven times per capita income, a filing threshold of Tk 36,000 for gross income inclusive of allowances has the desirable characteristic of excluding a large number of tax returns with insignificant yields. This feature would not be affected by changing over to an exemption limit.

12/ The conventional exemption limit is used widely across countries, including among others, India, Sri Lanka, Thailand and, more recently, Pakistan.

**Table 5.3. Comparative Tax Liabilities for Selected Income Levels
(Levels of Income) g/**

Tax Rules	Gross Income:							
	of which	50,000	75,000	100,000	125,000	150,000	175,000	200,000
	Investment Income	5,000	7,500	10,000	18,750	22,500	26,250	40,000
	Earned Income	45,000	67,500	90,000	106,250	127,500	148,750	160,000
I. Present System								
a. Employment Allowances b/		19,000	26,500	34,000	36,000	36,000	36,000	36,000
b. Investment Allowance		5,000	7,500	10,000	18,750	22,500	26,250	40,000
c. Exclusion of Investment Income d/		5,000	7,500	10,000	18,750	22,500	26,250	40,000
d. Taxable Income g/		-0-	-0-	10,000	51,500	69,000	86,500	84,000
e. Taxes Due		-0- g/	-0- g/	3,333	5,150	8,300	11,800	11,300
II. Conventional Exemption and No Employment Allowances								
a. Standard Exemption		36,000	36,000	36,000	36,000	36,000	36,000	36,000
b. Investment Allowance		5,000	7,500	10,000	18,750	22,500	26,250	40,000
c. Exclusion of Investment Income d/		5,000	7,500	10,000	18,750	22,500	26,250	40,000
d. Taxable Income h/		4,000	24,000	44,000	51,500	69,000	86,500	84,000
e. Taxes Due		400	2,400	4,400	5,150	8,300	11,800	11,300
III. Conventional Exemption and New Investment Rules								
a. Investment Income		5,000	7,500	10,000	18,750	22,500	26,250	40,000
b. Earned Income		45,000	67,500	90,000	106,250	127,500	148,750	160,000
c. Standard Exemption		36,000	36,000	36,000	36,000	36,000	36,000	36,000
d. Taxable Income (b-c)		9,000	31,500	54,000	70,250	91,500	112,750	124,000
e. Tax on Earned Income		900	3,150	5,400	8,550	12,800	17,325	20,700
f. Tax on Investment Income g/ (10%)		500	750	1,000	1,875	2,250	2,625	4,000
g. Gross Tax		1,400	3,150	6,400	10,425	15,050	19,950	24,700
h. Investment Tax Credit i/		500	750	1,000	1,875	2,250	2,625	4,000
i. Net Taxes		900	3,150	5,400	8,550	12,800	17,325	20,700

g/ Gross income is assumed to arise primarily from employment. Investment income is assumed to take up an increasing proportion of gross income. In the illustration above, the proportion of investment income is given by:

Income Range	% of Investment Income
At or below Tk 100,000	10
100,000 < Income < 200,000	15
At or above 200,000	20

Moreover, investment income is assumed to be entirely reinvested in approved assets.

- b/ Includes only housing and conveyance allowances.
- g/ Taxable income is below the filing threshold.
- d/ Investment income is virtually untaxed under existing tax rules due to special treatment and loopholes.
- g/ A withholding tax of 10 percent is used and assumed to be final.
- i/ Investment tax credit is assumed to be 10 percent of approved investment.
- g/ Taxable income is calculated in two steps. First, investment allowances, employment allowances and investment income (the last being in effect untaxed) are subtracted. Second, taxable income is either the excess of the above calculated figure over the filing threshold or the above calculated figure. It is the former, i.e., the excess, if one third of the excess is less than 10 percent of the above calculated figure. It is the latter if one-third of the excess is greater than 10 percent of the above calculated figure. Taxes due in row e are calculated correspondingly. For an explanation of these rules, see paragraph 5.3.
- h/ Equals gross income less investment income, less investment allowance, less standard exemption.

Figure 5.3: Income Tax Schedule Corresponding to Recommended System

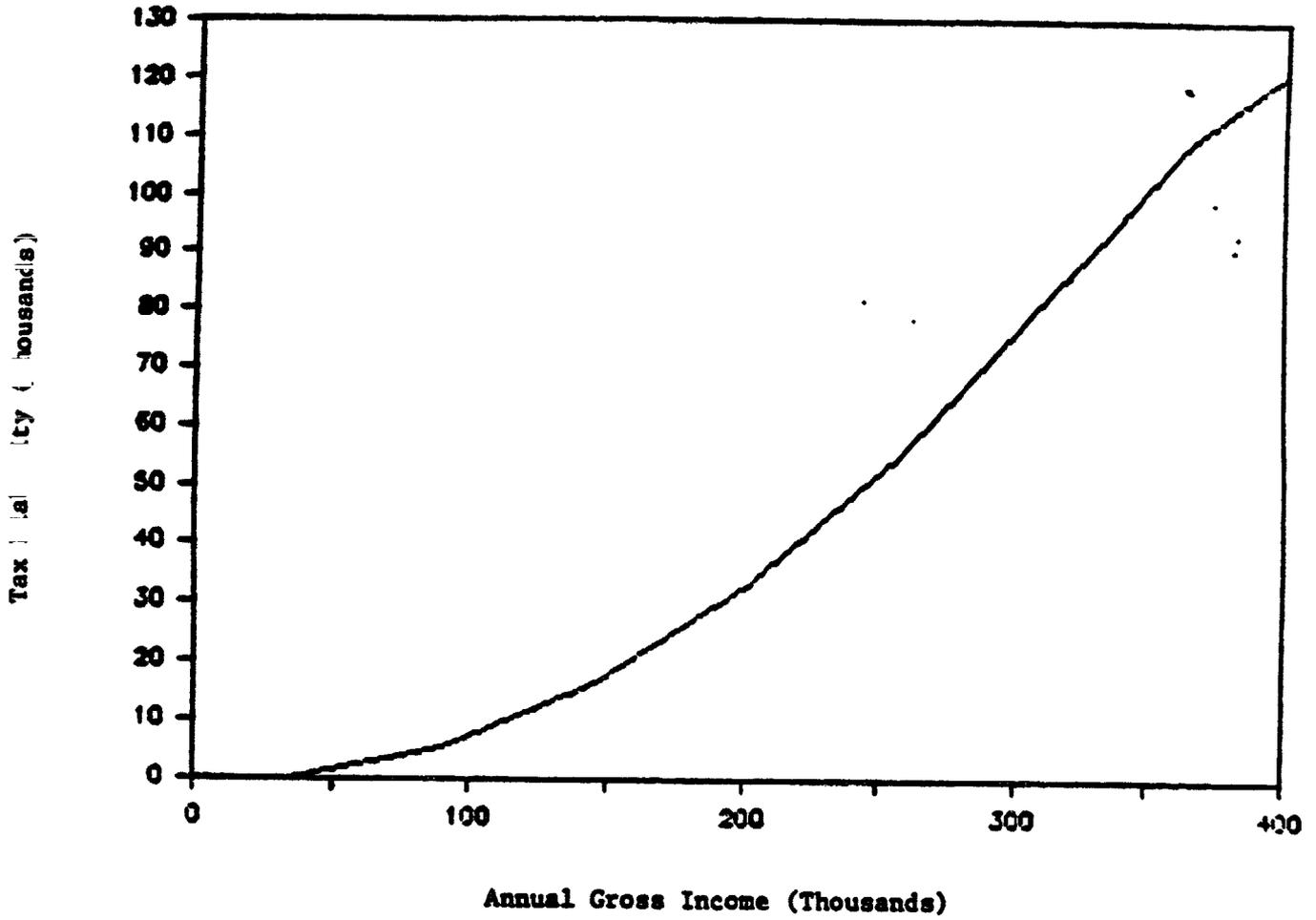
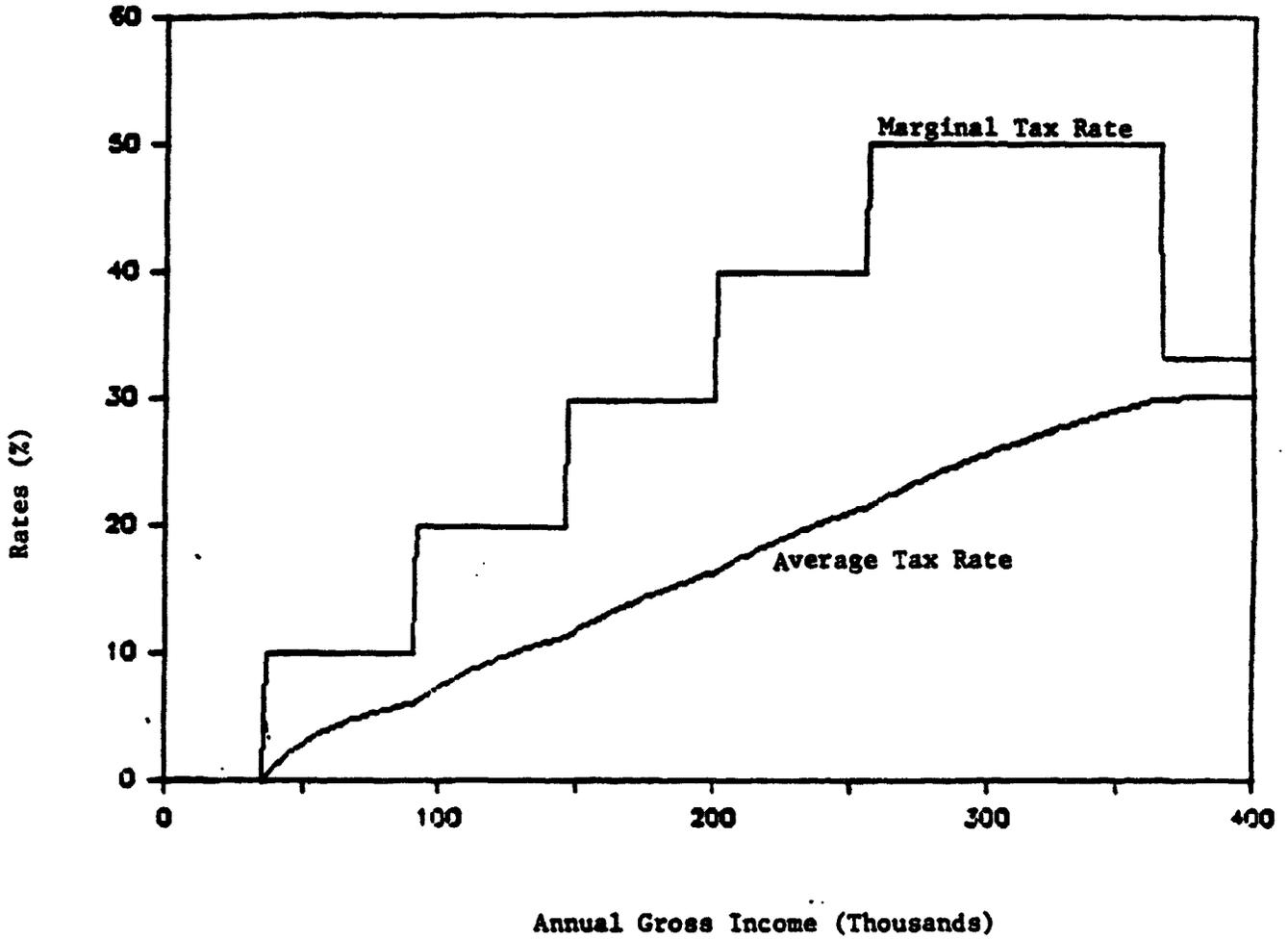


Figure 5.4: Average and Marginal Tax Rates Corresponding to Recommended System



However, inasmuch as salary earners with gross incomes between Tk 36,000 and Tk 60,000 will be required to file a return, there would be an increase in the administrative workload of the (direct) taxes wing of the NBR and its field organizations. This consequence is to be seen as the cost of broadening the base of the income tax system.

5.38 The above measures need to be complemented by those that remove the double allowance provisions that primarily benefit wealthier taxpayers. These changes would enhance the progressivity of the system, and by removing special incentives, restore the integrity of personal income taxation. The impact on revenue would be substantial. The mission therefore recommends the following:

B. Eliminate the Special Exemptions for Interest and Dividends and Introduce a Withholding Tax on Interest and Dividends Paid by Financial as Well as Non-financial Corporations, Irrespective of the Size of Income or Asset Holdings

5.39 Such a withholding tax, which would build on deduction-at-source provisions in the existing Income Tax Ordinance,¹³ would substantially reduce the scope for evasion by recipients of capital income. The rate of the withholding tax should be determined by the government on the basis of a balance between revenue requirements and saving incentives. Thus, if a 10 percent withholding tax is applied to the income arising from term deposits in commercial banks, corporate debentures and stocks, the resulting revenue is expected to be about Tk 700 million at 1984/85 prices.¹⁴ The intent of this rule is not to create a schedular tax for capital income. Individuals would ultimately be required to file a tax return in order to determine their additional tax liability or refunds. To simplify tax administration, however, the NBR may initially make the filing of tax returns optional, rather than compulsory; this is further discussed below.

13/ The scope of withholding taxes on ordinary income has been substantially expanded since the 1988/89 budget. Government agencies, parastatals, banks and listed companies are now required to deduct a tax from payments made to contractors, landlords, shipping companies and suppliers.

14/ The breakdown of revenue from the withholding tax is as follows: (a) Tk 1 billion from bank interest (based on 10 percent tax rate, 15 percent interest rate and term deposits of Tk 68.3 billion as reported by the banking system at the end of 1985); (b) Tk 30 million from dividends (based on Tk 2 billion paid-in capital reported by listed companies and (15 percent average rate of return on shares). Of the Tk 1.03 billion in estimated revenue, Tk 120 million are already being paid by companies. After the interest and dividend exemptions have been removed, the amount of tax refunds will depend on the eligibility criteria to be set by the NBR. In any case, tax refunds should not exceed 20 percent of collection, and the net incremental revenue should be about Tk 700 million. Repeating the above calculations with 1986/87 data yields a figure of roughly Tk 1 billion at 1986/87 prices.

5.40 This proposal is intended to lay the foundation for a major source of highly elastic revenue. Experience suggests that, as the economy and the financial system grow, revenue arising from interest and dividends increase more than proportionately. Thus, the share of revenue contributed by capital income is likely to increase, thereby enhancing the income elasticity of the tax system.

(i) Comparative Experience

5.41 Similar withholding taxes have been widely used in other Asian countries. In Pakistan, for example, a tax (Zakat) with compulsory deduction on financial assets has been implemented since 1980. The tax rate is 2.5 percent applied to the amount held in each account, which implies a rate in excess of 20 percent on income in recent years. In Thailand and Korea, a withholding tax (12.5 percent and 15 percent, respectively) has been in force for a long time. No exemptions are allowed in these countries for small accounts, although refunds are available for those who have no tax liabilities and file a claim. The withholding tax is regarded as the final tax for those who have elected not to file a return.

5.42 The case of Thailand might be instructive. When the withholding tax was proposed in the mid-1970s, considerable opposition was encountered. The main concern related to potential effects on financial institutions; there were worries about a run on banks or at least a slowdown of financial deepening. The withholding tax was nonetheless implemented in 1977. Experience since then has shown that the fear was much exaggerated. The degree of financial deepening, as measured by the ratio of interest bearing deposits or quasi-money to GDP, has grown from about 25 percent in 1977 to 48 percent in 1985. In the decade preceding 1977, the rate of increase was somewhat higher, rising from 10 percent to 25 percent. The difference is small, however, and possibly attributable to the higher growth rate of the earlier decade.

(ii) Effect on Financial Disintermediation

5.43 The concern over disintermediation arises from the assumption that term deposits are fairly responsive to changes in interest rates. If the assumption is correct, it follows that a withholding tax would lower the net yields received by depositors and thus encourage them to seek other forms of financial assets. In most low-income countries, however, this assumption is generally not valid for a variety of reasons. First, alternative financial assets with comparable combinations of risks and returns are scarce. Second, in the past few decades, a sustained growth has been observed in most low-income countries (with the exception of many in sub-Saharan Africa) and the positive income effect on deposits has tended to dominate the changes caused by interest-rate movements. When deposits are not highly responsive to changes in interest rates, a small withholding tax¹⁵ on interest income cannot cause serious disintermediation.

15/ A 10 percent withholding tax is equivalent to a tax of about 1.5 percent on deposits at current interest rates in Bangladesh. If the interest elasticity were to be as high as 0.3, the tax would cause a decline of about one half of one percent in deposits.

5.44 Estimates of interest elasticity (or responsiveness) for Bangladesh are given in Table 5.4. For both M_1 (narrow-money) and quasi-money (term deposits), interest elasticities are not significantly different from zero. According to these estimates, a withholding tax would cause a small increase in M_1 and a somewhat larger drop in quasi-money. A tax rate of 10 percent, for instance, would cause a net decline of less than one half of one percent in M_2 . These estimates, therefore, imply first that the effect of the tax on financial intermediation would be modest¹⁶ and, second, that the burden of the tax could fall primarily on depositors rather than borrowers or financial institutions.

C. Tighten the Scope of Investment Allowances

5.45 The deduction limit for allowable investments, being defined as a proportion (one-third) of income, increases with income. To rectify the attendant inequity while preserving investment incentives, it is recommended that the scope of the investment allowance be tightened considerably. The mission's preferred option is to replace the current investment allowances with an investment tax credit. It is suggested that the amount of tax credit be set equal to the investment in approved assets multiplied by the rate of the withholding tax, which is to be determined by the authorities.¹⁷

5.46 The effects of this new rule are as follows. First, this tax credit, together with the withholding tax proposed above, ensures that no double allowances or investment subsidies are granted. Thus, in the example considered in paragraph 5.22 above, the net of tax cost of Tk 100 of corporate debentures would be reduced by the rate of tax credit. However, the pretax return of Tk 15 would also be reduced by the rate of withholding tax. If the rate of tax credit equals the rate of withholding tax, the post-tax rate of return would remain unchanged at 15 percent. The effective tax rate on investment income would be zero for approved assets¹⁸ (thus preserving incentives to save in these assets) and equal to the withholding tax rate modified by the special levies, where appropriate, for other assets. Second, the government would gain revenue as the marginal tax rates applicable to the vast majority of investors would exceed the withholding tax rate. The revenue loss arising from the new tax credit

16/ These findings are consistent with results derived from cross-country analysis of financial assets and presented in Hanson, J.A., and C.R. Craig, "The Demand for Liquid Financial Assets: Evidence from 36 Developing Countries," Industry Department, World Bank, 1986, processed.

17/ Suppose the withholding tax rate is set at 10 percent. An individual who acquires Taka 1500 of approved assets will be given Taka 150 in tax credit, irrespective of his marginal tax rate. This tax credit is then deducted from his tax liability for the period.

18/ The 4 percent levy applying to capital income from approved assets does not significantly affect these calculations.

Table 5.4: Interest and Income Elasticities of Bank Deposits

Dependent Variable	Constant	Interest Elasticity	Income Elasticity	R ²	D.W	ρ
Money (M ₁)	0.251 (0.98)	-0.108 (-0.61)	1.351 (3.26)	83.1%	1.6	0.15
Quasi-Money (M ₂ - M ₁)	-4.620 (-1.10)	0.170 (0.64)	2.83 (4.15)	92.7%	1.43	0.17

NOTES

(a) Estimates are derived from the relation:

$$\ln M = a + b \cdot \ln r + c \ln \text{GDP}$$

(b) The regression is based on real (inflation deflated) variables, with serial correlation corrected by the Cochrane-Orcutt procedure.

(c) Figures in parenthesis are t-statistics.

(d) Sample period: 1976-1986.

(e) In neither equation (Money and Quasi Money) is the estimate of interest elasticity significantly different from zero.

would therefore be less than that arising from deductions of allowable investments.¹⁹ Third, the issue of vertical inequity would be corrected since, under the new rule, all taxpayers receive equal tax credit for the same amount of investment. The current disparity in tax benefits arising from graduated tax rates would therefore be eliminated.

5.47 An alternative way of tightening investment allowances is to set a Taka ceiling on deductible investment in approved assets to, say, Tk 12,000 per annum, which is equal to one third of the proposed exemption level. This method, though administratively somewhat simpler than the credit method, fails to address the equity issue fully.

D. Include Realized Capital Gains in the Tax Base. Irrespective of How the Proceeds are Used, if the Initial Investment from which the Capital Gains Arose was Deducted as an Investment Allowance

5.48 This change puts the taxation of capital gains in line with taxes on other forms of investment income. Ideally, only real (inflation-adjusted) gains should be taxed. But to introduce indexation for this purpose alone would complicate tax administration to an extent far greater than would be warranted by the importance of the tax in revenue. Moreover, two features of the current rules on capital gains taxation mitigate the effect of inflation:

- (i) the tax rate goes down as the holding period increases;
- (ii) the tax is levied upon realization, not upon accrual, which tends to lower the tax burden.

For these reasons, the recommendation proposed here does not involve indexation.

5.49 The above changes would remove some of the extraordinary incentives currently available under the personal income tax system, but the resulting tax regime would still remain highly favorable to saving and investment by international standards.

E. Transitional Measures

5.50 The measures suggested above affect the relative yields of assets. Since existing portfolios have been chosen on the basis of current tax provisions, these changes in tax rules may induce individuals to alter asset composition. Experience shows that certain preparatory steps should be taken before such a tax is introduced. In July 1985, a withholding tax on interest earnings was imposed and made effective immediately. Stringent conditions were attached, including the requirement that taxpayers pay additional taxes if the amount withheld fell short of the total liability determined by the graduated schedule. Public opposition was swift and strong. Within three weeks the government was forced to withdraw the tax.

^{19/} The data necessary to quantify the resulting revenue gain was not available at the NBR.

5.51 Despite the strong reaction of the public, the tax appeared to have caused no perceptible impact on the level of interest-bearing deposits. The time profile of quasi-money is shown in Figure 5.5 for the months preceding and following the introduction of the withholding tax in 1985. As is evident from the figure, not only did disintermediation fail to materialize, but in fact the growth in deposits proceeded with no interruption. The same pattern is observed with the 4 percent Jamuna bridge surcharge, which was introduced on interest income in October 1985. The flat portion in Figure 5.5 that occurred during December 1985 was due to unrelated seasonal factors. In any case, growth resumed after December despite the continuation of the Jamuna bridge surcharge.

5.52 To safeguard against a recurrence of the events that occurred in 1985, the following steps are recommended.

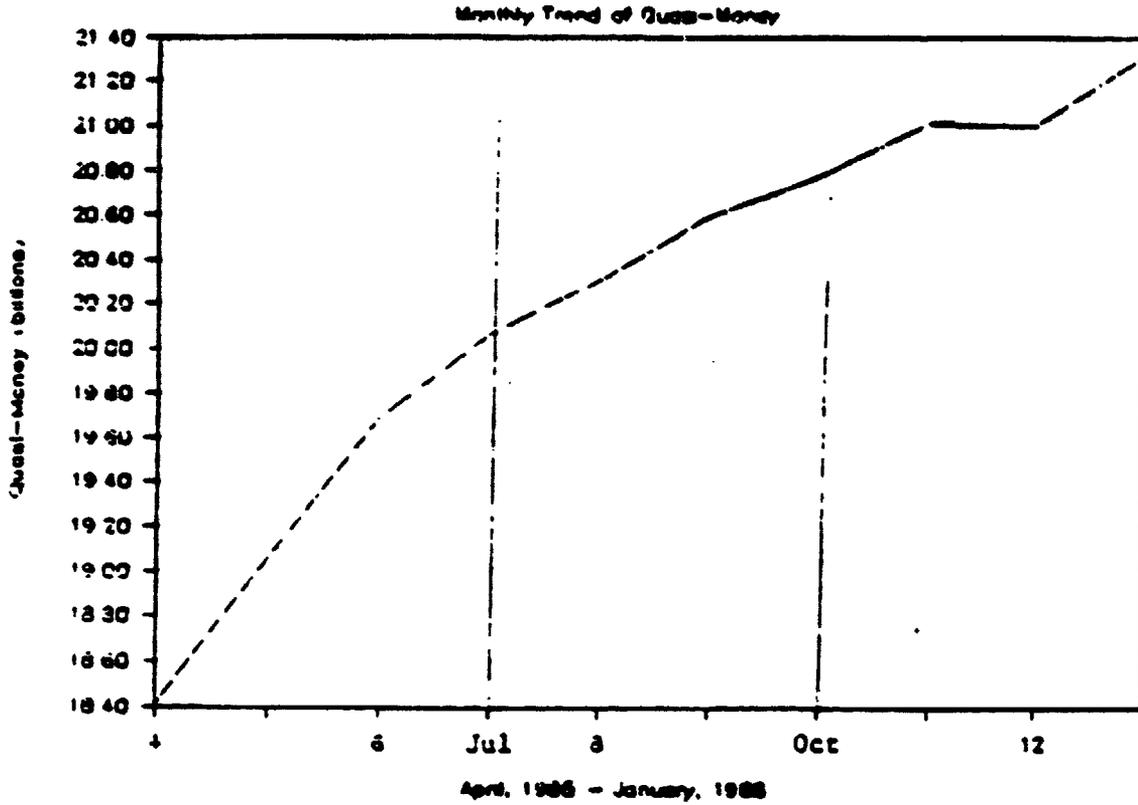
- An advance notice of at least 6 months be given to the public regarding the removal of the exemption for interest and dividends and the introduction of a withholding tax.
- Initially, the withholding tax rate be set relatively low in light of other existing charges and the time required for the public to restructure asset patterns. For example, a rate of 1.5 percent on deposits or 10 percent on interest might be attempted. This rate is considerably lower than the Zakat of 2.5 percent on deposits which has been implemented in Pakistan.
- Reconciliation of tax liabilities be made optional, at least initially. Thus, individuals with tax liabilities (due to the interest and dividends) exceeding the amount withheld would not be required to pay the balance in the first few years. Moreover, no refunds would be granted either, unless the amount involved exceeded a specified minimum, say Tk 1000. These transitional measures would also keep the workload at the NBR at manageable levels.
- At least initially, the parties responsible for withholding the tax be allowed to safeguard the anonymity of individuals to whom the relevant investment income accrues.

F. Tax Liability Under the Revised System

5.53 The above proposals, in addition to making a significant contribution to revenue, also enhance the equity of the tax system. This is best appreciated by considering the examples presented in paragraphs 5.14 and 5.15. With unchanged economic behavior in response to the tax reform,²⁰ individual A, who has a gross income of Tk 100,000 from salary

20/ More realistic assumptions would change the numbers presented here without reversing the thrust of the basic argument.

Figure 5.5: Time Profile of Quasi-Money Before, During and After the 1985 Withholding Tax



- SOURCES:**
1. Data supplied by the NBR
 2. International Financial Statistics, IMF

and employment benefits, would have a taxable income of Tk 64,000 and a tax liability of Tk 7300. Individual B, who has Tk 60,000 from salary and employment benefits, Tk 15,000 in interest and Tk 25,000 in dividend income, would pay Tk 2400 from salary income and Tk 4000 as a result of a 10 percent withholding tax, or a total of Tk 6400. Although this is a significant improvement compared to the status quo, the need to preserve anonymity of capital income recipients prevents such income from being treated on the same footing as other income and is an important factor in the feature to address the equity issue between A and B fully. Individual C, who has Tk 160,000 from employment, Tk 15,000 from interest and Tk 25,000 from dividends, would pay Tk 20,700 from salary income, and Tk 4000 from a 10 percent withholding tax, making a total of Tk 24,700. A 10 percent investment tax credit applying to approved assets reduces this figure to Tk 20,700. Thus A, with an income of Tk 100,000, faces an average tax rate of 7.3 percent, while that for B, who earns Tk 200,000 is 10.4 percent, thereby adding to the progressivity of the tax system.

III. COMPANY INCOME TAXATION

1. Basic Rules and Tax Rates

5.54 The FY88 budget reduced company income tax rates across the board to the following:

- Non-industrial Companies	-----	55 percent
- Industrial Companies	-----	45 percent
- Publicly Traded Companies	-----	40 percent

Intercompany dividends are taxed at a uniform rate of 15 percent. Capital gains are taxed as normal income if the holding period is less than two years; the rates decline as the holding period increases, reaching a minimum rate of 15 percent after 15 years. A balancing adjustment, which may be a deduction or an additional charge, is added to capital gains upon the disposal of assets.

5.55 Depreciation for tax purposes is based on historical costs and the declining balance method is applicable to most assets. The rates differ across assets, but most are within the range of 15 percent to 30 percent, including 20 percent for buildings and most machinery and 15 percent for furniture and office supplies. For certain vehicles, including inland and ocean-going ships, the straight-line depreciation method with rates varying from 10 percent to 20 percent is used. When the ships are used for transporting passengers and fishing, however, a special rate of depreciation (40 percent) is allowed in the first year.

5.56 Business losses may be carried forward, but not backward against taxes already paid. Moreover, foreign business losses incurred by a resident company may be set off against domestic income. A deduction is allowed for bad debts or doubtful debts incurred by a non-financial company, provided that the Income Tax Officer is satisfied with the evidence. For financial institutions, a tax-free reserve not exceeding 10 percent of the total income is granted at the discretion of the tax authorities. But if the amount of cumulative reserve has exceeded paid-up capital, no further exemption is allowed.

2. Investment Incentives

5.57 Two forms of major investment incentives are available in Bangladesh. The first is a tax holiday²¹ involving full exemption of business income for a specified period. The exemption however does not apply to capital gains or intercompany dividends. The duration of tax holidays varies from a minimum of 4 years, for industries set up in major cities, to a maximum of 12 years for industries located in the "least developed areas". During the period of tax holidays, normal asset depreciation for tax purposes is required. Tax holidays have been widely used since independence.

5.58 The second major investment incentive is an accelerated depreciation allowance (ADA). Under these incentives, the rates of first-year depreciation allowances for plant, machinery and furniture vary from 80 percent to 100 percent depending on location. Although the degree of tax concessions implied by this incentive is significant by international standards, especially when interest expenses remain fully deductible after the special depreciation has been written off, in practice few companies have chosen it. Tax holidays have been the preferred option.

5.59 Unlike in many other countries of the region, these incentives are not granted on a selective basis. Companies engaged in industrial production and tourism are automatically qualified, if an application is filed within a specified period and if the size of investment exceeds a threshold (currently Tk 100,000 in plant, machinery and equipment). No further performance conditions are imposed, although a specified share of the profit must be invested in selected government securities. Expansion of existing operations also qualifies for these incentives, provided separate accounts are maintained.

3. Assessment

5.60 The primary features of company taxation are the scope and concessions of tax incentives. Unlike other countries in the region, the tax authority in Bangladesh does not exercise discretionary power in granting tax concessions. Virtually all companies engaged in broadly defined industries, as shown in Table 5.5, are given guaranteed access to tax incentives. The degree of tax concessions is illustrated by complete exemption of profits for a period of up to 12 years and an investment write off of 80 to 100 percent in the first year for plant, equipment and vehicles. These concessions are particularly generous when it is recognized that much of the corporate investment is financed by instruments which are tax deductible at the personal income stage. The combination of broad coverage and liberal concessions gives tax incentives a more prominent role in private investment decisions than the standard tax rules.

21/ Originally, an undertaking had to be set up prior to June 30, 1990 to qualify for a tax holiday. Since August 1988, this termination date has been extended to June 30, 2000. Some of the requirements on the use of exempted profits have also been eased. The 60 percent plough-back-into-business rule is now replaced by a 15 percent investment in a broad range of assets.

Table 5.5: Industry Group Eligible for Tax Holidays

-
- Chemicals, drugs and pharmaceuticals (basic manufacturers).
 - Insecticides and pesticides (basic manufacturers).
 - Petrochemicals.
 - Wires and cables.
 - Agricultural machinery.
 - Boilers and compressors.
 - Tractors.
 - Machine tools and manufacture of other capital equipment.
 - Manufacture of trucks, cars, scooters, auto-rickshaws and bicycles.
 - Shipbuilding and repair.
 - Diesel engines and I.C. engines.
 - Textile machinery including manufacture of looms and spindles.
 - Ceramic and sanitary ware.
 - Livestock feed.
 - Gas and electric appliances, gas and electric meters and water meters.
 - Components of above.
 - Surgical instruments.
 - Sports goods.
 - Cutlery.
 - Carpets.
 - Other industries which export at least 30 percent of their production.
 - Poultry and dairy farming.
 - Any other industry using wholly or mainly raw materials produced in Bangladesh.
 - Any industry involving a manufacturing process.
 - Any other industry as may be prescribed by the National Board of Revenue in consultation with the Ministry of Industries.
-

Source: International Bureau of Fiscal Documentation

- Notes: (a) An application must be filed within 180 days after commencing commercial production.
- (b) Specified portions of exempted income must be invested in Government Bonds or ploughed back to business.

5.61 The magnitude of investment incentives provided by the company tax concessions may be captured by the "marginal effective tax rate" (METR) which equals the difference between the before tax rate of return on investment and the after tax rate of return, expressed as a percentage of the before tax rate of return. This measure summarizes the effects of taxation on income and capital gains over the life of a typical project after the various deductions, investment tax credit, balancing adjustments and dividend credit are taken into account. The METR may be estimated for different countries on the basis of the tax rules governing the operation of a typical project. A comparison of the METRs across countries may be made if the non-tax parameters in different countries are not varied. Included among the latter are the asset mix and financing method of the projects, the real rate of return, the rates of asset depreciation and the prevailing rate of inflation. The METRs for Bangladesh and a number of other developing countries for which estimates are available are given in Table 5.6.²²

5.62 While the statutory company tax rate in Bangladesh is one of the highest in this group of countries, its marginal effective tax rate is among the lowest, even when the standard tax rules apply. Among the reasons for the low METR are: high rates of tax depreciation for most assets and favorable treatment of capital gains (which include the balancing adjustment) when the proceeds are reinvested. The relevant tax regime for a typical project in Bangladesh, however, is not described by the standard tax rules, since tax holidays are granted to nearly all applicants. When this feature of company taxation is taken into account, the degree of tax concessions becomes even more pronounced. Thus, while the METR for a 4 year tax holiday is 23.3 percent, it falls to 9.6 percent for a holiday period of 8 years and to zero for 12 years (see the last row of Table 5.6). The positive METR arises from taxes due after the holiday period has expired.

4. Revenue Aspects

5.63 When an incentive is granted to a company, less revenue is collected than when standard rules apply. The difference is "tax expenditure" or revenue foregone. With adequate data pertaining to individual taxpayers, tax expenditures associated with each instrument may be estimated by aggregation over all companies receiving the particular incentive. Similarly, tax expenditures for the entire incentive system may be obtained by summing across incentive instruments.

5.64 Under a tax holiday, revenue loss arises from two main sources. The first is the direct loss due to exemption of company income during the holiday period. The second is the loss due to the transfer of profits from companies under standard tax rules to companies benefiting from tax

22/ The methodology underlying the METR calculations used here is explained in Appendix 5.2. Although the specific rates shown are sensitive to changes in a variety of assumptions made concerning tax rules and project characteristics, the ranking of countries by effective tax rates appears to be less affected by such changes.

**Table 5.6: Marginal Effective Tax Rates on Capital Investments
for Selected Countries**

Country	Statutory Rate	Effective Rate
Hong Kong	18.5	16.4
India	55.0	59.5
Indonesia	36.0	
Malaysia	40.0	23.4
Pakistan	55.0	49.0
Philippines	35.0	40.2
Singapore	40.0	23.2
Thailand	35.0	20.0
Bangladesh		
(A) Standard Tax Rules	45.0	23.3
(B) With Tax Holidays		
4 Years	0.0	23.3
8 Years	0.0	9.6
12 years	0.0	0.0

Source: (1) A. Pellechio et al., "Taxation of Investment in East Asian Countries," World Bank, Provisional Papers in Public Economics, 1987.

(2) Mission estimates

Note: Some of the major assumptions used for all countries:

- (a) 10 percent real rate of return (before-tax);
- (b) 5 percent rate of inflation;
- (c) 50 percent debt financing.

holidays. The second source of revenue loss is in fact an evasion and thus punishable by law. The transfer of profits, nonetheless, has been commonly observed in countries where tax holidays are granted. Its existence should not be ignored by prudent tax authorities.

5.65 The NBR has attempted to estimate the size of revenue foregone under tax holidays. A major problem was encountered, however, as a large number of companies under tax holidays failed to file tax returns as required. Based on the partial data available, the NBR placed the amount of revenue loss over a five-year period (from FY1980 to FY1984) at Tk 200 million or Tk 40 million per annum.

5.66 An alternative estimate may be obtained, however, on the basis of a random sample of company tax returns furnished to the mission by the NBR. There are 309 cases in the sample, with 170 reporting positive taxable income, 63 zero income and 76 losses.²³ After allowing for the reported losses,²⁴ the average taxable income per company for the same is Tk 1,407,550, implying a tax liability of Tk 633,340 per company at a 45 percent tax rate. Since there are about 200 companies currently on tax holidays, the expected revenue loss is about Tk 126 million per annum. If the sample is indicative of the tax-paying population as a whole, the size of revenue loss is three times greater than available government estimates. This estimate is of course subject to a considerable margin of error, due both to the limited sample size and the extent to which the sample reflects the characteristics of tax-holiday companies. If, for instance, companies on tax holidays are on average larger than general taxpaying companies, then the estimate given here would err on the low side. If, on the other hand, tax-holiday companies account for a large proportion of new taxpayers, which tend to have low profitability, then the given estimate might be biased upward. In spite of these uncertainties, it appears that the magnitude of revenue losses is quite significant, accounting for nearly 6 percent of company tax revenue in 1984/85.

5. Resource Allocation

5.67 Two desirable properties of a company tax system are (i) neutrality with respect to ranking of investment projects; and (ii) neutrality among different sources of finance. The first ensures that the ranking and, hence, choice of investment projects is not distorted by the company tax system. The second does not discriminate, for example, between debt and equity finance and therefore does not require the authorities to impose restrictions on the financial policy of companies.

A. Neutrality With Respect to Project Selection

5.68 It can be shown that the system of accelerated depreciation allowances with 100 percent write-off of investment expenditure in the first year (also known as "full expensing"), which is one of the instruments already available in Bangladesh, together with no

23/ The sample was drawn from the 1984/85 tax returns.

24/ Reported losses amounted to almost 80 percent of report income in the sample.

tax-deductibility of interest payments on loans, can satisfy the above properties. Appendix 5.3 develops the argument with a simple example. Its intuitive basis may be seen as follows. Expensing, by allowing complete writeoff of investment expenditures against company taxation in the first year, reduces the cost of a project to the investor by the rate of company taxation. Correspondingly, profits from the investment are taxed at the same rate. This symmetric treatment of costs and benefits makes the tax on new marginal investments zero. This effectively makes the government a partner in the firm, sharing in costs and profits alike. It is this property which makes the tax system preserve the ranking of projects vis-a-vis a no tax situation.²⁵ The zero taxation of marginal investment is, however, consistent with raising revenue, since the government gets a share in inframarginal profits.

5.69 The above argument implies that such a company tax system, by not taxing the marginal project, preserves incentives to invest as well as efficiency, a property consistent with that argued for VAT-type taxes in Chapter 2. However, it assumes that there are always sufficient taxable profits for the accelerated depreciation allowance to be used to offset tax liabilities. If this is not the case, the tax system must allow losses to be carried forward at the nominal interest rate.

5.70 Concern is sometimes expressed that expensing embodies a bias in favor of capital intensive projects. The preceding paragraphs (and Appendix 5.3) have argued that expensing without interest deductibility does not interfere with project choice vis-a-vis a no tax situation. Hence the cost of capital and, therefore, capital-intensity of projects, is not changed by expensing. Since this feature is also present in a company income tax which provides allowances corresponding to true economic depreciation and deductibility of interest, a switch from one alternative to the other should not affect capital-intensity. However, in as much as the existing company income tax in Bangladesh fails to approximate a true income tax because of difficulties in calculating economic depreciation and "inflation-proofing" the system, the above comparison may not be the appropriate one. In that case, while replacement of existing depreciation allowances by a larger first year writeoff might lower the cost of capital, the opposite is true for phasing out of interest deductibility. Hence there is no presumption that moves towards expensing would increase capital-intensity; the answer will vary from case to case depending inter alia on depreciation schedules, sources of finance and the rate of company taxation.

B. Neutrality With Respect to Financing

5.71 Neutrality (or non-discrimination) among different modes of financing is ensured as follows. Existing provisions for deducting interest under the tax system discriminate in favor of debt finance. With no interest deductibility and a "classical" system of company taxation

25/ This property can also be shown to hold with interest deductibility provided that the proceeds from new borrowing are taxable. However, that version of the company tax is not discussed further here. See M. King: The Cash Flow Corporate Income Tax (Discussion Paper No. 95, Project on Taxation, Incentives and the Distribution of Income, London School of Economics, May 1986).

where shareholders get no credit for taxes already paid by the company, there would be no discrimination between debt and equity finance. This is shown in the example of Appendix 5.3.

5.72 The choice between retained earnings on the one hand and debt and equity finance on the other for financing investment would also be unaffected if capital gains could be taxed at the same rate as other sources of income (See Appendix 5.3). However, since capital gains can in practice be taxed only upon realization rather than accrual, the effective tax rate on capital gains is necessarily lower, thus making the retained earnings option attractive for all but tax-exempt investors.

C. Tax Holidays vs. Accelerated Depreciation Allowances

5.73 It has already been observed (cf. Table 5.6) that the marginal effective tax rate under tax holidays is zero for the duration of the tax holiday. This is also the case for full expensing (or 100 percent ADA) with no interest deductibility, a classical system of company taxation and taxation of capital gains in line with other income. There are nonetheless two major differences between these options. First, full expensing raises revenue for the government from inframarginal projects, whereas tax holidays forego revenue completely. Second, while all marginal projects are subject to zero effective rate under full expensing, tax holidays imply different effective rates depending on the length of the holidays and the duration of the projects. Differences in METRs arising under different tax holidays granted to promote regional development were illustrated in Table 5.6. Differences in the useful lives of projects can also cause additional variation in marginal effective tax rates.

6. Recommendations

5.74 The extensive and liberal tax incentives have been used mainly as an instrument for promoting industrialization. The authorities have perceived the need to offer special inducements to offset some of the country's disadvantages pertaining to infrastructure and the shortage of managerial and technical manpower needed for successful industrial operations. Moreover, the tax incentives encourage new firms to register with the NBR and become future taxpayers. Current revenue losses have thus been regarded as necessary and justifiable.

5.75 The objective of fostering industrial growth in Bangladesh is warranted. However, this goal is best achieved by improving the quality of transportation facilities, power supplies and communications networks, providing scientific and technical services and streamlining regulatory procedures. Compared to these alternatives, the tax instrument has the following disadvantages:

- (i) It involves revenue losses and economic distortions as indicated in previous sections;
- (ii) The benefits of current tax incentives accrue to those who do not actually need them (i.e. the more profitable firms);

- (iii) The integrity of the tax system is compromised, since many abuses can be committed under the current incentives.

Short Term

5.76 Notwithstanding their extensive use, no reliable account of the benefits of tax holidays is currently available. It is therefore recommended that a study be commissioned as a matter of high priority to determine to what extent industrialization and regional development in Bangladesh can be attributed to tax incentives. The study should also calculate revenue losses from tax holidays more carefully including those arising from possible abuses of tax holidays through inter-company profit transfers.²⁶ The findings would allow an informed judgment as to how the revenue costs of investment incentives may be lowered without prejudice to industrialization. In the meantime, it would be entirely inappropriate to reduce the burden of company taxation any further. It may be noted that there is no evidence in Bangladesh to suppose that further reductions in company tax rates would improve tax compliance and increase revenue.

Long Term

5.77 Should the proposed study on tax incentives and industrialization find that a narrowing of the presently generous scope of tax holidays is warranted, the mission recommends that more reliance should be placed on 100 percent ADA provisions--an instrument already familiar to the business community. However, it is important that the interest deductibility provision be phased out, so that the tax on marginal investment projects continues to be zero. Otherwise, with the continuation of interest deductibility as well, investment would be subsidized at the margin.²⁷ Such a subsidy, in addition to involving loss of revenue, would distort the choice of investment projects, with deleterious consequences for efficiency. One way in which interest deductibility could be phased out would be to gradually reduce to zero the proportion of interest payments that are deductible. The advantages of this form of taxation were discussed in Section 5 of this chapter.

26/ The NBR has taken the view that tax holidays, by attracting firms, have made a significant net contribution to indirect tax revenue. Absence of any data precludes an assessment of this position.

27/ Appendix 5.3 below works out a numerical illustration of 100 percent ADA (full expensing) with or without interest deductibility.

5.78 The revenue impact of a switch from tax holidays to full expensing would be small in the short run, but becomes increasingly important with time. Initially, companies already under tax holidays continue to enjoy tax exemption until the holiday period expires. New companies receive special depreciation allowances and pay little in taxes in the first few years. The reform nonetheless increases revenue with time because companies using special depreciation start paying taxes sooner than those under tax holidays. A simple calculation is provided in Figure 5.6. Scenario I is the projection of income tax revenue based on the assumption that current tax incentives are maintained. (The underlying rate of growth is based on the trend growth rate observed from 1975 to 1985). Scenario II incorporates the incremental revenue arising from restructuring the incentives as suggested above. The annual gain in revenue increases from Tk 13 million in the first year to Tk 212 million in the 10th year after the restructuring. Over the 10-year period, cumulative revenue increases amount to more than Tk 1 billion. (More details of the calculation are given in Appendix 5.4).

5.79 The above long-term option involves the use of full expensing for new projects and a continuation of tax holidays already granted for existing ones. It offers the advantages of a gradual transition which is, however, offset by a modest short-term effect on revenue, and tax disparities between companies on tax holidays and those subject to full expensing during the transitional period. An alternative, and somewhat more forceful long-term option, consists of a termination (revocation) of all existing tax holidays from a particular date and a switch to full expensing across the board.²⁸

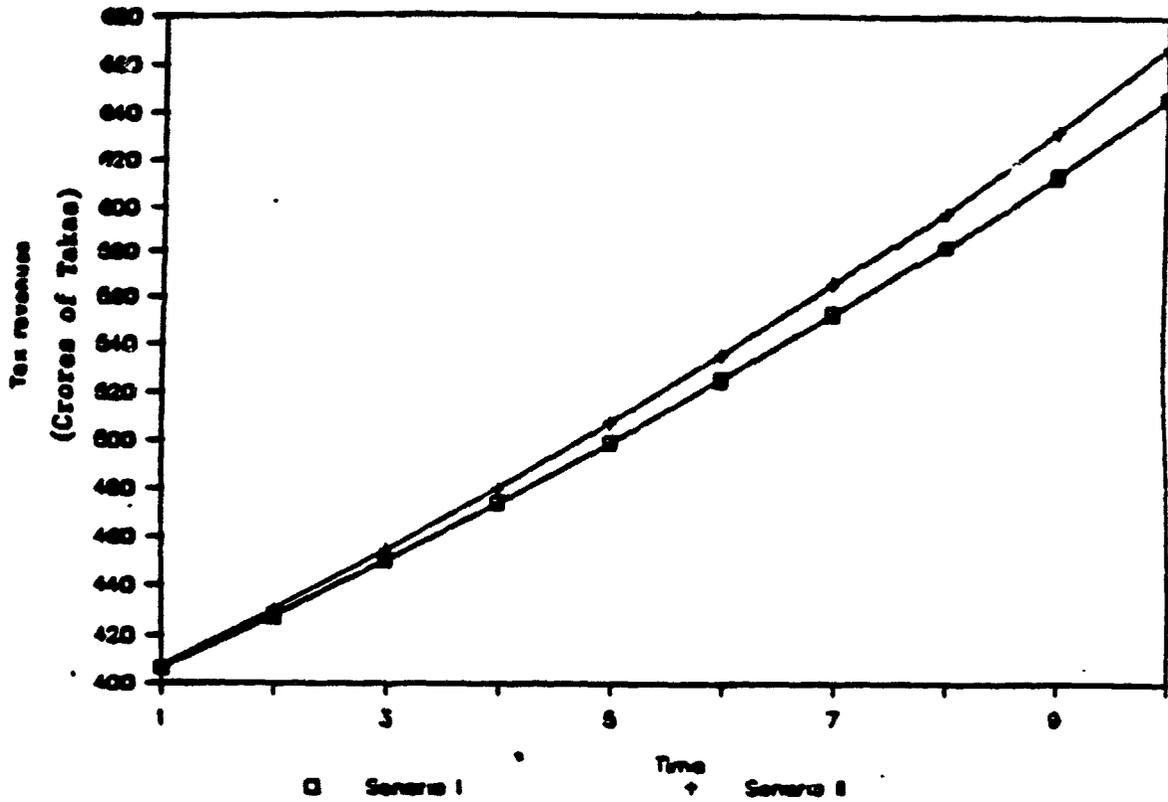
5.80 The second option, if adopted, would provide the same tax regime for all companies. Although some of the remaining benefits expected by companies on tax holidays would be cancelled, it would create no disincentives for new investment. The principal benefit of this option, however, is the increase in short- and medium-term revenue: the average gain in annual revenue in the first 5 years is estimated to rise from about Tk 67 million (Scenario II) to Tk 110 million under this option. It is recognized however that the extra revenue gains flowing from this particular option are not realized without cost: they involve a revocation by government of tax holidays previously granted to companies.

28/ Existing companies, whether or not on tax holidays, could write off the remaining book value of fixed assets.

Figure 5.6

BANGLADESH

Simulation values of tax revenues for switch from tax holidays to ADA without interest deductibility



1 Crore = 10 million

APPENDIX 5.1

Revenue Impact of Eliminating Employment-Related Allowances and
Switching to Conventional Exemption

As described in the text, the proposed changes in tax rules governing basic exemptions will bring in new taxpayers and thus generate more revenue. The increase will be offset somewhat, however, by the additional exemptions claimed by those with property income (rental income, primarily), which are disallowed under the present system. This appendix details the procedures and assumptions used in estimating the various magnitudes involved.

The principal assumption is that the size distribution of household income can be approximated by a two-parameter log-normal distribution. The estimated mean of household income is Tk 31,128, based on per capita income of Tk 5,188 in 1987 and an average family size of 6, where all calculations are at 1986/87 prices. In the absence of a more detailed analysis of income distribution, no estimates of the variance are available. (Note that the variance estimated on the basis of taxable income is a poor measure of the population variance, since the sample consists of observations drawn exclusively from the upper-tail of the distribution.) In this calculation, however, the variance estimated is derived (based on the ratio of the standard deviation and the means) from a study of income distribution in India.¹ To the extent that income distribution in India is similar to that in Bangladesh, this procedure may be an acceptable short-cut approximation. Based on this method, the estimated standard deviation is Tk 318,866. The implied parameters for the corresponding normal distribution based on the transformed variables are: mean = 8.016 and standard deviation = 2.159.

With these assumptions, the households covered by the tax net (those with more than Tk 62,000 of gross income) represented 8.2 percent of the population or about 384 thousand units. The population changes will expand the tax coverage to about 551 thousand household units (those with gross income above Tk 36,000.) As discussed in the text, only these additional households and the existing taxpayers with property income would be affected by the proposals. For the rest of the population, tax liabilities would remain unchanged.

The new taxpayers would have taxable income of Tk 13,000 per household, implying an addition of Tk 2,431 million in taxable income. This increase would be reduced by two factors

- (a) deductions claimed by existing taxpayers with property income
- (b) investment allowances claimed by taxpayers.

1/ (M. Ahmed and N. Bhattacharya, "Size Distribution of per Capita Income in India", Indian Statistical Institute, in T. N. Srinivasan and P. K. Bardhan, Poverty and Income Distribution in India, 1974).

Deductions based on property income may be estimated as follows: First, 15.5 percent of existing taxable income,² or about Tk 1133 million, is attributable to owners of property. This entire amount would be subject to tax under the current regime. With the proposed system, however, a standard exemption of Tk 5,000 would be deducted from each household. If property owners on average had the same taxable income as the general income tax payer³ then about 55.2 percent of property income would be deducted as standard exemptions. Thus, an estimated amount of Tk 623 million of taxable income would be given up.

The reduction based on investment allowances is estimated as follows: It is assumed that the new taxpayers would deduct the same percentage of their reported income as existing taxpayers. Since 13.3 percent of report income is currently deducted as investment allowances,⁴ the new taxpayers may deduct as much as Tk 323 million. Since the new taxpayers are in a lower income bracket, it is likely that their actual investment will be smaller proportionately. Therefore, the estimate of this source of deductions may well be on the high side.

After an allowance is made for the potential reduction, the net gain in taxable income is expected to be about Tk 1,485 million. The implied increase in tax revenue would be about Tk 149 million at a 10 percent marginal tax rate. If it is also recognized that compliance is initially likely to be weak among new taxpayers, then further downward adjustment would be necessary. A revenue gain of about Tk 100 million might be a reasonable estimate, in the beginning, rising towards Tk 150 million as tax administration is strengthened.

2/ Based on a 1985 sample of 172 individual tax returns randomly drawn from the income tax files.

3/ Also based on the same sample, the average taxable income was 29,295 (1986/87 prices). For property owners, the average taxable income would be 65,295.

4/ See footnote 2 above.

APPENDIX 5.2

Calculation of the Marginal Effective Tax Rate (METR)

The method presented in this appendix uses tax, financing, and economic factors to compute the cash flows that can be expected from an investment project. The cash flows combine the individual streams for each asset (credits, depreciation, replacement investment) with the income generated by the project and other project-wide flows (e.g., debt service payments) to yield a single before-tax cash flow and a single after-tax cash flow for the entire project. These two cash flows are used to compute a METR for the project as a whole.

If "b" denotes the real before-tax rate of return and "a", the real after-tax rate of return, then the marginal effective tax rate is given as follows:¹

$$\text{METR} = (b - a)/b$$

This formula has been used extensively in the literature on the taxation of capital investment.²

The before-tax (BTCF) and after-tax (ATCF) cash flows can be summarized as follows:

$$\text{BTCF}_i = - E_i - dK_i + R_i - \text{Int}_i - \text{Prin}_i + \text{NetSales}_i \quad (1)$$

$$\begin{aligned} \text{ATCF}_i = & \text{BTCF}_i - \tau(1+s) [R_i - \text{Dep}_i - \text{InvDed}_i - \text{IntDed}_i - \text{Carryover}_i \\ & + \text{CapGain}_i + \text{BalAdj}_i] + c\text{Div}_i \quad (2) \end{aligned}$$

1/ Adapted from A. Pellechio, et al., Taxation of Investment in East Asian Countries, (World Bank Provisional Papers in Public Economics, 1987).

2/ See, A. Auerbach, "Taxation, Corporate Financial Policy and the Cost of Capital," Journal of Economic Literature (September 1983), and King, M. and D. Fullerton, The Taxation of Income from Capital (University of Chicago Press 1984).

where

E_i	-	amount of equity used to finance the investment in period i .
d	-	economic depreciation rate for capital stock
K_i	-	capital stock
R_i	-	investment income, net of operating costs
Int_i	-	interest payment
$Prin_i$	-	principal payment
$NetSales_i$	-	sales proceeds in
t	-	statutory tax rate
s	-	surtax rate
Dep_i	-	depreciation allowances
$IntDed_i$	-	investment deductions
$InvDed_i$	-	interest deductions
$Carryover_i$	-	carryover losses
$CapGain_i$	-	capital gains
$BalAdj_i$	-	balancing adjustment
c	-	dividend credit rate
Div_i	-	dividends

(The subscript i refers to period i)

The equity used to finance the investment is a positive amount in the period before the investment generates income, i.e. $E_0 > 0$, and is zero afterwards. The rate of return underlying the METR calculation is a return to equity.

Replacement investment is undertaken which reduces the before-tax cash flow. Replacement investment equals the amount of economic depreciation for each asset.³

3/ If the investment project includes more than one asset then dK represents the sum of the depreciation rates for each asset time their respective capital stocks.

The investment project starts generating income in period i . Investment income is the marginal increase in net revenue that results from the investment project.⁴ Investment income keeps pace with inflation because replacement investment preserves the productive capacity of the project.

Interest and principal payments on debt used to finance the investment are subtracted from the before-tax cash flow. When the investment is sold, the proceeds are added to the before-tax cash flow. Net sale proceeds equal the sale price minus the payoff of the balance of a loan, if applicable.

The after-tax cash flow equals the before-tax cash flow minus taxes paid and plus tax credits. The statutory tax rate, t , plus any surtax rate, s , are multiplied by taxable income to yield the regular tax liability. Taxable income is given by the term in brackets in equation (2). Taxation income, in its most basic form, equals investment income minus depreciation allowances, investment deductions, and interest deductions. Investment deductions are given in addition to depreciation and are intended to serve as an incentive for investment. They may be given for the project as a whole or on an asset-specific basis. A positive taxable income may be reduced by losses being carried forward. If taxable income is negative and full loss offset is not assumed then the loss is carried forward. When the asset is sold, any taxable capital gains or balancing adjustment are added to taxable income.

The last term in equation (2) refers to any special tax treatment for dividends. In particular, a credit may be given on dividends at the personal level to offset the taxation of dividends at the corporate level. Since this credit reduces corporate taxes, it is added to the after-tax cash flow in equation (2).

4/ "Net" is taken to mean net of wages and purchases of intermediate goods and services.

APPENDIX 5.3

Taxation, the Cost of Capital and the Cash Flow Company Tax¹

The financial cost of capital is the pre-tax rate of return net of depreciation that a project must earn in order to call forth the funds necessary to finance it. Production efficiency requires that the tax system preserve the equality between the financial cost of capital and the interest rate on a marginal project. This section presents a simple example to demonstrate that a cash flow company tax, while raising revenue, preserves production efficiency.

Consider an asset purchased for Tk 1 in Year 1 that lasts exactly one year, yields a gross return denoted MRR and has no residual value. The rate of company tax is 50 percent. With full expensing of investment expenditure and no other investment allowances, the effective cost of the asset to the investor is Tk 0.50.²

The discussion below considers three sources of finance: (1) debt, (2) equity and (3) retained earnings.

A. Efficiency

(i) Debt

The project is entirely financed by borrowing at an interest rate of 10 percent. In Year 2, the project yields MRR. Taxes paid equal

$$0.50 \times [MRR - (0.1) (0.5) \beta]$$

where $\beta = 0$ if interest payments cannot be deducted from taxable profits.

$= 1$ if interest payments can be so deducted.

Principal and interest repayments equal 0.50×1.1 .

Hence net profits in Year 2, being the difference between gross receipts and tax and loan payments, equal

$$(0.5) MRR - 0.55 + 0.025 \beta \quad (1)$$

1/ This appendix adapts the comprehensive discussion in M. King: Public Policy and the Corporation (London: Chapman and Hall 1977) to a simple example to bring out the basic ideas underlying cash flow taxation.

2/ It is assumed in this discussion that the firm has enough taxable profits for the depreciation allowances to be used to offset tax liabilities. If this is not the case, the tax system must allow losses to be carried forward at the nominal interest rate.

The return that the project must earn in order to qualify as an attractive investment is that which makes the above expression zero. If interest payments cannot be deducted for tax purposes ($\beta = 0$)

$$\text{MRR} = 1.1$$

Since the asset has no residual value in Year 2, the rate of depreciation is unity and the financial cost of capital,

$$c = \text{MRR} - 1 = 0.1$$

Thus the financial cost of capital equals the rate of interest, just as in the absence of company taxation.

If interest payments are fully deductible ($\beta=1$), then from (1):

$$\text{MRR} = 1.05$$

Hence the financial cost of capital after depreciation is $c = \text{MRR} - 1 = 0.05$. Since that is less than the rate of interest, the combination of full expensing and interest deductibility therefore implies an investment subsidy.

(ii) Equity

With equity financing, the financial cost of capital depends, inter alia, on the tax treatment of dividends distributed by the company. Suppose that for every taka of gross (i.e., before tax) dividends distributed to the shareholders, an amount d is taxed away by the government, leaving $(1-d)$ with the shareholders. The current exemption of dividends from personal income taxation in Bangladesh implies that $d = 0$.

Recall that the cost of the asset is Tk 0.50. Suppose that the firm raises this amount via new share issues and distributes the profits and original capital to the shareholders in Year 2. Since taxes paid equal $(0.50 \times \text{MRR})$, the dividends received by the shareholders net of any additional tax liability attracted by them equals:

$$(1-d) \times [(0.50 \times \text{MRR}) - 0.50] \tag{2}$$

where the term in the square brackets is the gross dividend, defined as after tax profits less repayment of capital. In order to qualify as an attractive investment, the above return to the shareholders must equal the amount they could earn by lending Tk 0.50 at the market rate of interest of 10 percent. If interest income is taxed at a rate m , this return is

$$(1 - m) \times 0.1 \times 0.50 \tag{3}$$

Equating the two expressions, (2) and (3)

$$\text{MRR} = 1 + \left(\frac{1 - m}{1 - d} \right) \times 0.1$$

Hence, if $m = d$ so that interest and dividends are taxed at the same rate under the personal income tax

$$MRR = 1.1$$

and the financial cost of capital,

$$c = MRR - 1 = 0.1$$

Once again, in this case the financial cost of capital equals the rate of interest, just as in the absence of company taxation. However, this requires $m = d$, or what is known as a "classical" system of company income taxation.

(iii) Retained Earnings

The financial cost of capital in this case depends, inter alia, on the tax treatment of capital gains. Denote the rate at which capital gains are taxed by z . Then the capital gains resulting in Year 2 are

$$(1-z) \times [(0.50 \times MRR) - 0.50] \quad (4)$$

In order to qualify as an attractive investment, this once again must equal (2), so that

$$MRR = 1 + \left(\frac{1 - m}{1 - z} \right) \times 0.1$$

Hence, if $m = z$ so that capital gains are taxed at the same rate as other sources of capital income under the personal income tax

$$MRR = 1.1$$

and the financial cost of capital equals the rate of interest as before.³

The above example makes clear the sense in which the cash flow company tax does not tax the marginal investment project. It does however raise revenue by taxing inframarginal projects; this is shown below.

3/ Since capital gains tax may in practice be realized only on realization rather than accrual, the effective tax rate on capital gains will be lower than on other sources of income.

B. Revenue

Consider the marginal project. Expensing implies that the government gives up Tk 0.50 of revenue in Year 1. Revenue in Year 2 is $(0.50) \times \text{MRR}$, giving the government, like the private investor, a "return" of MRR on its "investment". The government thus shares equally in both risk and return. Since MRR is one plus the rate of interest, the tax revenue earned on the marginal project is zero in present value terms (i.e., in Year 1 taka).

Now consider a inframarginal project earning a 20 percent return, so that $\text{MRR} = 1.2$. In that case, revenue in Year 2 is $(0.50) \times 1.2 = 0.6$.

The government "earns" 20 percent as well $\left[\frac{0.6}{0.5} - 1 \right]$, thus sharing in the

inframarginal as well as in the marginal return. Revenue from the tax is positive in present value terms, demonstrating that the cash flow tax, while nondistortionary at the margin, raises revenue from inframarginal projects.

APPENDIX 5.4

Revenue Implications of Restructuring Company Tax Incentives

The purpose of this appendix is to show the methods and assumptions used in the calculation of revenue gains arising from changing incentive instruments. Two cases or scenarios are considered. The first scenario pertains to the situation in which tax holidays are used as the primary incentive instrument. The second pertains to the situation in which full investment expensing is allowed, but interest deductibility is removed. In the second scenario, new tax holidays are no longer granted, although companies already receiving the incentive may continue till it expires.

Scenario I is essentially the maintenance of the status quo and the rate of growth in revenue is taken to be the historical trend obtained from the regression:

$$\begin{aligned} \text{Log } R &= a + b \cdot t \\ \text{where } \log &\text{ is natural logarithm;} \\ R &\text{ is the (real) income tax revenue in constant prices;} \\ t &\text{ is a time variable.} \end{aligned}$$

The estimate of b gives the trend growth rate. For the sample period from 1975 to 1985, with the immediate post-war observations removed, the estimate for b is 5.3 percent per annum.

Under scenario II, income tax revenue is at least as high as scenario I. The first year after the restructuring of tax incentives new companies will make use of the special depreciation allowances and incur no tax liabilities. From the second year on, however, some of the new companies will start paying income taxes. The number of new companies joining the taxpaying pool is taken to be the same as the average increase in the number of tax-holidays companies observed in the past. The tax contribution of each company is taken to be the average obtained from a random sample of 309 companies after losses have been deducted. This average contribution is assumed to grow at the same rate as the aggregate income tax revenue. The following relationships summarize the calculations:

$$\begin{aligned} XR_t &= N_t * AVR_t \\ N_t &= 20 * t \\ AVR_t &= (0.0633) * (1.053)^t \end{aligned}$$

where XR_t denotes the incremental revenue
 N_t denotes the number of new taxpayers
 AVR_t denotes the average tax collection per company.

The results of the calculation are given below.

Simulation Values of Tax Revenue
(crores of 1984/85 Taka)

Time	Tax Revenue <u>a/</u>	Additional Taxpayers	Additional Tax Revenues	Total Tax Revenues _{b/}
0	385.9	0	0.0	385.9
1	406.3	20	1.3	407.6
2	427.8	40	2.8	430.6
3	450.5	60	4.4	454.9
4	474.4	80	6.2	480.6
5	499.5	100	8.2	507.7
6	526.0	120	10.4	536.4
7	553.9	140	12.7	566.6
8	583.2	160	15.3	598.5
9	614.1	180	18.1	632.3
10	646.7	200	21.2	667.9

a/ It is assumed that tax revenues will grow by an annual compound rate of 5.3 percent (scenario I).

b/ In addition to the assumption made in scenario I, the number of new tax payers is assumed to rise as follows: $N_t = 20 t$, where, t=time. scenario II.

Note: 1 Crore = 10 million

Chapter 6: DIRECT TAXATION: THE AGRICULTURAL SECTOR

I. INTRODUCTION

6.1 There are two principal sources of direct taxation on agriculture: (1) the Land Development Tax and (2) the Non-judicial Stamp Tax. Table 1.3 shows that, next to the income tax, these are the only two direct taxes of any significance. This chapter provides a detailed assessment of those two taxes (Section II and III), examines the burden imposed on the sector via direct, indirect and implicit taxation (Section IV) and suggests what role such taxes could play in further attempts to mobilize domestic resources. (Section V)

II. LAND DEVELOPMENT TAX

1. History

6.2 Agricultural land taxation has a long historical pedigree that is matched only by an equally long history of resentment by the farmers who pay it. Most governments shifted tax instruments to less contentious sources of revenue, such as indirect taxes on domestic and international trade, at their earliest opportunity. The British, however, faced with financing their Indian administration, adopted the traditional Indian land tax, and retained it well into the 20th century. They established zamindars, or "tax farmers", to collect the revenue from individual tenants.¹ The taxes were based, in general, on the produce of the land, and were often oppressive, reaching in some areas a levy of over half the net produce. The tax rates in Bengal were fixed in nominal terms at ten-elevenths of net rental receipts for zamindars at the time of the Permanent Settlement Act of 1793. Over time, as this fixed nominal tax obligation fell in real terms, the zamindar absorbed an ever-increasing fraction of the tenants' rent, and began to partition his holdings among assistants who were then responsible for collection. In 1900, government revenue demand was Rs 39 million, but zamindars collected Rs 165 million. Land revenue receipts as a fraction of total (state plus central) revenues declined from 69 percent in 1793/94 to 36 percent in 1891/92, and to 16 percent in 1938/39.

1/ Bird, Richard M., Taxing Agricultural Land in Developing Countries (Cambridge University Press, 1974), p. 67.

6.3 Following the partition of 1947, and the Homestead Act of 1950, zamindars in Bangladesh lost title to the land, and much of it was turned over to the tenants. Within the limits on property taxes specified by the 1950 act, land taxation was continued, and based (with various adjustments) on the past zamindar assessment. Despite a gradual decline in the importance of land taxation in East Pakistan, as recently as 1959/60 agricultural direct taxes on land comprised 66.2 percent of all direct taxes, and 19.8 percent of total central tax revenue.

2. Post Independence

6.4 After independence, revenue from land taxation fell sharply because the newly formed government exempted landowners with less than 8.25 acres from the tax. Since 1976, however, the government has turned to a Land Development Tax for revenue. It is based on land area alone and, from 1976-82, consisted of a flat rate on commercial and residential areas with a two-slab rate system for agricultural land; Tk 3 per acre for holdings under 8.25 acres, and Tk 15 per acre above 8.25 acres. By being based simply on the acreage of land ownership (at least for agricultural land), it is unusual among most land-based taxes in avoiding the problem of imputing the intrinsic value, or income, of the land. While the tax does not distort agricultural production decisions, it is inequitable: an acre of very productive land is taxed at an equal rate to unproductive land. A progressive tax exacerbates this problem when land holdings are inversely correlated with land productivity, as they are in Bangladesh. A landowner with more than double the LD tax under a progressive tax schedule, despite the fact that the two landowners realize equal land income. The degree of

inequity is likely to be minimal, however, given the unimportance of the LDT relative to the total value of landholdings.²

2/

By contrast, taxes based on the intrinsic value of land, net of improvements, are attractive in theory because neither improvements in the land nor output are directly taxed -- only the land itself, which is in fixed supply. Hence this tax will not reduce incentives to irrigate or otherwise maintain the land, or to increase output from the land.

Unfortunately, such a tax is nearly impossible to administer. There are generally two ways by which the intrinsic value of the land (less improvements) can be determined. The first is by developing an objective measure of soil quality and location; such schemes are discussed in Bird op. cit. However, these measures are often extremely costly, especially in a country with many separate plots and with a high cost of laboratory or cadastral quality evaluation. The second technique is to observe the value of produce from the past, and determine current land quality from past data. This method of assessing the value of land is, unfortunately, highly inelastic with respect to revenue, since past data will lag far behind current prices and productivity. Furthermore, current improvements in land quality will lead to higher future tax assessments, owing to the difficulty of separating out the value of land improvements from its intrinsic value.

An alternative method of taxation which is often closer in spirit to the lagged assessment method noted above, is a tax on actual or imputed agricultural income. There are rarely sufficient written records to form a basis of farm income, so tax authorities often impute agricultural income from the quality and size of land holdings. If such income imputations are based on the recent history of land income, then it will ultimately resemble the land tax as measured by the second method described above -- the income tax will be some function of past land profits. Presumptive income taxes may vary with respect to current produce prices, but are subject to much the same administrative problems, and have much the same incentive effects, as land taxes with potentially progressive rates.

6.5 In its first year, the LDT raised a total of Tk 17 crore. The commercial and residential rates were adjusted upward in 1980 and 1982, and in 1982 the agricultural rates underwent a major revision. Rather than a relatively flat rate on agricultural land between Tk 3 and 15 per acre, the 1982 Land Development Tax specified a sharply progressive schedule for agricultural land, which remained at Tk 3 per acre for less than 2 acres, but which rose in six rate "slabs" from Tk 15 per acre for holdings between 2 and 5 acres to a marginal assessment of Tk 145 per acre for land holdings above 25 acres (See Table 6.1). At the same time, commercial and residential rates rose by a factor of 10. Despite the initial stagnation of nominal revenues caused by administrative difficulties in implementing the rate structure, LDT revenue has increased in real terms since 1982. Another rate increase for commercial, industrial and residential land was passed in 1986 and applied retroactively to the 1985/86 fiscal year.

6.6 To measure the changes in rates over time, the average tax rates per acre of land were calculated under the 1976 and the 1982 schedules, and adjusted by the GDP deflator to 1984/85 Takas. The actual number of acres for which this average measure is calculated is written in the parenthesis in the first column of the table (e.g., 2 acres, 5 acres). Even after adjusting for inflation by expressing both average 1976 and 1982 LD tax payments in terms of 1984 Taka in columns 3 and 5 respectively, the sharp increase in progressivity between 1976 and 1982 is apparent. Perhaps even more significant is the real fall in the tax rate on land under two acres in area, from Tk 8.4 per acre to Tk 3.9 per acre in constant 1984/85 Taka. Indeed, the tax burden on two acres of land fell between 1976 and 1982 from two-thirds to one-fifth of the daily wage. Additional commercial and residential rates, presented below the agricultural rates, are discussed later in this chapter.

6.7 Total revenue collection adjusted by the GDP implicit price deflator to 1984/85 prices is shown in Table 6.2 and Figure 6.1. Despite substantial rate increases implemented during the past 10 years, it is only in the 1985/86 budget that real tax collections have regained the levels collected during 1976/77. The LDT has also assumed a smaller relative role in aggregate tax revenue of the central government; while it collected 2.1 percent of aggregate government revenue in 1976/77, by 1984/85 it collected only 1.4 percent. While the revenue collected from this tax may be minor, its potential for raising revenue clearly dominates that of any other tax leviable on agriculture in Bangladesh.

3. Experience

6.8 In practice, there is usually a substantial degree of tax arrears in any given year and it is reported that in some districts, as little as 48 percent of tax demand is collected. Such low collection rates have led some observers to suggest that more vigorous tax collection efforts be encouraged to increase revenue generation from this tax.

6.9 The mission does not find this view to be plausible. While greater tax compliance with the LDT assessments is a desirable goal, it will have little effect on long-term tax revenue. Taxpayers have three years to pay their taxes. They are subject to a 6.25% annual penalty for late payment, and after three years, their land is subject to auction.

**Table 6.1: Land Development Tax Rates
1976, 1982, 1985**

	Rate per Acre 1976	Av. Tax (Tk 1984)	Rate per Acre 1982	Av. Tax (Tk 1984)	Rate per Acre 1985
<u>Agricultural Land</u>					
Less Than 2 Acres (2 Acres)	3	8.4	3	3.9	3
2 - 5 Acres (5 Acres)	3	8.4	15	13.1	15
5 - 8.25 Acres (8.25 Acres)	3	8.4	36	26.2	36
8.26 - 10 Acres (10 Acres)	15	14.2	36	29.7	36
10 - 15 Acres (15 Acres)	15	23.5	60	45.5	60
15 - 25 Acres (25 Acres)	15	30.8	95	76.1	95
More Than 25 Acres	15		145		145
<u>Non-agricultural Land</u>					
(Area Within Police Stations)*					
Commercial and Industrial	600	1676.0	6000	7712.1	10000
Residential	300	838.0	1200	1542.4	2000
(Other Areas)					
Commercial and Industrial	300	838.0	800	1028.3	1500
Residential	150	419.0	300	385.6	500

*Primarily areas close to local police stations in Dhaka, Chittagong, and Khulna. Other rates apply for any area within the municipalities at the district headquarters.

Av. tax denotes average tax per acre of land.

Source: Land Development Tax Ordinance, 1976, Notifications in the Bangladesh Gazette, 26 June 1982, and 25 January 1986.

Table 8.2: Land Development Tax and Non-Judicial Stamp Tax Revenues:

Nominal and Adjusted by the GDP Deflator, 1976/77 - 1985/86
(Tk crore)

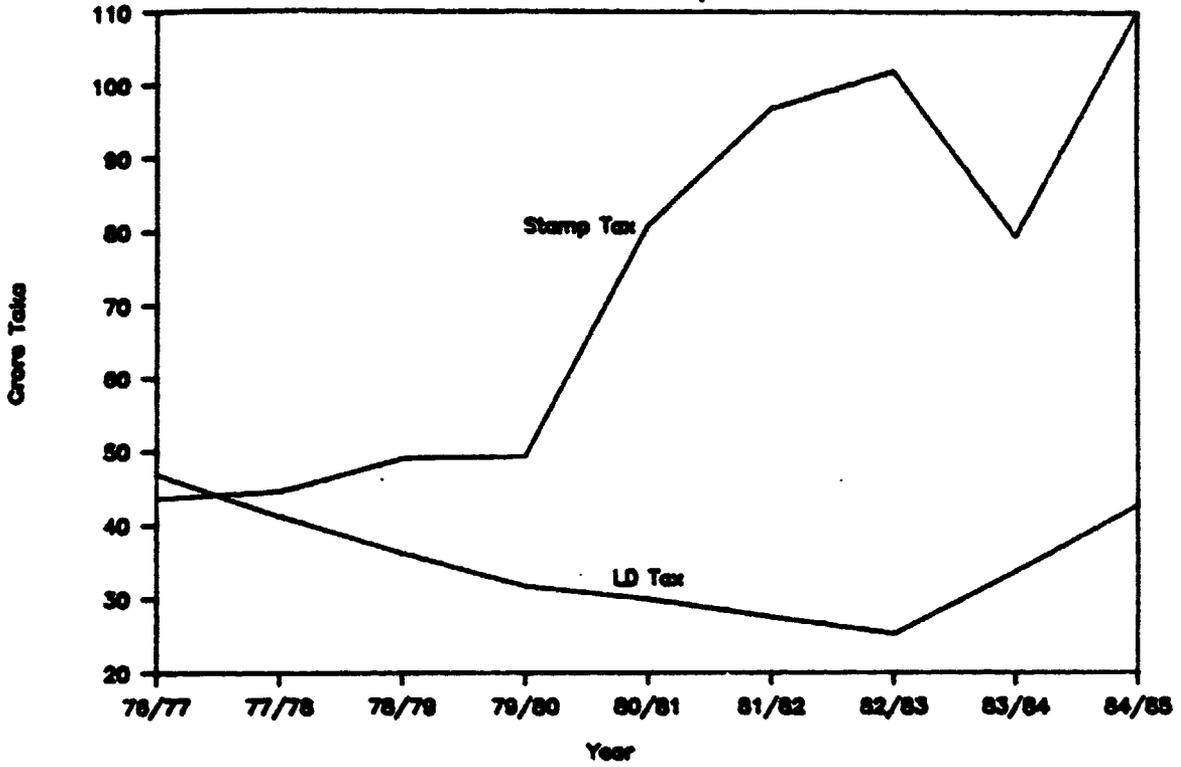
	76/77	77/78	78/79	79/80	80/81	81/82	82/83	83/84	84/85	85/86
LDT	16.8	19.3	19.1	18.9	19.7	20.4	19.6	30.7	42.8	54.7
LDT (1984-85)	46.9	41.3	36.2	31.7	29.9	27.5	25.2	33.8	42.8	49.7
Stamp Tax	15.6	20.9	25.9	29.4	53.2	71.8	79.4	71.8	110.0	134.0
Stamp Tax (1984-85)	43.6	44.6	49.1	49.3	80.7	96.9	102.1	79.2	110.0	121.8

Source: Taken from GOB Statistics. The years 83/84 - 85/86 differ slightly from documents in the Ministry of Land Administration and Land Records, they are Tk 27.7, 39.5 and 48.5 crore, respectively.

1 crore = 10 million

Figure 6.1

Land Dev. Tax and Stamp Tax Revenue in Constant 1984/85 Taka



Land is rarely auctioned for the purpose of taxes, since the tax is such a trivial fraction of land value. Hence the arrears typically represent recently unpaid taxes for many landowners, rather than the uncollectable liabilities of a few.

6.10 The important feature of the LDT is that total collections in any year appear to be roughly equal to total demand. This may appear to contradict the findings discussed above that current demand regularly exceeded current revenue. Yet when arrears are included (and in 1985/86, arrears comprised 32.5 percent of total LDT collections), total revenue collection is roughly equal to current tax demand. Hence while tax collection must have lagged at some point in the past, it appears to be generating approximately current demand in recent years.

6.11 Consider a new, hypothetical collection policy that will induce all taxpayers to pay their arrears and current payments. In the first year, the revenue authority would be awash with arrears and current payments; revenue would jump by roughly 40 percent. But in the next year, no arrears would be available, and the yearly revenue would be equal to the status quo, or approximately current demand. Even if taxes could be enforced perfectly, the only benefit would be a one-time increase in tax payments of Tk 180 million, but with no change in revenue thereafter. It is recognized that even a one-time increase in revenue of Tk 180 million is beneficial. However, a simple way to encourage timely tax payments is to increase the late penalty from 6.25 percent to a level, say, 6 percent above the inflation rate. By doing so, arrears would be reduced and the government would increase revenue from the stepped-up late fee.

6.12 Table 6.3 reports the maximum tax revenue that could be collected by the LDT under the assumptions that taxpayers fully comply with the LDT, and report their land holdings to the authorities,³ and are based on the 1977-78 Land Occupancy Survey. The table suggests two observations. First, the tax is progressive; the wealthiest one-percent of the population pays 55 percent of the total tax. Second, maximum collection is estimated to be Tk 453 million. Both conclusions warrant closer examination. The following discussion is based on the mission's visit to two Tahsil offices.

4. Progressivity

6.13 The LDT is collected at local Tahsil offices. There is currently an average of one Tahsil office for every two of the most local unit of government (the Union Parishads), although current plans are to provide a Tahsil office in every Union Parishad. The tax collection office is administered by a Tahsildar, an assistant Tahsildar, and two to three assistants.

3/ These calculations are reprinted from Booth, A., "Prospects for Raising More Development Resources from the Agricultural Sector in Bangladesh," (World Bank 1985, processed) Table 6.1.

**Table 6.3: Expected Revenue Yield from the 1982 Rate Structure:
Land Development Tax**

<u>Size of Owned Holding (Acres)</u>	<u>Numbers of Households (000)</u>	<u>Tax Assessment Per Household (Taka)</u>	<u>Total Tax Assessment (Tk Million)</u>	<u>Percentage Breakdown</u>	
				<u>Holdings</u>	<u>Tax Assessment</u>
0-1	5,376	1.0	5,376	52.4	1.2
1-2	1,830	4.4	7,961	17.8	1.8
2-3	1,045	12.3	13,324	10.2	2.9
3-4	621	27.8	17,236	6.1	3.8
4-5	371	42.8	15,852	3.6	3.5
5-6	253	66.5	16,847	2.5	3.7
6-7	174	103.9	18,047	1.7	4.0
7-8	111	139.9	15,507	1.1	3.4
8-9	95	175.6	16,668	0.9	3.7
9-10	67	213.4	14,291	0.7	3.2
10-11	61	275.4	15,641	0.6	3.4
11-12	39	320.4	12,389	0.4	2.7
12-13	36	378.6	13,725	0.4	3.0
13-14	26	444.0	11,497	0.3	2.5
14-15	20	499.8	9,836	0.2	2.2
Over 15	<u>96</u>	<u>2,604.8</u>	<u>249,509</u>	<u>0.9</u>	<u>55.0</u>
Total	<u>10.264</u>	<u>6.45</u>	<u>453.676</u>	<u>100.0</u>	<u>100.0</u>

Sources: Booth, 1985; 1978 Land Occupancy Survey as reported in F. Jannuzi and J. Peach, The Agrarian Structure of Bangladesh, Appendix E.

6.14 One of the difficulties in the administration of the LDT is the lack, in many Tahsil offices, of recent cadastral and Record-of-Rights (ROR) information. The Record-of-Rights is the primary register on which the plot (or khatian) number is recorded, along with the owner(s), sometimes the type of land (swamp, forest, etc.), and other information. In both Tahsil offices visited by the mission (in rural areas of Tangail and Dhaka districts), the RORs dated from the early 1960s. These in turn were based on cadastral surveys from 1914.

6.15 The striking characteristic of the sampled records is the small size of each plot, and the high fraction of plots which are subject only to the Tk 3 per plot rate. The size distribution of the recorded khatians (based on a combined sample of 111 entries) is presented in Figure 6.2. Sixty-eight percent of the sample was for khatians less than 40 decimals, or 0.4 acres; only two were larger than two acres in size.

6.16 It seems clear that some effort has been made to assign the progressive rates to the different plots of land. Figure 6.3 illustrates average Land Development Tax rates per acre, broken down by the size of the plot. Surprisingly, the tax rates are highest for the smallest plots of land, owing to the minimum tax payment of 1 Taka regardless of plot size. For example, the tax per acre on a plot size of 5 decimals (0.05 acres) is the minimum 1 Taka, or a rate of Tk 20 per acre. While average tax rates rise by a minimal degree (from Tk 5 per acre to Tk 7.5 per acre) for larger plots, the degree of progression is not large.⁴ The seemingly paradoxical drop in the average tax rate for plots two acres and larger is an anomaly due to the small sample size (2) for that group.

6.17 The small size of each plot is consistent with findings from the Land Use Survey. As Table 6.4 shows, the 1977 Agricultural Census found that 44 percent of large farmers reported owning 20 or more separate plots. Even among small farmers owning less than 1 hectare (2.47 acres) of land, 43 percent reported more than 6 plots. To complicate record-keeping even further, many of these plots are owned by 4 or 6 owners, who may be siblings or cousins who have shared in an inheritance.⁵

4/ The assumption here is that wealthier farmers will also tend to hold larger plots of land. They are also more likely to hold a greater number of plots.

5/ The common ownership of often very small plots of land among four or six owners is due in part to the Moslem laws of inheritance, which provide for each of the decedent's children or grandchildren.

Figure 6.2

Size Distribution of Khatians Dhaka and Tangail District Sample

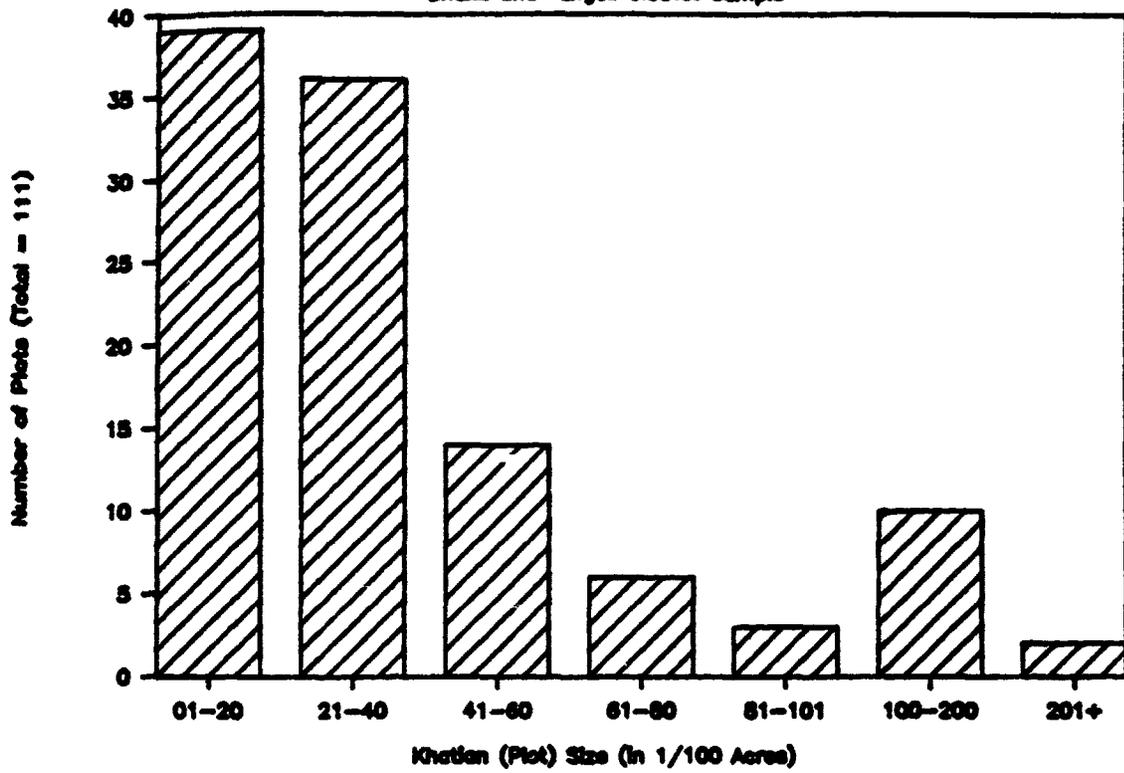


Figure 6.3

Tax Rates per Acre

By Size of Khetian: Dhaka and Tangail

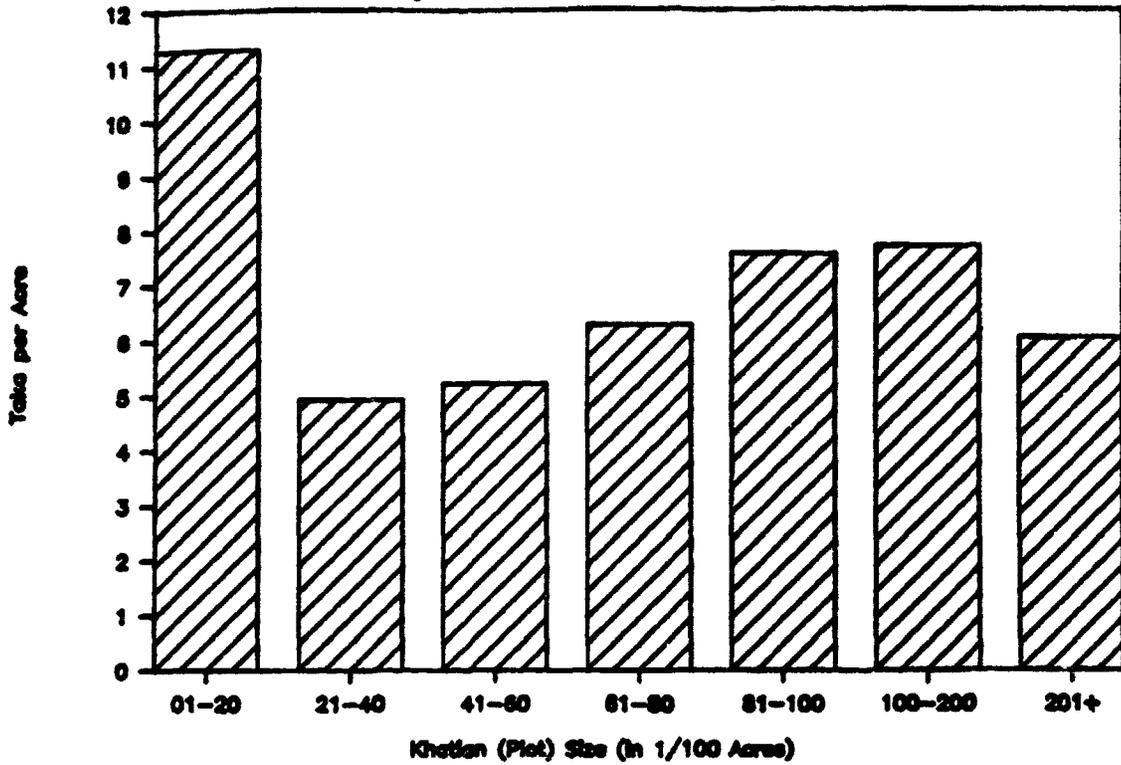


Table 6.4: Fragmentation of Holdings in Bangladesh, 1977

Size of farm (ha)	<u>Percent of Holdings</u>			<u>Reported Number of Plots</u>		
	one	2-3	4-5	6-9	10-19	20 & over
Small farm (Less than 0.1 ha)	3.7	25.2	28.4	28.0	13.5	1.2
Medium farm (1.0-3.1 ha)	1.5	5.6	11.9	26.0	42.9	12.1
Large (3.0 +)	<u>1.1</u>	<u>2.4</u>	<u>5.8</u>	<u>11.9</u>	<u>34.7</u>	<u>44.1</u>
All farms	2.6	15.1	19.5	25.7	27.2	9.9

Source: Bangladesh Agricultural Development Strategy Working Paper, BBS, Bangladesh Agricultural Census, 1977

6.18 There appears to be substantial difficulty in cross-referencing plots of land with individual owners. While those owners with large holdings were supposed to have reported their total holdings in 1982, this rule was suspended owing to resistance from the landowners. The Tahsil may have local knowledge about landownership, but, given the large size of his district and the multiplicity of ownership patterns, he may find it difficult to match owners with their plots of land.

6.19 In summary, these calculations indicate low tax rates for agricultural land (except for the smallest plots). Given the small size of the khatains and hence the enormous effort necessary to match owners with khatains, it is not surprising that the Tahsildars find the steeply progressive rates specified in the Land Development Tax code difficult to implement.

6.20 The results presented above, are therefore, inconsistent with the implication drawn from Table 6.3 that 55 percent of the revenue should be collected from taxpayers with land holdings in excess of 15 acres. The average tax per acre paid by taxpayers in that bracket is, in nominal terms, Tk 35.4. The sampled revenue measures are not even close to one-quarter this average rate.

6.21 Even if the Tahsildars were able to match land records with landowners, it is not clear how they would allocate the progressive rates among different land plots. For example, if farmer A owns 10 one-acre plots, the Tahsildar can either determine total tax liability, and divide that among all ten plots, or arbitrarily choose some plots to be taxed at higher rates than others. Matters are further complicated if, for example, the owner sells a single acre, since the rates for each of the remaining nine plots would have to be recalculated. The Tahsildars interviewed by the mission did not seem clear on this question -- they simply collected what was written in the Registry, which in turn seems to have been based on informal discussions.

6.22 It is important to pinpoint the reason for the low revenue collection of the LDT. It is not, as often claimed, that the Tahsildars are remiss in collecting the tax. On the contrary, it was the Mission's impression that the Tahsildars were successful in collecting the Taka assessment entered in their Registers; the problem appears to be that the latter understates the true tax liability. An updated Record of Rights, which would allow the consolidation of khatains by individual ownership, therefore appears to be necessary before tax measures can be strengthened.

6.23 There are two additional factors which make the Tahsildar's job difficult. First, the landowner may maintain plots of land outside the Union Parishad, making it almost impossible for the Tahsildar to assess the progressive tax rates. Second, the rate of mutation, or updating of Records of Rights, is very slow. Land may continue to be held in the name of a long dead grandfather, with the taxes paid by the grandchildren. Yet this particular plot may not be included in calculating the progressive rates of the grandchildren.

6.24 Apparently, different Tahsil offices have dealt with the difficulty of administering land taxes in different ways. To simplify this problem, one Tahsil office resorted to using the progressive tax system on the basis of the plot size. Hence an individual with 15 one-acre plots would pay a total of Tk 45 (15 times 3) under this system. Given, as mentioned above, the fragmented nature of land holdings, this interpretation of the tax code implies a simple Tk 3 per acre proportional tax on land.

6.25 In short, the progressive slab system of the LD tax appears to be extremely difficult to administer properly, given the highly fragmented plot holdings of the wealthier farmers, the limited resources of the Tahsil offices, and the age of the land records. The degree of progressivity of the agricultural land tax appears very low; it can perhaps best be characterized as a Tk 7 per acre proportional tax, with a limited degree of (random) progressive taxation.

5. Revenue

6.26 A comparison of potential revenue of Tk 453 million for the LD tax from Table 6.3 with actual tax collections in 1985/86 of Tk 485 million⁶ suggests that the LDT is very efficient at collecting assessed revenue. However, aggregate LD taxes include revenue from the commercial and residential sectors, so that collections from the agricultural sector will be somewhat less. Existing data do not permit this to be calculated as statistics compiled by the Ministry of Land Administration and Land Reform (MLALR) do not separate revenue from agricultural and nonagricultural sources. However, if the mission's sample of LD tax collections is representative of the rural sector generally, then the land tax collection from agriculture is less than previously thought. The average yield per acre in the combined sample is Tk 6.7 per acre. This, when multiplied by the 28 million acres in Bangladesh, results in only Tk 188 million per year.⁷ It may be the case that the size of plots in these two districts are smaller than usual. Other authors have found the average LD tax assessment from the Tangail district to be 2.99 in 1980/81 compared to a countrywide average of 5.33. Even after adjusting by the fraction $5.33/2.99$, total agricultural revenue collections would be, at most, Tk 310 million.⁸

6/ This is the collection figure according to MLALR. See Table 6.2.

7/ The figure of 28 million acres comes from summing cultivated land, current fallow land, cultivatable waste and forest. (Bangladesh Agricultural Development Strategy Working Paper, World Bank, undated, p. 1).

8/ The countrywide average, of course, will reflect the very high collection rates per acre in the urban areas. For example, the per acre collection in Dhaka was 16.5 taka per acre in 1980/81, compared to the average collection of 6.3 taka per acre. Hence, the adjustment that follows is likely to overstate total collections.

6.27 The substantial growth in LD revenue in the last four years recorded in Figure 6.1 may be explained as follows. One part may be improved administration, as Tahsil offices over time match ownership records with individual land holdings. There are, in addition, cadastral surveys being conducted in different parts of the country, although those completed records are not always provided to the Tahsil offices quickly. Another possibility is the retroactive 1986 ordinance which increased the tax on plantations growing tea, coffee, or rubber to Tk 110 per acre, although additional revenue from this source is unlikely to be large. The most likely explanation for the continued growth in the LD tax is from the very high tax rates on commercial and residential land, primarily in cities. In particular, the nominal rates on commercial and industrial property in the central city areas of Dhaka, Chittagong and Khulna increased by a factor of ten between 1976 and 1982, and have risen again in 1985. The tax rates on agricultural land have not changed in nominal terms since 1982. Since that time LD tax revenue has almost doubled. It seems likely that the higher rates on "urban" land account for the increase in two general ways. First, there is a continuing shift of land from agriculture to urban use, which, holding tax rates constant, will result in higher revenue. A shift of one percent in total land area from agricultural to commercial use would increase tax revenue by Tk 420 million or more, depending on the urban rates.⁹ The second reason for the increased revenue comes from the increase in commercial rates during 1985. This may be illustrated by considering the revenue collections from the LDT in the urban Dhaka area. In 1983/84 and 1984/85, Tk 22 million was the tax demand in an area roughly consistent with the Dhaka municipal region. Following the increase in commercial and residential rates in 1985, assessments jumped to Tk 39 million in 1985/86; for 1986/87, the rates were adjusted downward somewhat to Tk 33 million. Thus the long-run tax demand increased by 50 percent from 1984/85 to 1986/87. Another way to view this change is that the city of Dhaka, which in 1984/85 paid 5 percent of total LDT revenue, accounted for 17 percent of the total change in collections from 1984/85 to expected revenue in 1986/87.

6. Administrative Cost

6.28 To determine the net revenue available for government expenditures, it is necessary to subtract costs of administration. Although administrative costs have been falling relative to aggregate collections since 1983/84, the fraction was as high as 66 percent in 1985/86. This implies that only Tk 185 million is provided for the use of the GOB. Average administrative costs for the LDT exceed the administrative costs of other taxes in Bangladesh by a factor of seven. Records from rural districts suggest that some local Tahsil office expenses (e.g., salaries for the Tahsildar and his assistants) exceed the revenue collected in that district.

9/ One percent of land area is 280,000 acres. Assuming the tax per acre rises from, say, Tk 6 per acre to Tk 1500 per acre (commercial land outside of the main cities), revenue will increase by Tk 42 crore.

6.29 The mission encountered two responses to this finding. The first is that it is the objective of the government to provide employment; hence a tax which employs individuals is justified given the GOB's goal of increasing employment. What this view ignores is that the money could have been used for other, more valuable purposes, such as supporting socially productive flood control projects, for example. A second, and better, justification for these high administrative expenses is that the Tahsil also fulfills the valuable role of providing informal titles in a society where land ownership is highly valued. Hence the LD tax on agricultural land, as presently administered, maybe thought of as a filing fee for annual ownership records. While simply paying the land tax on a plot of land does not establish ownership rights, such evidence is admissible in legal disputes and is therefore important in a society where land ownership is highly valued.

7. Comparative Evidence

6.30 The discussion in this chapter has shown that the agricultural land tax has declined in importance, not only since the British colonial era, but also since 1976 when the Land Development Tax was implemented. The reason for this gradual decline is that taxes are denominated in nominal terms, so that inflation erodes their real value. Hence, in the agricultural sector, the importance of land taxation continues to decline. To place this trend in perspective it is helpful to briefly compare the Bangladeshi system with other countries' land tax policies.

6.31 It is rare when a country raises more than 3 or 4 percent of total revenue through property taxes. Table 6.5 presents the percentage of property taxes to total revenue, the percentage of property taxes to GDP, and a brief description of the statutory agricultural rates for selected countries. These countries were usually chosen on the basis of having a high fraction of total revenue accounted for by property taxation; in most countries less than one percent of revenue is accounted for by property taxes. The property tax measures here include both urban and rural property taxation, as well as wealth and inheritance taxes, but exclude local property taxation.

6.32 The picture which emerges from Table 6.5 is that the rates of property taxation for those countries that collect a substantial amount of revenue (e.g., Paraguay, Burundi) seem to rely on per acre tax rates that are fixed in currency terms by the government, rather than attempting to base the tax on cadastral value. In Bolivia, which bases its revenue collection on 0.64 percent of assessed property value, total tax collections account for only 0.05 percent of GDP. Bangladesh, with its lower statutory rates, collects a larger fraction of GDP than does Bolivia. A similar story holds for Chile, which assesses a flat 2 percent tax on land, but which, at least recently, gained little revenue from land taxation. Although there are few conclusions that can be gained from such a cursory examination of the experience of different countries, it appears

Table 6.5: Agricultural Property Taxation in Selected Countries

Country	Property Tax Total Revenue (%)	Property Tax - GDP (%)	Legislated Rates (as % of assessed unless noted)
Bangladesh (1983)	1.66	0.17	Progressive slab system: .01% for 2 acres .09% for 10 acres**,
Bolivia (1984)	0.82	0.05	.64% flat tax on assessed value of rural land
Brazil (1984)	0.05	0.01	Tax exempt below 25 hectares. Sliding scale above that amount from 0.2% to 3.5%
Burundi (1981)	8.95	1.14	Rates from BF 20,000/ acre to BF 50,000/acre (at official 1985 exchange rates, US\$167 to US\$690) Exempt for income < US\$300.
Korea (1985)	0.58	0.12	Rates from 6 to 10% of agricultural income from land above US\$1500 minimum. (Class A property)
Nepal (1982)	6.89	0.60	Rates vary from district to district
Paraguay (1984)	9.36	0.94	Cadastral value set by government in slabs from US\$5.40 to US\$ 81. per hectare (1985 official exchange rate)

** Property value assumed to be Tk. 25,000 per acre.

Source: IMF, Government Finance Statistics Yearbook (1986); International
Bureau of Fiscal Documentation (Amsterdam).

that the ability of the government to increase rates with inflation (rather than to readjust cadastral assessments), and compliance with the property tax, are more important determinants of revenue collection than the statutory rates themselves.¹⁰

6.33 Java appears to have enjoyed some success at raising revenue from land taxation. A land tax which is "increased annually on the basis of increases in the price of rice, and other agricultural staples" was estimated to have raised one percent of agricultural income during the mid 1970s.

III. PROPERTY TRANSFER TAXATION

1. Description

6.34 The most important tax on the value of transferred property is the Non-judicial Stamp tax which has been in existence since 1899.¹¹ Its 1976/77 tax collection was similar to that of the LD Tax; by 1985/86, its yield was 2.5 times the LDT yield. Its rate structure is progressive, although the progressivity is based on the total value of the transferred property, and not on the income or wealth of either the buyer or seller. The rates are shown in Table 6.6; they range from 6 percent for declared value under Tk 10,000 to 18 percent for declared value exceeding Tk 100,000. The average tax burden on transactions is quite high; for a property transfer valued at Tk 100,000 the average tax rate is 12 percent, or Tk 12,000.

10/ Looking at other countries of the subcontinent, the combined land tax and immovable property tax contribution to provincial tax revenue in Pakistan is small, not exceeding 6 percent. In terms of aggregate revenue, the proceeds are less than 0.2 percent. Recent ordinances have legislated the ushr, which is an off-budget tax of up to 5 percent on agricultural produce, and is earmarked for the indigent. However, to date, the revenue collections from this tax have been minor.

Indian states make general use of direct agricultural taxation through land revenue taxes, and, to a much lesser extent, agricultural income taxes and surtaxes. Between 1951/52 and 1973/74, the fraction of NDP from agriculture accounted for by direct agricultural taxes in India declined from 1.12 percent to 0.68 percent. Similarly, the percentage of total state revenue collected by these agricultural taxes fell from 13.2 percent in 1951/52 to 1.8 percent in 1978/79.

11/ Placed on top of this tax is the Immovable Property Transfer Tax (IPTT) for the use of local governments, and a small registration fee. Until recently, the IPTT rate was a flat one percent of declared value, but it has recently been increased to two percent; one percent for the local government, and one percent for the central government, less a small administration fee.

Table 6.6: Non-Judicial Stamp Tax

Property Assessment	Percentage Rate of Duty	Average Tax (value calculated at)	
Up to Tk. 10,000	6%	6.0	(10,000)
10,000 - 30,000	9	8.0	(30,000)
30,000 - 60,000	12	10.0	(60,000)
60,000 - 100,000	15	12.0	(100,000)
100,000 +	18	15.0	(200,000)

6.35 This tax, which is administered by the NBR, works as follows. Stamps are bought prior to the deed transfer, and are presented to the sub-register at the time of the title transfer (if the tax is less than Tk 300, it may be paid directly to the subregister). There is some under-assessment that occurs, but if the subregister suspects criminal fraud, he refers the document to the District Commissioner, who may then draw up the case and collect the extra tax plus a 10-15 percent fine. The mission was informed that the undervaluation of property transfers is not uncommon. There is a strong incentive for landowners to split property into smaller units to avoid the high marginal rates. Notwithstanding this fact, the tax has exhibited substantial real growth since 1976/77. Figure 1 and Table 6.1 contrast the growth of Stamp tax revenue with Land Development Tax revenue. In 1976/77, they each raised roughly equal amounts. As noted above, LDT revenue remained stagnant by 1984/85, but the Stamp Tax had more than doubled in real terms. The increased revenue was caused by the stepped up rates in 1980, and by "bracket creep", in which land transactions are taxed at even higher rates as inflationary pressures increase the nominal (but not necessarily the real) property value.

6.36 On purely economic grounds, it may appear surprising that this transfer tax collects so much more revenue than the LDT. Land which is transferred from one year to the next is a small fraction of total land area (especially in rural areas), yet the tax raised from these transactions far exceeds the tax on aggregate land wealth. To evaluate this tax, it is first compared to the rates charged for property transfers in other countries. Its efficiency and equity aspects are then discussed.

2. Comparative Evidence

6.37 Property transfer tax structures for 17 different countries are outlined in Table 6.7. The rates are statutory, and there is little information on the extent of compliance, or underassessment, in the collection of the tax. Furthermore, not all local stamp taxes or registration fees are reflected in these rates. Nevertheless, they do provide a representative picture of the importance of property transfer taxes in both developing and developed countries.

6.38 In general, the transfer tax rates for other countries are lower than those in Bangladesh. Most countries, when they impose a transfer tax, charge from two to four percent of the assessed value. Pakistan relies relatively heavily on the transfer tax; provincial rates range from 4 percent for agricultural land to 5.5 percent for non-agricultural land. Countries with the highest rates include Nepal, which assesses a 7 percent

Table 6.7: Immovable Property Transfer Taxation in Selected Countries

Country	Rate(s)
Argentina	1.5% to 4.0% in provinces; 30-50% in the Federal district of Buenos Aires
Brazil	2%
Burundi	*
Chile	*
France	17-18% Business Property, 6.7%, Houses
Germany	2%
Greece	11%, with lower rates of 4% and 9% for qualified property
Kenya	3% urban land; 2% non-urban land
Korea	3.15% non-farm land; 1.15% farmland
Malawi	3%
Malaysia	*
Nepal	13% urban areas; 7% non-urban areas
Pakistan	4.0% agricultural land; 5.5% for other property (provincial)**
Peru	3%
Sri Lanka	*None, except for transfer to non-citizens
Thailand	*
Zambia	5%

* denotes no transfer or stamp tax listed (they may be assessed at the local level)

** Jetha, N., and S. Akhtar, "Financing Pakistan's Provincial Services Trends and Issues," World Bank (March 1981) p. 50.

Source: International Bureau of Fiscal Documentation, Amsterdam (1986).

tax on agricultural land, France, which imposes a 17-18 percent tax on businesses, and Greece. (Argentina also imposes a very high rate on urban property transfer in the federal district of Buenos Aires.) Even in comparison with countries exhibiting high transfer taxes, the Bangladesh non-judicial Stamp Tax, in combination with the Immovable Property Transfer Tax (IPTT) stands out as imposing a very heavy burden on property transfers. For agricultural transfers larger than roughly Tk 30,000 (less than US\$ 1,000), the combined property transfer tax exceeds that of any other country known to the mission.

3. Incidence

6.39 The effect of a transfer property tax is to discourage the transfer of property. In doing so, the purchase of land which may provide more value in another use will be discouraged, and hence can have harmful effects on its efficient use. The high rates of the property transfer tax are thought to be justified on equity grounds.¹² However, this depends on whether the tax raises or depresses the selling price. The former outcome would affect a potentially wealthy purchaser, while the latter could affect a distressed seller of land. In turn, this depends on the relative supply of other property available for sale if the price rises, and the degree to which buyers are discouraged by higher property prices.

6.40 Consider the simplest case of an acre of land which yields, on average, an annual rent of Tk 6,000. Looking at this investment only in terms of the future value of rent, ignoring the associated benefits from speculation and prestige and assuming that the relevant interest rate at which future rents are discounted is 10 percent, it can be shown that the market value of this land would be Tk 60,000. The property transfer assessment is, ignoring the IPTT, Tk 6,000. Then any (wealthy) landowner seeking to add to his land acquisitions will be willing to pay, at most, only Tk 54,000 net of the transfer tax. In this simple case, the seller, -- perhaps a distressed landowner who must sell to pay off loans -- will bear the full burden of the tax. Hence, there is little presumption that the property transfer tax will necessarily penalize only the acquisitive wealthy landowner and leave unharmed the debt-ridden small landholder.

6.41 It is likely that urban landowners bear a large fraction of the tax. Because of the progressive nature of the tax, transfers of the more valuable urban property will be assessed at a higher rate. Some confirmation of this hypothesis is provided by the Dhaka and Chittagong Zilas. The proportion of the Non-judicial Stamp Tax revenue generated by these two zilas alone (out of a total of 64 zilas) was 39 percent in 1985/86. Hence it appears likely that property transfer taxes are borne to a large extent by the urban sector.

12/ There is evidence that the concentration of land ownership has increased since the 1950s. See Rahman, Atiur, "Land Concentration and Dispossession in Two Villages of Bangladesh," The Bangladesh Development Studies X(2) June, 1982. pp. 51-83.

6.42 The positive feature of this tax is its elasticity with respect to inflation and property value increases. Since it is specified as a percentage of property value, it maintains revenue collection, in real terms -- and even gains, owing to the "bracket creep" of the progressive tax structure -- over time. This sets it apart from most property taxes, in which assessment lags often result in revenue inelasticity and a sudden upward revision of lagging assessment values leads to taxpayer resentment.

6.43 Although taxpayers attempt to understate their property values to avoid the tax, its elasticity will not suffer, if the fraction of property which is undervalued remains constant over time. For example, if at 100 percent valuation, property tax collections increase from Tk 1 billion to Tk 1.1 billion, a 10 percent increase, then at 80 percent valuation, collections would increase from Tk 800 to Tk 880 million; still a 10 percent increase in revenue. Only if evasion becomes relatively more pronounced over time will tax collections lag behind the base.

IV. THE TAXATION OF AGRICULTURE

6.44 The previous two sections have argued that both the Land Development Tax as well as taxes on property transfers collect a large proportion of their revenue from the urban sector. At most half of the minimal Tk 1.8 billion collected by these combined taxes are borne by the agricultural sector. Yet these low tax collections by themselves do not imply that there is room for increasing them. Implicit or explicit taxes on agricultural output can lead to substantial distortions and hardship for farmers. In this section, the effects of direct, indirect and implicit taxation are examined in turn.

1. Direct Taxation

6.45 There is essentially no income tax on the agricultural sector. As noted before (cf. footnote 2), the lack of records and difficulty of tracing ownership of income make it difficult to tax all but a tiny fraction of income from agriculture. Evidence from the Consumer Expenditure Survey of 1980/81 suggests that the wealthiest farmers are taxed at 0.5 percent or less of income through direct (non-property) taxation. If the LDT is included as an additional direct tax on income from land, then the direct tax burden is increased, at most, by 2 percent. A study of average net profits arising from land ownership calculated that net profits, defined as gross output value less material and labor costs of cultivation, were an average of Tk 2640 per acre in 1984/85.¹³ For a farmer owning 2 acres, the ratio of tax payment to profit from his land would be 6/5280, or 1/10 of one percent of profits. Even if the largest landowner, with 20 acres, pays the full amount of LD tax, his tax liability will be only 1.9 percent of tax on over Tk 52,000 profits. If, to maintain

13/ Cf. Hossain, M. Akash M.M. and Rahman, "Agricultural Taxation in Bangladesh: Potential and Policies," Bangladesh Institute of Development Studies (BIDS, October 1985).

comparability with non-agricultural income taxation, family income were included, then the tax would be an even smaller fraction of annual land income. Even if half of Property Transfer Tax revenue is included, the direct tax burden on agriculture is extremely small, on average less than 0.5 percent of annual land income.

2. Indirect Taxation

6.46 The taxation of goods consumed by the agricultural sector reduces the purchasing power of farmers and tenants, and acts indirectly to reduce their real income. Hence it is important to measure the differential burden of customs, sales and excise taxes on the agricultural versus the non-agricultural sectors. The framework developed in Chapter 4 to examine the revenue and incidence effects of indirect taxation is used to measure the relative impact of the commodity tax system in Bangladesh on the purchasing power of different income groups. For each of the aggregated 35 commodities identified by the data, total tax rates are calculated which include not only final goods taxation, but the increased price of final goods caused by intermediate goods taxation as well. Taxpayers are separated into ten income groups (8 rural and 2 urban) as described in Table 6.8. Using the detailed Bangladesh Household Expenditure Survey of 1980/81, the impact of the different commodity taxes, expressed as a fraction of average income, can then be calculated for each of these income groups. Column 1 of Table 6.8 provides a measure of the fraction of income for each group accounted for by indirect taxation, holding income, wages and relative prices fixed. This partial exercise suggests that except for large and largest farmers, the agricultural sector enjoys a lighter burden of taxation than either the urban formal or the urban informal sector. The average commodity tax payments for rural farmers other than those falling under the large farm classification ranged from 6.0 to 7.4 percent, while the urban sector taxes were 8.3 and 10.1 percent of income for the informal and formal groups respectively. When direct taxation is included in measuring total tax burden (column 3), the average urban formal sector worker is taxed at 16.4 percent of income, compared to a burden of 10.9 percent for the wealthiest landowner.

6.47 The above analysis ignores the impact of the tax on producer prices, and employment and distribution of workers and wages. Incorporating such overall economy-wide shifts requires a framework such as that developed and described in Chapter 4. This yields implications somewhat different from the partial exercise described above. The impact of the combined indirect taxes are now more uniform across income groups, since a part of the tax burden is shifted backwards -- thereby affecting wage rates across many industries -- rather than being reflected solely in consumer prices. The fall in the tax burden on urban formal income is the most striking. Yet the combined impact of direct taxation (which is unaffected by the inclusion of economywide considerations) plus the indirect tax burden in the urban formal sector exceeds the tax burden of each income group in agriculture. The results also suggest that, as a fraction of income, the urban informal sector pays roughly equal taxes as much of the agricultural sector, when both direct and indirect taxes are taken into account.

Table 6.3 Tax Burden of Indirect and Direct Taxation by Income Class

Income Class	Description	Indirect Taxation		Direct Taxation
		Burden (excl. Economywide considerations)	Burden (incl. Economywide considerations)	
1	Landless	6.0	6.8	0.0
2	Small Farm	6.4	6.8	0.0
3	Medium Farm (tenants)	7.1	6.7	0.0
4	Medium Farm (owners)	7.4	6.5	0.0
5	Large Farmers	8.5	6.3	0.5
6	Largest Farmers	10.6	5.8	0.3
7	Rural Informal	8.3	7.1	0.0
8	Rural Formal	8.9	5.9	1.1
9	Urban Informal	8.3	6.9	0.0
10	Urban Formal	10.1	4.9	6.3

Source: Framework of Chapter 4. All percentages are expressed in terms of income.

6.48 In sum, the urban and rural sectors appear to share approximately equally in the burden of indirect commodity taxation. There is some variation in overall tax burdens, in part caused by differences in income classes and savings rates. The fact that urban employment is subject to direct (income) taxation, while the rural sector is largely exempt, explains why the urban sector is, on average, more heavily taxed than even the group of largest landowners. The relative burden is further increased when account is taken of property taxes levied on urban households.¹⁴

3. Implicit Taxation

6.49 Governments in developing countries have often found agricultural output a tempting source of government revenue. Maintaining the exchange rate at an artificially high level leads to less expensive imports for the government and the urban elite, but lower domestic prices for farmers seeking to export their produce. The institution of marketing boards, or of procurement prices below the market prices, leads to the hidden taxation of farmers through lower output prices. For example, in Tanzania the ratio of producer prices for agricultural goods relative to border prices was 63 percent at official (1984) exchange rates. Valued at the true exchange rate, the ratio was less than 20 percent. Equivalently, Tanzania has imposed a tax on marketed agricultural output of 80 percent, although the revenue will be reflected in marketing board profits rather than explicit tax revenue. Similarly, Ghanaian government prices paid for cocoa during 1982 were 30 percent of those paid in the Ivory Coast. Another example is provided by the Philippines, in which sugar producers were subject to an average effective 23 percent tax on their exports during 1974-82.¹⁵ It is therefore important to test whether farmers are taxed in this concealed way. Account must also be taken of the terms of trade between agricultural and non-agricultural sectors. An intensification of taxes may not be the appropriate policy instruments for farmers if they are generally struggling with a deterioration in their terms of trade.

6.50 The following is based on an existing study of internal prices for rice in Bangladesh from 1959/60 to 1982/83.¹⁶ First, the study examined whether the government paid a procurement price below the market price (the difference would measure the implicit tax on government procurements). While a mild government tax was imposed during the 1960s, the government has paid above market price for its procurements since 1975/76. Hence there is little evidence that public purchases of rice systematically tax farmers who market their surplus to the government.

14/ For a discussion of property taxes see Bangladesh: Urban Government Finance and Management Issues and Opportunities (World Bank Report No. 5790-BD, June 1985).

15/ World Development Report, 1986 and Bale, M. "Agricultural Trade and Food Policy: The Experience of Five Developing Countries", World Bank Staff Working Paper #724 (1985).

16/ Hossain, Rahman and Akash, op. cit.

6.51 A second factor which could cause an implicit tax distortion is the existence of a wedge between the domestic price and the world (export) price of agriculture. In the case of coarse rice, little evidence was found in favor of a systematic price "wedge"; in the most recent year, 1983/84, the domestic price was above the fob price of rice.¹⁷

6.52 Finally, evidence on the change over time in the relative prices of agriculture and industrial commodities shows the following. Adopting the ratio of agriculture prices to industrial prices as the terms of trade index, there was a fall from the base year of 1969/70 (equal to 100) to 78 in 1973/74, and thereafter fluctuating ratios between 80 and 99 from 1974/75 to 1983/84. While the terms of trade was worse in 1982/83 than in 1969/70, there has not been, in recent years, any consistent decline in the agricultural terms of trade.

6.53 In sum, there is little evidence that implicit or explicit taxes place a discriminatory burden on farmers and tenants. In fact, the picture which emerges is that the urban sector is more heavily taxed than the rural sector. On both historical grounds, and in comparison with many other countries, agriculture (and wealthy landowners in particular) is taxed relatively lightly. This is not to suggest that the agricultural sector as a whole should be taxed more heavily. On the contrary, the mission supports a more equitable tax system which, by taxing wealthy landowners more heavily through direct means, reduces the necessity for the regressive commodity taxes which are distributionally neutral rather than progressive in Bangladesh.

6.54 A relatively light taxation of the agricultural sector might be justified on the grounds that it encourages self-sufficiency in rice. While this might in certain circumstances be a plausible objective, it may entail substantial inequity. The concentration of land ownership among a very few number of wealthy farmers is cause for concern. An important study followed land ownership patterns in two villages between 1951 and 1981.¹⁸ While 17.6 percent of the combined sample households held 48.8 percent of the land in 1951, only 5.0 percent of households held 40.7 percent of the land in 1981. Although findings based on two villages must be treated with some caution,¹⁹ the evidence suggests that land holdings have become progressively more concentrated in the hands of the wealthiest 5 or 10 percent of the population. Yet there is no effective tax on their often vast wealth. The feasibility of tapping the often extensive wealth of agricultural landowners is explored in the next section.

17/ Cf. "Bangladesh Agricultural Development Strategy Working Paper," and Bangladesh: Promoting Higher Growth and Human Development (World Bank Report No. 6616-BD, March 10, 1987).

18/ Rahman, op. cit.

19/ The Agriculture Census of 1983/84 reports that 4.94 percent of households own 25.92 percent of land.

V. RECOMMENDATIONS

6.55 The evidence of this chapter shows that (1) the direct tax burden on agriculture is less than 0.5 percent of annual land income, (2) the indirect tax burden on rural and urban sectors is broadly comparable, (3) there is no implicit taxation of agriculture via procurement price policy, domestic pricing below international prices or unfavorable terms of trade movements between agriculture and industry, and (4) agriculture is taxed lightly both on historical grounds and relative to a number of other countries. Furthermore, the negligible direct taxation of agriculture intensifies the presumption that the system creates serious rural-urban inequities.

A. The Short Term

6.56 Improvements in tax administration can yield some extra revenue from the LDT in the short run.²⁰ The mission was informed that the target for LDT collections was exceeded by Tk 100 million in 1986/87, leading to a total revenue yield of Tk 660 million. It is understood that the 1987/88 target is Tk 700 million and that the revenue authorities expect to collect a significantly greater amount. However, it is acknowledged that a revenue yield substantially in excess of the above range would require investment in a single Record of Rights and a far-reaching overhaul of the LDT administration.

B. The Medium-to-Long Term

6.57 The only feasible way of implementing a progressive LD tax is to improve and update the Record of Rights (ROR). Currently the Division of Land Records is undertaking such an updating but, at the present rate of progress, the process will take a long time to complete. The new RORs subdivide land into categories such as highland, lowland, public utility, roads, buildings and, most importantly, whether or not, it is irrigated. Once complete, such a classification would allow rates to be differentiated according to land quality. Consideration could then be given to introducing an exemption limit and an implementable structure of rates that would impart an element of progressivity into the Land Development Tax.

6.58 These desirable features, however, come at high cost. The cost of updating the records is approximately Tk 50 million per (old) district area; hence the total cost of updating the Record of Rights would be Tk 1 billion. Aside from its value in resolving land disputes, the cost would be unlikely to justify the extra revenue gained from the tax, given the existing low levels of the LD tax slabs. For example, assume that the ROR for each (old) district is updated every five years. Then the yearly

20/ Various other proposals have been made to collect more revenue from the agricultural sector in Bangladesh. One involves taxing agricultural marketed surplus; another is the introduction of a presumptive income tax. The mission believes the first to be administratively difficult and the second virtually infeasible given the current state of the Record of Rights.

expenditures for such updating would be approximately Tk 200 million. However, maximum potential revenue from the LDT on agricultural land would be Tk 453 million (plus whatever extra revenue is collected from the Tk 110 per acre tax on tea, coffee and rubber plantations). If the government presently collects roughly Tk 250 million from agriculture, then the revenue gain would just meet, but not exceed, the extra expenditures. Furthermore, in the absence of other administrative measures, even constant updating of the RORs would not prevent landowners avoiding the highest marginal rates owing to ownership of plots outside the Union Parishad. Hence, the feasibility of the LDT's making an important contribution to revenue in the medium-to-long term depends critically on the degree to which the land tax administration can use the information made available by the new RORs to effectively implement a progressive tax without a significant reduction in compliance. The mission therefore suggests that a detailed study of this question be undertaken by the GOB.

C. Revenue-Sharing

6.59 The potential revenue from such a tax appears to be minimal from the perspective of the central government: thus, an increase in customs and excise taxation by 0.2 percent can increase revenue by a greater amount than current collections from the entire LDT less administrative costs. But, as mentioned before, its revenue-raising role at the margin is potentially important. An alternative to viewing the LDT as a proxy for an income tax is to regard it as a fee for services such as rural construction, maintenance, police, markets and other services provided by local governments. The mission recommends that increases in agricultural LD tax collections be linked to payments to local governments. A survey conducted in two villages²¹ indicates that taxpayers are more willing to pay the LD tax, for example, if they understand that the additional revenue is earmarked for use in the local area. In the short-term, the earmarking could be accomplished quite simply -- the Tahsildar would divide the daily collection into two parts, depositing one part into the local government (Upazila) account and the other into the central government (MLALR) account. Most Upazilas would continue to receive grants from the central government, although as the share of Upazila revenue from local sources is increased, consideration should be given to reducing central grants. In this way, the land tax could combine to discharge the valuable function of registering land ownership and generate revenue which could provide a stable tax base for local governments, thereby enhancing their fiscal autonomy.

21/ Hossain, Akash and Rahman, op. cit.

Chapter 7: DIRECT TAXATION: ADMINISTRATION

I. INTRODUCTION

1. Background

7.1. There is considerable scope for improvement in the administration of direct taxes in Bangladesh. Table 3.1 of this report for example showed that in 1985/86 income tax arrears, at Tk 3.3 billion, exceeded indirect tax arrears of Tk 3.29 billion. And this notwithstanding the fact that income taxes accounted for only 14 percent of total tax revenue, as against 78 percent for indirect taxes (see Table 1.3). This is both a measure of the weakness of the direct tax administration and of the gap that exists between its performance and that of the indirect tax administration. Another example may also be cited. The Income Tax Law gives the authorities the usual powers of a deterrent nature. These include powers of survey (Section 115 of the Income Tax Ordinance, 1984) search and seizure (Section 117-119), as well as powers to levy penalty for concealment of income (Section 128), to recover tax by attachment and sale of property either through arrest and detention in prison or appointment of a Receiver for the management of a defaulter's business/assets (Section 139). In actual practice, however, these powers are seldom invoked. Such selective administration has resulted in poor enforcement and has virtually eliminated sanctions on fraudulent taxpayers.

7.2 The workload of a tax department in developing countries is normally expected to grow anywhere from 5 percent to 15 percent every year even if attention is confined, not to collections, but to the number of taxpayers. Table 7.1 shows that the position in Bangladesh is no different. Since it is virtually impossible to add to manpower and other resources at this rate of growth, the only workable option is to tailor workload to available resources. It is therefore necessary to avoid unnecessary paperwork and complexities in tax procedures. Failure to do so results in the proliferation of disputes and litigation, generates arrears of work and damages the relationship of mutual trust and confidence which should prevail between the taxpaying public and the Administration.

7.3 This chapter accordingly proposes reforms in administrative structures and procedures which, in the opinion of the mission, are essential for the effective operation of a reformed direct tax system. Care has been taken to ensure that the recommendations build on the existing structure. The chapter also distinguishes between proposals that would have an immediate impact from those whose impact would be felt over a longer period of time.

2. Existing Organizations

A. National Board of Revenue

7.4 The National Board of Revenue (NBR) is the apex of the administration and is, inter alia, responsible for the administration of direct taxes including income taxes on persons and companies. Figure 3.1, which gives the present organization of the NBR, shows that out of its five members only two take care of all the direct taxes. (A sixth member has

Table 7.1. Number of Income Taxpayers

Fiscal Year	Number of Income Taxpayers	Percentage Increase Over Preceding Year
1973/74	1,62,428	-
1974/75	1,69,903	4.6%
1975/76	1,81,462	6.8%
1976/77	2,01,024	10.8%
1977/78	2,09,390	4.2%
.....
.....
1983/84	3,49,121	-
1984/85	3,81,571	9.3%
1985/86	3,99,611	4.7%
1986/87	3,88,527	a/
1987/88	4,08,302	(Provisional) 5.1%

a/ The decrease this year appears to be due to raising of the filing threshold from Tk 30,000 to Tk 36,000.

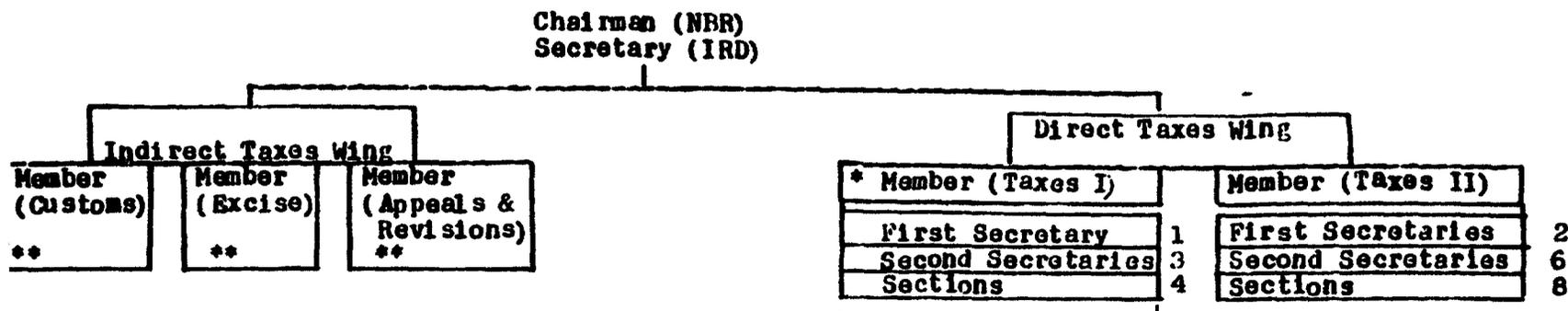
Source: Final report of the Taxation Enquiry Commission, Bangladesh and National Board of Revenue.

since been added for Administration but it is understood that this pertains to the administration of indirect taxes only). The Director (Research and Statistics) appearing as a part of NBR serves both the indirect as well as the direct tax wings. The present organization of NBR in respect of the two Members (Taxes) is shown in Figure 7.1. The present division of work between Member (Taxes-I) and Member (Taxes-II) is as follows:

Member (Taxes-I):

- (A) All matters relating to income tax other than the following:
 - (i) Write-off demands;
 - (ii) All matters relating to registration of income tax practitioners under Section 1974;
 - (iii) Scrutiny of Orders of the Taxes Appellate Tribunal and proposals for references to High Court Division and appeals to the Appellate Division of the Supreme Court;
 - (iv) All matters relating to waiver of tax in connection with filing of appeals;

Figure 7.1
Present Organisation of the National Board of Revenue (NBR) —
Direct Taxes Wing (Internal Resources Division, Ministry of Finance)



- NOTE**
1. * In addition to the 4 Technical Sections shown under Member (Taxes I) he also has 4 other sections under him dealing with administration of the Direct Taxes Wing manned by one First Secretary and 3 Second Secretaries who are not drawn from the Langla Desh Civil Service (Taxation) Cadre and are, therefore, not included in the sanctioned strength of that cadre given in Table 7.9
 2. ** There is a comparable structure on the Indirect Taxes side, the details of which are given in Figure 3.1.
 3. Directorate of Research & Statistics shown in Fig. 3.1 services both the Indirect Taxes Wing and Direct Taxes Wing.
 4. The figures shown against boxes indicate number of posts sanctioned.

- (v) All matters relating to Statistics and Returns, etc.;
 - (vi) All matters relating to Provident Fund and Superannuation Fund;
 - (vii) All work relating to printing and publications and translation into Bengali;
 - (viii) All work in connection with survey;
 - (ix) All cases of evasion of taxes, under assessments, penalty and prosecution;
 - (x) All matters relating to tax holiday applications;
 - (xi) All matters relating to approval of religious/charitable institutions and funds; and
 - (xii) All cases of exemptions under Section 44(4)(b) including exemption of interest on foreign loans;
- (B) Administration of Taxes Department.
- (C) Inspection including the offices of the Commissioners of Taxes.
- (D) Audit objections.

Member (Taxes-II):

- (i) Items enumerated at Sl. (i) to (xii) in (A) above;
- (ii) All matters relating to Wealth-Tax, Foreign travel Tax, Advertisement Tax, Electricity Duty and Shop Tax;
- (iii) All matters relating to Sales Tax Act, 1951, Urban Immovable Property Tax, Estate Duty and Gift Tax since repealed;
- (iv) All matters relating to House Rent Tax, Betterment Tax, Jute Tax, Professional Tax, Agricultural Income Tax since repealed;
- (v) Enquiries; and
- (vi) Training under the Directorate of Inspection and Training.

B. Auxiliary Organizations

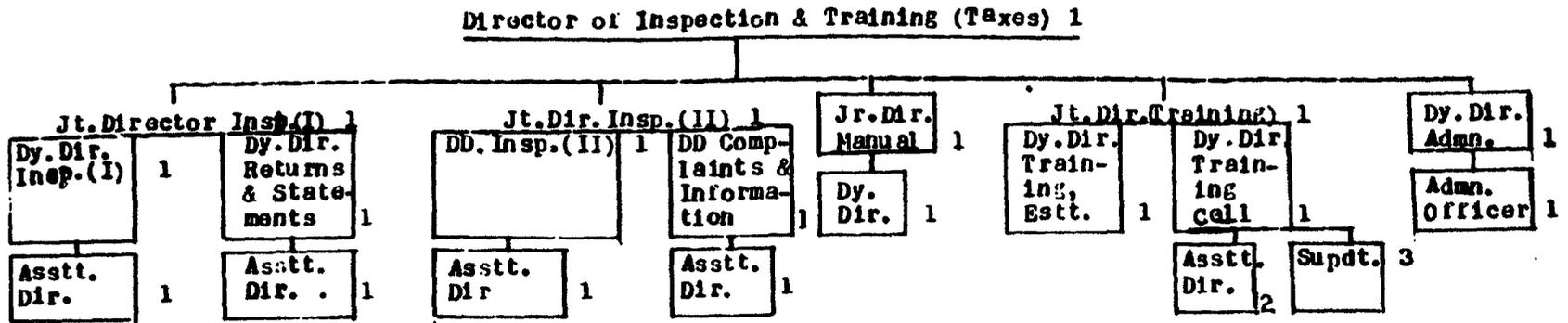
7.5 The Directorate of Inspection and Training (Taxes) is the only auxiliary organization available to assist the NBR on the direct taxes side. Accordingly it has wide ranging duties assigned to it, which, inter alia, include:

- (i) advising NBR on technical matters of policies formulation concerning direct taxes;
- (ii) providing executive and operational guidance to field staff;
- (iii) printing and publication of tax manual and forms;
- (iv) overseeing and examining the inspection reports of all tax offices with a view to
 - (a) scrutinizing assessment orders and computing taxes in different tax offices;
 - (b) auditing the accounting records of tax offices;
 - (c) inspecting clerical performance;
 - (d) monitoring progress of collection in field offices;
 - (e) supervising all technical work done in field offices, and
 - (f) commenting on the quality and quantity of inspections.
- (v) examining all periodical/reports and returns;
- (vi) observing disposal of appeals by departmental appellate authorities;
- (vii) enquiring into all complaints and dissemination of information to tax offices;
- (viii) providing suggestions for improvement of law and administration including staffing requirements;
- (ix) monitoring arrears of assessment and collection work; and,
- (x) formulating training policy and programs and undertaking training imparting to all levels.

The present organization of the Directorate of Inspection and Training (Taxes) is at Figure 7.2.

7.6 There is another Directorate of Complaints (Investigation) which is expected to collect intelligence and conduct investigations regarding evasion of taxes and duties by the members of the public or trade and of corruption by the officers of the Central Excise, Land and Sea Customs, Income Tax, Narcotics and Liquor Departments. Similar functions are also performed by the Anti-Corruption Department and by the officers of the NBR. As a result, the complaints actually handled by this Directorate are very

Annex 7.2
Present Organisation of the Directorate of Inspection & Training (Taxes)



NOTE: The figures shown against boxes indicate the number of posts sanctioned

limited (around 100 or so per year) of which less than 10 percent are against officers of the NBR. The Director is a Deputy Inspector General of Police. Deputy Directors and Superintendents of Police and Assistant Directors are drawn from the police as well as the direct and indirect taxes wings of the NBR. The Head Office is at Dhaka with a branch office at Chittagong. Although apparently requested, there are no offices in Rajshahi or Khulna.

C. Field Level Executive Organizations

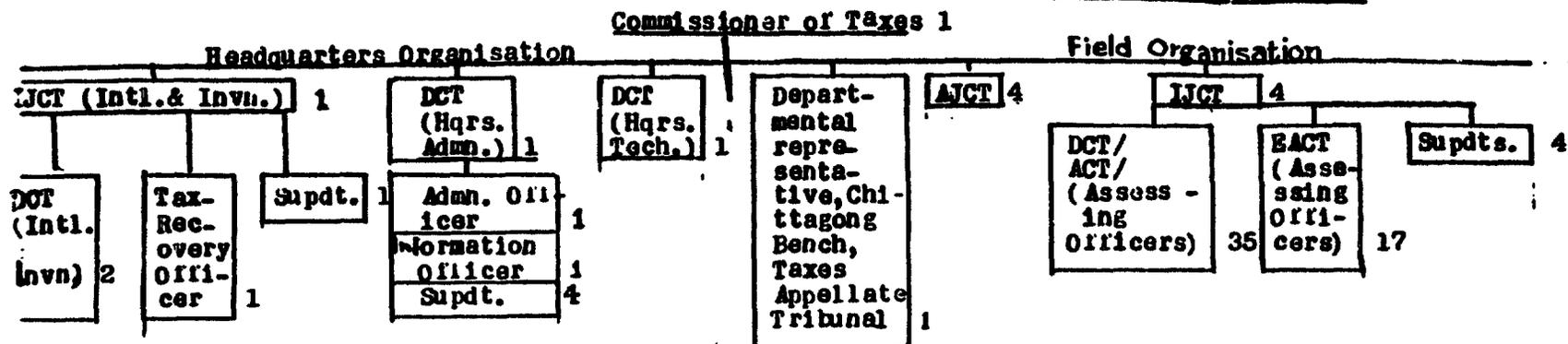
7.7 The field level organizations responsible for direct taxes administration are the Zonal Commissioners of Taxes. Jurisdiction of the Zonal Commissioners is fixed territorially and there are eight executive zones covering the entire country: four at Dhaka, two at Chittagong and one each at Rajshahi and Khulna. The Zonal Commissioners are supported by Range Inspecting Joint Commissioners (IJCT) on the executive side and by Range Appellate Joint Commissioners (AJCT) on the appellate side. The Inspecting Joint Commissioners, in turn, supervise and control the work of about twelve assessing officers in each Range. However, each Zonal Commissioner is also provided at his headquarters with a smaller Range of IJCT comprising only one or two assessing officers who are meant to take care of the important intelligence and investigation work in selected cases.

7.8 Assessing officers are at three levels viz., Deputy Commissioners (DCs) and Assistant Commissioners (ACs) in Class I and Extra Assistant Commissioners (EACTs) in Class II. No assessing officer at any level oversees the work of any other assessing officer. The assessing officer is a key figure and the success or otherwise of the tax administration depends entirely on the quality of these officers and their output. Such officers must ensure the successful completion of the chain of operations starting with (i) the deduction of tax at source and advance payment of tax, followed by (ii) the filing of a return of income/wealth (together with evidence of payment or admitted tax, e.g., under Section 74 of the Income Tax Ordinance) and (iii) ending with an assessment resulting in the creation of a demand or the determination of a refund, taking into account taxes already prepaid. The assessment could be the result of a detailed audit by the assessing officer or be confined to acceptance of a return filed under the self-assessment procedures (see Appendix 7.3 and Rule 38 of the Income Tax Rules). In a large number of cases, this stage spills over into rectifications and penalties. The last stage consists of proceedings for recovery which have their own problems when coercive methods have to be used to secure payments from recalcitrant tax defaulters (See Section 139 of the Income Tax Ordinance). The assessing officers are supported by adequate Class III and other staff. The present organization of one of these Zonal Commissioners (Chittagong South Zone) is given in Figure 7.3 by way of illustration. This zone presently has the largest manpower assigned to it.

7.9 In addition to an IJCT (Int. and Inv.) attached to each Zonal Commissioner at his headquarters, there is also a Commissioner (Int. and Inv.) at Dhaka. This organization follows the same pattern as that of the other Zonal Commissioners with two major differences. The office has no territorial jurisdiction and its size is considerably smaller. Individual cases needing in-depth investigation, are assigned to this zone by the NBR. One IJCT and four assessing officers currently handle only 704 Income Tax and 133 Wealth Tax cases.

Figure 7.3

Present Organisation of Zonal Commissioner of Taxes, Chittagong (South) Zone



Note: Figures shown against boxes indicate number of posts sanctioned.

7.10 The field organization now also includes a Senior Commissioner of Taxes (Survey, Search and Seizure). This was set up following the FY87 budget speech and is yet to be fully staffed. The present organization of the Senior Commissioner (whose salary scale is the same as that of a Member of NBR and who reports directly to the Chairman, NBR) is at Figure 7.4. The Senior Commissioner has been given concurrent jurisdiction over the whole of Bangladesh and has the power, wherever necessary, to issue instructions to the Zonal Commissioners in the matter of tax evasion.

D. Field Level Appellate Organizations

7.11 The first appeal from the order of the Assessing Officer is made to the Appellate Joint Commissioner and the second appeal by the taxpayer or the Commissioner to the Taxes Appellate Tribunal, which is the final fact-finding authority. Thereafter, either side may refer matters to the High Court. Any decision of the High Court is subject to appeal to the Appellate Division (Supreme Court). The Tribunal is created under the Income Tax law and consists of judicial and accountant members recruited from the bar, district judges or Joint Commissioners of Taxes and above. It functions under the Internal Resources Division of the Ministry of Finance. The members of the Tribunal enjoy the status of Commissioners, while the President has the rank of a member of the NBR.

3. Workload and Manpower

7.12 This section examines the relationship between workload and manpower of the direct tax administration as well as the norms established to ensure that tax assessment and collection are expedited through voluntary compliance.

A. Workload

7.13 It is worth noting that in addition to administering income tax, which is its main concern, the direct tax administration also has responsibility for several other direct taxes.¹ But, as Table 7.2 shows, revenue from and work involved in those other taxes is negligible. The following analysis of the workload, is therefore based on income tax figures. Inasmuch as the other taxes are neglected, it should be understood, however, that the output of the tax administration will be somewhat more than that reflected by the income tax figures.

7.14 Reference was made above to the growing volume of the income tax workload. The number of payers has increased by 17 percent over the five years ending 1987/88 despite increases in the filing threshold (see Table 7.1). Over the same period direct tax revenue has virtually doubled (see Table 7.2), with recent growth averaging Tk 1 billion per annum. Another factor adding to the complexity and volume of work is the process of regular amendments to the law necessitated by the evolution of tax policy.²

1/ This is apparent from the duties assigned at S. No. (ii), (iii) and (iv) to Member (Taxes-II) NBR (See paragraph 7.4).

2/ Examples from the three most recent budgets include tax rebates for small and cottage industries, amendments in the exemptions limit for

Figure 7.4

Present Organisation of Senior Commissioner of Taxes (Survey, Search & Seizure) Dhaka

Senior Commissioner of Taxes 1



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- NOTE:**
1. The figures shown against boxes indicate the number of posts sanctioned.
 2. Two IJCTs are located at Dhaka and one at Chittagong.

Table 7.2. Head-wise Collection of Direct Taxes for the Financial Years 1983/84 to 1987/88

Sl. No.	Heads	1983/84	1984/85	1985/86	1986/87	Tk in Thousands 1987/88
1.	Foreign travel tax	3,88,98	7,33,49	8,52,85	8,92,42	15,41,14
2.	Wealth tax ^{a/}	14,04	31,51	54,07	52,11	53,21
3.	Gift tax (repealed)	24,03	28,65	8,06	1,71	2,60
4.	Electricity duty	4,75,10	8,15,70	8,13,02	13,23,70	11,42,37
5.	Advertisement tax	1,00,36	89,11	1,44,43	1,83,79	1,88,74
6.	Urban immovable tax (repealed)	58,81	43,11	16,76	7,51	2,20
7.	Biman ticket tax (repealed)	-----	-----	-----	2,43,79	2,16,14
8.	Turn over tax (repealed)	92	24,52	17,65	21,33	9,88
9.	Estate duty (repealed)	10	-----	17	-----	-----
10.	House rent tax/ Jute tax (repealed)	10	5/Jute tax	10	06	-----
11.	Shop tax		23,71	83,50	94,88	60,98
TOTAL		10,62,44	17,89,85	19,90,61	28,21,30	32,17,26
12.	Income tax	338,87,00	385,85,00	462,15,00	553,29,00	664,40,00 Provisional
GRAND TOTAL		349,49,44	403,74,85	482,05,61	581,50,30	696,57,26

^{a/} The number of Wealth taxpayers in 1987/88 stood at 2,226 (provisional) against the number of Income taxpayers in the same year 4,08,302 (provisional).

Source: National Board of Revenue.

7.15 The limited data available allow the following picture to be assembled.

7.16 Table 7.6 for the year 1986/87 classifies collections source-wise and shows that 75 percent of income tax revenue came from 10,102 companies. Of that figure, 1032 are government-owned companies which contributed about one-third of that revenue.

7.17 Table 7.3 for FY 1986/87 provides the breakdown of certain kinds of workload (both current and arrears) arising from (a) salary cases (where scope for audit or scrutiny is strictly limited); (b) various kinds of companies (which yield about 75 percent of all income tax revenue); and, (c) "self assessment" cases where returns are expected to be accepted without any audit or scrutiny.³ The figures on disposals show the latter falling short of current additions to workload, resulting in increases in arrears of work. Of greater significance is the fact that, as between salary and company cases, no priority apparently attaches to completion of company cases, the percentage of workload disposed in both categories being a little over 34 percent only. The mission is aware that senior officers are posted to company circles. Such placements, however, have, in practice, not ensured priority to disposal of company cases. What is needed is more officers devoting more time to priority cases and not merely senior officers to be put in charge of them.

7.18 Table 7.4, also for 1986/87, provides a breakdown of the complete Income Tax workload (both current and arrear) income-wise, i.e., cases with incomes exceeding Tk 80,000 (Category I), with incomes from Tk 50,001 to 80,000 (Category II), with income from 30,001 to 50,000 (Category III) and with incomes not exceeding Tk 30,000 (Category IV). This shows that the bigger taxpayers number only 11,240 and that, here again, no priority is accorded to completion of their cases compared to those of the much larger number of cases of smaller taxpayers. The average overall disposal is 46.8 percent of the total workload against 51.1 percent for Category I cases and 49.3 percent and 48.2 percent for Category II and Category III cases respectively.

7.19 Table 7.5 for FY 1984/85 provides the number, by Commissioners' Zones, of self-assessment returns filed and the corresponding tax paid. This shows that the average tax paid by new taxpayers using this facility was only Tk 227 per head, as compared to an average of Tk 1644 per head for existing taxpayers. This is perhaps inherent in the self-assessment procedure since it applies to incomes upto Tk 125,000 only and expects such taxpayers to show incomes increasing by at least 10 percent from year to year. The table also shows that the self-assessment procedures covered only 12 percent of the total of 381,571 taxpayers and yielded 1.15 percent

3/ Cf. Rule 38 of the Income Tax Rules.

Table 7.3. Workload and Disposal of Salary, Company Self Assessment: Penalty Cases Year 1986/87 (ending June 1987)

S1. No.	Heads	Percent of Workload Disposed of		Workload		Disposal	
1.	Number of Salary Cases	34.3%	(a) Current Cases	58,737		13,623	
			(b) Arrear Cases	<u>78,928</u>	1,35,663	<u>32,805</u>	46,528
2.	<u>No. of Company Cases</u>						
	(A) Government Owned Financial Institutions	27.6%	(a) Current Cases	787		156	
			(b) Arrear Cases	<u>858</u>	1,645	<u>299</u>	455
	(B) Government Owned Non-financial Institutions	32.4%	(a) Current Cases	245		34	
			(b) Arrear Cases	424	669	<u>183</u>	217
	(C) Public Limited Financial Institutions	31.2%	(a) Current Cases	16		5	5
			(b) Arrear Cases	<u>10</u>	26		-
	(D) Other Public Limited Companies	37.4%	(a) Current Cases	931		187	
			(b) Arrear Cases	<u>934</u>	1,865	<u>511</u>	698
	(E) Private Limited Companies	35.3%	(a) Current Cases	7,156		1,040	
			(b) Arrear Cases	<u>8,307</u>	15,463	<u>4,428</u>	5,468
	(F) Tax Holiday Companies Where Tax Holiday Period has not Expired	37.0%	(a) Current Cases	967		390	
			(b) Arrear Cases	<u>731</u>	1,698	<u>239</u>	629
3.	Self Assessment Cases	64.9%	(a) Current Cases	53,126		34,966	390
			(b) Arrear Cases	<u>18,056</u>	71,182	<u>11,232</u>	46,198
4.	Penalty Proceedings Under Chapter XV of the Income Tax Ordinance 1984						
	(A) Concealment Cases	69.9%	(a) Current Cases	78		46	
			(b) Arrear Cases	<u>238</u>	313	<u>173</u>	219
	(B) Other Cases	41.0%	(a) Current Cases	30,075		4,975	
			(b) Arrear Cases	<u>37,889</u>	67,964	<u>22,919</u>	21,894

a/ Total arrear company cases is 11,264. Total current company cases is 10,102. Total of company cases for disposal is 21,366. Total disposal of all company cases is 7,472. Percentage of workload disposal is 34.8%.

Source: National Board of Revenue.

Table 7.4. Category-wise Workload and Disposal of Current and Arrear Income Tax Cases for the Year, 1986/87

Category	Workload			Disposal			Percentage of Workload Disposed of
	Current	Arrear	Total	Current	Arrear	Total	
I	11,240	12,239	23,479	4,104	7,894	11,998	51.1%
II	21,067	24,758	45,825	7,632	14,975	22,607	49.3%
III	2,12,016	1,52,491	3,64,507	88,141	87,663	1,75,804	48.2%
IV	<u>1,44,204</u>	<u>1,90,145</u>	<u>3,34,349</u>	<u>17,529</u>	<u>1,31,920</u>	<u>1,49,449</u>	<u>44.6%</u>
TOTAL	3,88,527	3,79,633	7,68,160	1,17,406	2,42,452	3,59,858	46.8%

Source: National Board of Revenue.

Table 7.5. Commissioners' Zone-wise Number of Self Assessment Cases and Collection for the Financial year 1984/85

Sl. No.	Name of Zone	No. of Self Assessment Returns Filed		Income-Tax Paid	
		By Old Assesses	By New Assesses	By old Assessee	By New Assessee
1.	Dhaka North Zone	3,458	4,065	5,753	1,094
2.	Dhaka South Zone	4,349	2,775	6,634	511
3.	Dhaka East Zone	1,864	1,491	7,106	876
4.	Dhaka West Zone	3,007	2,201	4,197	231
5.	Dhaka Intelligence and Investigation	12	-	54	-
6.	Chittagong South Zone	4,478	3,993	6,453	690
7.	Chittagong North Zone	3,519	1,716	5,899	1,007
8.	Khulna Zone	1,837	3,182	2,266	382
9.	Rajshahi Zone	<u>1,357</u>	<u>3,179</u>	<u>911</u>	<u>337</u>
	TOTAL	23,881	22,602	39,271	5,128
				i.e. Tk 1644 per return	i.e. Tk 227 per return

Source: National Board of Revenue.

**Table 7.6. Final Collection of Income Tax (Classified)
for the Year 1986/87**

Sl. No.	Heads	"Tk in thousands"	
		Collection	Percentage
1.	Collection from Non-Government Company Cases	278,16,94	50.3
2.	Collection from Government Owned Company Cases	135,89,64	24.6
3.	Collection from Salary Cases	34,84,18	6.3
4.	Collection from Other Cases	<u>104,37,98</u>	<u>18.8</u>
	TOTAL	553,28,74	100.0

Source: National Board of Revenue.

Table 7.7. Statement of Appeal Cases with AJCTs

Fiscal Year Ending 30 June	Appeals Pending at the Beginning of the Year	Appeals Filed During the Year	Total for Disposal	Disposal During the Year	Appeals Pending at the End of the Year
1984/85	13,177	13,632	26,809	19,178	7,631
1985/86	7,631	11,352	19,983	11,196	8,787
1986/87	8,787	11,541	20,328	12,463	7,865
1987/88 (upto Feb. '88 i.e. for 8 months)	7,865	34,650	42,515	20,741	21,774

Source: National Board of Revenue.

Table 7.9. Statement of Appeal Cases in the Three Branches of the Taxes Appellate Tribunal, Bangladesh Showing Pending Cases as of August 7, 1985, institution and Disposal of the Cases in 1985/86 and 1987/88 and Pending as of July 1, 1988

Fiscal Year Ending June 30	Appeals Pending at the Beginning of the Year	+	Appeals Filed During the Year	=	Total for Disposal	Disposal During the Year			Appeals Pending at the End of the Year
						Division Bench	Single Bench	Total Disposal	
1985/86									
Division Bench, Dhaka	10,207	+	1,971	=	12,178	- 1,719	-	-	= 10,459
Single Bench, Dhaka g/									
Chittagong Bench, Chittagong	2,633	+	527	=	3,160	- 895	-	-	= 2,265
Khulna Bench, Khulna	31	+	553	=	584	- 132	-	-	= 452
TOTAL	12,871	+	3,051	=	15,922	- 2,746	-	-	= 13,176
1986/87									
Division Bench, Dhaka	10,459	+	1,822	=	12,281	- 673	+ 1,171	1,844	= 10,437
Single Bench, Dhaka g/	-		-		-				
Chittagong Bench, Chittagong	2,265	+	937	=	3,202	- 813	-	813	= 1,389
Khulna Bench, Khulna	452	+	541	=	993	- 86	-	86	= 907
TOTAL	13,176	+	3,300	=	16,476	- 1,572	+ 1,171	= 2,743	= 13,733
1987/88									
Division Bench, Dhaka	10,437	+	1,631	=	12,068	- (913	+ 810)	= 1,723	= 10,345
Single Bench, Dhaka	-		-		-				
Chittagong Bench, Chittagong	2,389	+	591	=	2,980	- (583	+ 0)	= 583	= 2,397
Khulna Bench, Khulna	907	+	398	=	1,305	- (128	+ -)	= 128	= 1,177
TOTAL	13,733	+	2,620	=	16,353	- 1,624	+ 810	= 2,434	= 13,919

/ Single Bench at Dhaka started functioning from 1986/87.

Source: Taxes Appellate Tribunal, Dhaka.

of the tax collections of Tk 3.86 billion for the year 1984/85. The workload on the appellate side, i.e., with AJCTs and the Tribunal is 1987/88. Notwithstanding that development, they carry only about a years' explanation for sudden spurt in appeals instituted before the AJCTs in workload with them. On the other hand, the Tribunal's output is lower than its intake year after year, mainly on account of vacant posts, with the result that it now carries about 5 years' workload at its present rate of disposal. This represents a serious bottleneck. Old issues pending settlement in appeals for several years imply more appeals (and more avoidable work) on the same or similar issue in all subsequent years both with AJCTs and the Tribunal.

7.20 Section 75 of the Income-tax Ordinance, 1984 requires that a return of income is to be furnished in the prescribed form shall be filed with the Deputy Commissioner of Taxes. The prescribed form of return is fairly simple and comprehensive and it does not require any changes. The Deputy and Assistant Commissioners have the responsibility of receiving the returns, conducting whatever audit is deemed advisable and making an assessment of taxes.

7.21 Section 135 of the Ordinance envisages that where any tax is payable in consequence of any assessment made or any order passed under this Ordinance, the Deputy Commissioner shall serve on the taxpayer a notice of demand in the prescribed form specifying therein the sum payable and the time within which it is payable. In the cases of delay or non-payment, interest as well as penalty is payable. Various coercive methods to recover the tax from the defaulters are prescribed. In spite of these provisions, total arrears of taxes have increased as reflected in Table 7.9 that reproduces Table 3.1 of this report. A further breakdown of the inventory in terms of size of arrears is presented in Table 7.10. It shows that 31 percent of the arrears are accounted for by customs duties, 2 percent by sales tax, 19 percent by excises and 48 percent by direct taxes. The Director of NBR's Research and Statistics Department indicated that firm data were not readily available but that the percentage of arrears for the public sector would be much less in the smaller category of units--less than Tk 10 million owed by a single unit--than in the larger--Tk 10 million or above. Therefore, application of a percentage of 50 to the public sector for arrears in units of less than Tk 10 million would lead to the division of the inventory between the public and private sectors as of June 30, 1986 to be as depicted in Table 7.11. Thus, it could be assumed that the public sector accounted for approximately 70 percent of arrears on June 30, 1986. Data for the year ending June 30, 1987 were not available at the time of the mission but it is reasonable to assume that no significant change in trend has occurred.

7.22 The figures on arrears should however be interpreted carefully. In fact, a fairly large proportion, perhaps 50 percent, is not collectible because a sizable percentage of the inventory of direct taxes relates to assessments made before independence on December 16, 1971.⁴ The assessments apply against

4/ Efforts were made earlier to secure details on specific accounts, particularly of units of more than Tk 10 million, in order to gain a better idea of the collectibility. However, the Director, Research and Statistics, stated that such detail was not readily available and that a great amount of time would be needed. The mission was then given a collectibility estimate of 50 percent.

**Table 7.9. Bangladesh: Arrears in Collection of Taxes
(Millions of Taka)**

As of	Customs	Excise	Direct	Total
June 30, 1982	1,278.0	803.5	3,513.0	5,594.5
June 30, 1983	1,311.1	764.6	3,316.1	5,391.8
June 30, 1984	1,491.6	721.7	3,753.9	5,967.2
June 30, 1985	1,834.1	694.2	3,073.6	5,601.9
June 30, 1986	2,054.5	1,237.0	3,324.0	6,615.5

Source: National Board of Revenue.

**Table 7.10. Bangladesh: Breakdown of Arrears in Collection of Taxes
by Size of Arrears, June 30, 1986
(Millions of Taka)**

Total	6,615.5
Customs	2,054.5
Total of Tk 10 million or above from single unit	1,858.4
Public sector	(1,506.1)
Private sector	(352.3)
Total of less than Tk 10 million per single unit	196.1
Sales	128.0
Excise	1,237.0
Total of Tk 10 million or above from single unit	1,115.7
Public sector	(1,101.9)
Private sector	(13.8)
Total of less than Tk 10 million per single unit	121.3
Direct Taxes	3,196.0
Total of Tk 10 million or above from single unit	1,052.7
Public sector	(763.7)
Private sector	(289.0)
Total of less than Tk 10 million per unit	2,143.3

Source: National Board of Revenue.

Table 7.11. Bangladesh: Breakdown of Arrears in Collection of Taxes by Public and Private Sector, June 30, 1986 (Millions of Taka)

<u>Total</u>	<u>6,615.5</u>
<u>Public Sector</u>	<u>4,665.2</u>
Customs	1,604.1
Excise	1,162.5
Direct	1,898.6
<u>Private sector</u>	<u>1,950.3</u>
Customs	450.4
Excise	74.5
Direct	1,425.4

Source: National Board of Revenue and IMF estimates.

some of the government-owned entities in Pakistan and little effort has been made over the years to effect collection. The public sector inventory for excise tax arrears, largely reflects that incurred by two or three gas companies that cannot pay since they cannot collect receivables from their customers. In contrast, private sector delinquencies represent the usual problems involved with the timely payment of taxes.

B. Manpower

7.23 The sanctioned strength of the direct taxes administration in 1979, 1983 (pre-revision), 1983 (post-revision by Martial Law Committee) and 1988 appears in Table 7.12. The data shows that while the sanctioned strength of Class I and Class II officers of the Tax Department virtually doubled in the four years ending 1983, there have been no commensurate additions to tackle the increased workload in the five years ending 1988. Furthermore, there are major gaps between the present sanctioned strength and the actual working strength in the cadre of Deputy Commissioners and Assistant Commissioners which are primarily responsible for assessment work. For example, of the 107 (98 + 9) posts of Deputy Commissioners, as many as 64 were found to be vacant. Similarly, of the 160 (152 + 8) posts of Assistant Commissioners, 36 were unfilled in 1988. Thus, there is a shortage of 100 posts (37.5 percent) in the Assessment cadres. It may also be noted that 14 DCs/ACs were sanctioned for the Directorate of Inspection and training and another 32 were meant to be posted to the Headquarters of the Commissioners (including those in the Intelligence and Investigation Cells). Thus the manpower actually available for assessment work is further reduced by these 46 posts.

7.24 A major reason for the lack of effective enforcement of the provisions of the direct tax laws, is the low morale and motivation of the departmental staff. Discussion with the staff as well as those outside the administration who have to deal with it frequently identified a number of reasons for this situation. These include pay scales and facilities, inadequate promotion prospects in relation to that obtaining on the

Table 7.12. Sanctioned Strength of Direct Taxes Field Organization

	1978/79	1982/83 (pre-revision)	1983/84 (post-revision)	1987/88
<u>Class I</u>				
1. Senior Commissioner	-	-	-	1
2. Commissioner/Director	6	11	10	10
3. Departmental Representative/ Senior Joint Commissioner/ Joint Director	-	2	7	7
4. Inspecting Joint Commissioner	21	30	28	31
5. Appellate Joint Commissioner	9	20	21	21
6. Deputy Commissioner/Deputy Director	153	101	88	98
7. Assistant Commissioner/Assistant Director/Tax Recovery Officer		143	160	160
<u>Class II</u>				
1. Extra Assistant Commissioner	80	91	115	115
2. Public Relations Officer/ Information Officer	-	4	8	8
3. Administrative Officer/ Superintendent	39	66	74	80
<u>Class III and IV (MISS)</u>				
1. Inspectors	245	400	448	472
2. Ministerial Staff	1784	2859	2035	2083
3. Class IV (MISS)	648	1245	1038	1071
Total Sanctioned Strength	2986	4972	4033	4157

a/ In addition, the following sanctioned posts were also there for equivalent posts of NER:

Member	2	Equivalent to Senior Commissioner
First Secretary (Taxes)	3	Equivalent to Senior Joint Commissioner
Second Secretary (Taxes)	9	Equivalent to Deputy Commissioner.

b/ In addition, leave, deputation and training reserve of 10 percent of entry posts (viz., 10 percent of Assistant Commissioners' Cadre of 160 posts i.e., 16 posts) was created in March 1988. These posts are yet to be filled.

Source: Final report of the Taxation Enquiry Commission, Bangladesh and NER.

indirect tax wing, complaints of outside interference with the administration decision-making process, thus undermining the rule of law; and the existence of a continuing voluntary disclosure scheme, which permits an individual taxpayer to declare any amount of income under the head 'Other Sources' and pay concessionary taxes thereon.⁵ Such concessions are intended to induce the taxpayers to disclose correct income. In India also, attempts have been made in the past to capture undeclared income. But, firstly, the Voluntary Disclosure Schemes were temporary and for limited periods and they were not incorporated in the main statute. Secondly, implementation of temporary disclosure schemes was preceded and followed by effective enforcement of law and measures like search and seizure, so that the tax administration may not lose its credibility. A permanent disclosure scheme as part of the main statute gives a wrong signal to the taxpayers. What makes it worse is the fact that it grants concessions not only in the matter of penalty/prosecution but also with respect to the rate of tax applicable.

C. Norms

7.25 The Martial Law Committee which reviewed the organizational set-up of the Direct Taxes Department in 1982 observed that the main revenue yielding cases are Category I (i.e., with business/property income of Tk 50,001 and above) Category II (between Tk 25,000-50,000) and Category III (Tk 15,001-25,000) cases.⁶ The main thrust of work was found to be towards the disposal of Category I and II cases so as to improve collections. It was noted that each assessing officer on average is expected to dispose of 1200 cases per year except the assessing officers of salary and company cases. Inclusion of the Class II EACTs who also perform assessment duty and exclusion of such ACs and DCs as not meant for assessment work (e.g., those in Commissioners' headquarters or in the Directorate or in the NBR), implies that there are a little over 300 officers sanctioned for this purpose. At 1200 assessments per head, those officers are, on average, expected to dispose of 360,000 assessments a year. This is precisely what was accomplished in 1986/87 (see Table 7.4). The fact that in that year several of these 300 posts were vacant implies that each officer's output was well above the average of 100 assessments per month. That would have allowed barely 2 hours per taxpayer, a figure that precludes making a detailed audit and examination of a tax return.

5/ The relevant portions from the Budget Speeches of the Finance Ministers in FYs 87, 88 and 89 are reproduced in Appendix 7.1. See also last part of paragraph 14 of the Budget Speech for FY90 according to which this concessionary treatment will cease after 1989-90.

6/ The limits for these categories have since been revised upward (in 1986). For the new categories see paragraph 7.18 and Table 7.4.

7.26 The tentative conclusions of the preceding paragraph were sought to be verified by conducting a quick work study of the output of the assessing officers of one of the Zonal Commissioners at Dhaka. The study period covered five working days, from August 16, to August 21, 1988. It was found that during this period one of the DCs handling company cases completed four assessments per day besides handling a daily average of more than 18 two-way communications. In the case of two other assessment officers the daily averages of assessments completed in 1987/88 were 3 and 2 respectively. In a non-company circle with territorial jurisdiction, the daily average disposal of assessments was found to be about 11. A copy of the relevant portion of the work study report is reproduced at Appendix 7.2. It is clear that company cases do not receive the special attention or time they are supposed to. Accordingly the mission's recommendations that appear later in the chapter are directed at ensuring that more important cases receive much more attention than at present. Indeed, any meaningful examination and audit of each return would require at least 2 mandays, so that the output expected from officers handling such cases should not go beyond 150 to 200 per year.

7.27 While the norms evolved above may be used to guide the deployment of assessing officers, the norms to be applied for deployment of middle management (IJCT) and higher level officers (Commissioners) can be determined with reference either to the span of control or to revenue collections. In both areas guidance is available from the history of the tax administration. The final report of the Taxation Enquiry Commission, stated that a Commissioner's charge should have no more than 4 Inspecting Joint Commissioners and that the optimum span of control of an Inspecting Joint Commissioner should extend to only 8 assessing officers exercising general jurisdiction or to only 4 officers exercising jurisdiction over Company or big investigation cases.⁷ Going by the revenue criterion, again, it is noted that in 1965 when revenue collections reached Tk 100 million, the single Zonal Commissioner's office at Dhaka was split into two zones, indicating that Tk 50 million was then considered to be a proper norm to be applied in determining the number of Commissioners required. After allowing for inflation, a norm of Tk 500 million appears to be called for at the present time. The mission finds these norms to be reasonable and, as discussed later, finds that they can actually be applied with existing manpower if emphasis is shifted away from the present perfunctory scrutiny of all tax returns to a more detailed examination of selected returns only.

II. RECOMMENDATIONS

1. Objectives

7.28 The mission's recommendations are motivated by the need to broaden the tax base and to encourage voluntary compliance within the manpower constraints likely to obtain in the near future. This will require simplifying laws and procedures, redeploying available manpower to priority areas, improving training, inspection, auditing, management information systems and research for the formulation of tax policy and reduction of

7/ Report of the Taxation Enquiry Commission, Government of Bangladesh, page 191.

avoidable paperwork. In parallel with the situation obtaining in the customs and excise administration, the recommendations call for changes at all levels: (1) at NBR headquarters; (3) in the auxiliary organizations; and, (3) throughout the field level offices, both executive and appellate. Once again, the mission suggests economies via reorganization and mergers, so that the recommendations have the twin characteristics of building on existing administrative structures and of not committing the government to substantial new expenditures. This chapter further indicates how existing organizational charts may be modified to create the new units proposed by the mission.

2. Tax Arrears

7.29 Little effort appears to have been made to analyze the accounts and write off as uncollectible those accounts with no chance of collection, so as to allow figures on arrears to reflect a realistic accounts-receivable inventory. After an assessment is made, no statute of limitation applies to the collection of the account.

7.30 It is recommended that the following procedures be instituted to resolve this continuing problem.

7.31 The NBR should appoint an ad hoc committee chaired by a senior official to handle this problem. The committee should have representation from each of the three areas involved--customs, excise and direct taxes. The Committee shall examine each delinquent account and decide about writing off of uncollectible items.

7.32 As the statute for collectibility does not expire on assessed accounts, the accounts written off as uncollectible could be placed in an "inactive" account and they could be reviewed periodically. If information become available to indicate the possibility of full or partial collection, the account could be reconverted to active status, and assigned to an official for collection.

7.33 This project should be given high priority, expedited and deadlines established for the completion of the various tasks. It is recommended that upon selection of the ad hoc committee, the chairman be given a period of 90 days to analyze the accounts inventory and classify the accounts. The collectible accounts should be assigned to specially selected officials with instructions to determine collectibility by contact with the taxpayer and to make collection to the extent possible within another 90 days. If acted on promptly, the major portion of the collectible accounts could be handled during 1989/90. If 10 percent of the arrears is collected on an annual basis, this would result in Tk 660 million in additional revenue per annum, until the collectible portion of the arrears are exhausted. In the mission's view, this is possible with a diligent effort on the lines proposed.

3. National Board of Revenue

7.34 One of the objectives as per the agenda for reforming the Bangladesh tax system is to strengthen the NBR (paragraph 1.19). This has been achieved partly as one of the aspects of reform of the administration of indirect taxes by appointing two more members, one in charge of taxation

policy, planning and research, the other in charge of training and administration (paragraph 1.77). If the ratio of direct taxes to the total tax revenue is to be increased, it is imperative that the NBR is strengthened to improve the effectiveness of direct tax system as well. As mentioned earlier, the growth of the direct tax administration has not been commensurate with the growing volume and complexity of its workload. The number of taxpayers has increased from 1,62,428 in 1973/74 to 4,08,302 in 1987/88 (Table 7.1). The collection of income-tax has increased from Taka 3,38,8700 thousands in 1983/84 to Taka 6,64,4000 thousands in 1987/88 (Table 7.2). The manpower of the field organizations has increased from 2986 in 1978/79 to 4157 in 1987/88 (Table 7.12). The mission believes that the workload of the members of the NBR is excessive. It may be noted in this connection that one of the members handled 3117 receipts in the year 1987/88 while the other was also found to be equally overworked. This adversely affects their contribution to tax policy and leaves them with little time to effectively supervise and control the field organization. As a result, important matters that receive inadequate attention include problems of tax evasion and avoidance, weaknesses in recruitment, cadre management, inspections and training, inadequacies in management information systems and the virtually total neglect of research and tax analysis.

7.35 The mission recommends that two more members be added to the direct taxes wing of the NBR. One of the new members may be designated Member (Administration). This member will also look after inspection, training and internal and AGs audit work, and take responsibility for vigilance against corruption. The second new member may be designated Member (Investigation) and will, in addition, look after tax policy and legislation. It will be his responsibility to ensure strict application of tax laws to identified bigger and revenue yielding cases, in order to serve as an example for others and hence to allow the proposed enlarged self-assessment scheme to get off the ground. He will also be in charge of Research and Statistics. The present Member Taxes-I may be redesignated Member (Income-Tax) and will be in charge of all income tax operations excluding those relating to recovery, appeals and investigations, search and seizure, penalty and prosecution, etc. The present Member Taxes-II may be redesignated Member (other taxes). He will, in addition, deal with all income tax recovery, appellate or judicial, survey, tax withholding and taxpayer education work.⁸

7.36 The Members of the Board currently have only functional duties and do not exercise any territorial administrative control over the Zonal Commissioners or Directors. With the enlargement of the organization, it would be preferable if, in addition to their functional duties, each member exercised supervision over some of the Commissioners/Directors. In view of the proposals to come, the mission suggests the following structure.

8/ Consideration could eventually be given to bifurcating the present single board into two separate boards for direct and indirect taxes, with necessary coordination being provided by the Secretary, Internal Resources Division.

<u>Designated Member</u>	<u>In Charge of</u>
Member (Income Taxes)	All Zonal Commissioners in Dhaka
Member (Other Taxes)	All Zonal Commissioners in Chittagong Director (Survey and Tax withholding, etc.)
Member (Investigation)	Commissioner (Intelligence and Investigation), Dhaka Director (Research and Statistics) Director Complaints (Investigation)
Member (Administration)	Zonal Commissioners at Khulna and Rajshahi Director (Training) Director (Inspection)

7.37 Only one of the two proposed new posts of Members need to be created at present. In view of the recommendation to abolish the Senior Commissioner's organization made below, the other can be filled by converting the present post of Senior Commissioner to that of Member as both carry the same scale of pay.

7.38 Turning to the office of Director, (Research and Statistics) which functions as a part of the Board, the mission noted that it is mainly a repository of direct and indirect tax statistics. No effort is apparently undertaken to analyze the data and therefore suggest changes on the basis of such analysis. This is partly due to the fact that this latter function is also assigned to the Directorate of Inspection and Training to whom copies of the statistics are also sent by the field formations. However, this function is neglected there as well for want of manpower. The mission suggests that this directorate take a broader view of its functions. It should not only receive and consolidate statistics but also analyze and suggest corrective action to the respective Directors/Commissioners. That can be the only justification for retaining this directorate as part of the NBR. One of its early tasks should be consolidation of the numerous reports and returns, with a view to eliminating data on which no follow-up action is taken. At present the assessing officers send about a dozen separate monthly reports to the higher officers. This could conveniently be combined into a single monthly progress report covering all important aspects of work which need to be monitored.

7.39 The directorate of research and statistics is not currently engaged in any research. It is desirable that it cultivate a policy orientation and advise NBR in such matters. Research conducted by this

directorate can support policymakers by analyzing the revenue consequences of changes in exchange rates, interest rates and trade and industrialization policies, all of which affect the tax base. It should also assess the impact of fiscal policies on different sectors of the community. To be able to discharge this function, the directorate needs to be suitably strengthened on the same pattern as proposed on the indirect taxes side in paragraphs 3.25 to 3.31 of this report and in Appendix II to Chapter 3.

7.40 Some other items on which studies are required are identified later in this chapter, in connection with switching over to a considerably larger self-assessment procedure, coupled with effective scrutiny of a much smaller number of cases. Those studies should also be conducted by this directorate, if necessary, in association with local academic institutions which may also be interested in the subject.

7.41 One difficulty in keeping this directorate in the NBR is that although the director is of the rank of commissioner, he loses the facilities of housing and transportation on being transferred to this position. Finding candidates for the position has accordingly become difficult. One solution could be to make the directorate an auxiliary office of the NBR, so that, in common with the other directorates, the head of the department will be entitled to those facilities. Alternatively, if the facilities are available in the feeder cadre of commissioners/directors, there seems little justification for taking them away for the Director (Research and Statistics) in the NBR. The mission would prefer the director to continue in the NBR and would recommend that the position carry with it the necessary facilities.

4. Auxiliary Organizations

7.42 Reference was made to the fact that the Directorate of Inspection and Training (Taxes) is the only auxiliary organization on the direct taxes side available to assist the NBR. The mission found that acute inadequacy of manpower prevented its essential functions from being performed effectively. The vacancy position in the Directorate was found to be as follows.

Cadre	Sanctioned Strength	Working Strength	Vacancies
Deputy Director	8	0	8
Assistant Director	6	1	5
Superintendent	3	0	3
Inspectors	10	8	2

This Directorate has a long history of separation and merger of its two major functions, namely, inspection and training. Till 1978 there used to be a common Directorate for those two functions. But in January 1979 a separate Directorate of Inspection (Taxes) was created and the importance of the separation endorsed by the Taxation Enquiry Commission.⁹ When the

matter was reviewed by the Martial Law Committee in 1982, the two Directorates of Inspection and Training were again merged. Depletion of manpower since that time has implied that the directorate is hardly able to contribute anything of substance to the tax administration.

7.43 The mission is of the view that the functions of inspection and training need to be looked after by two separate directorates as was the case between 1979 and 1982. In addition, the manpower available to the two directorates needs to be augmented so that the functions assigned to them as detailed in paragraph 7.5 are adequately discharged. The importance of these functions in improving the quality of those responsible for operating the tax system is overwhelming. Furthermore, almost everyone in, as well as out of the administration with whom these matters were discussed by the mission, pointed to inadequacies in the present organization in these two vital areas.

7.44 Figures 7.5 and 7.6 present the proposed organization of the two proposed directorates after the present consolidated directorate of inspection and training is bifurcated.

7.45 It will be seen from Figure 7.5 that the mission recommends enlargement of the functions of the Directorate of Inspection (Taxes) so that it can also take care of the important allied areas of O&M, systems audit, and vigilance against corruption. It is proposed that all matters pertaining to development of the organization and methods and systems of the tax administration be the responsibility of this directorate. At present no one is specifically assigned this important function. This directorate will also deal with all complaints received against officers that have a bearing on their efficiency or integrity. It may also be noted that the figures provide for separate joint directors for inspections of assessing officers and for all other officers. It will be the responsibility of these joint directors to produce inspections manuals laying down the guidelines for carrying out inspections at all levels in the department, the actual inspections to be done by more senior officers in the field. It will also detail an annual program of inspections and monitor compliance with it. It will additionally be responsible for ensuring that follow up action is taken on the inspection reports, particularly in areas of inefficiency or lack of integrity and that the results of these inspections are reflected in the annual confidential reports of the officers concerned. The audit function and, in particular, internal audit also needs to be enlarged and regularized by producing an internal audit manual. That will be the responsibility of Joint Director, Audit. He will be supported in due course by at least 11 Assistant Directors, Assistant Commissioners or EACTs (one for each zone), who in turn will be supported by at least 3 inspectors each to carry out the actual work of internal audit throughout the field organization. These officers of the directorate could be located in the respective zones. The necessary manpower at the level of EACT and inspectors will be found as a result of reorganization of the field formations proposed later in this chapter. Thus no new posts at these lower levels need be created. In view of these proposals, the work of training and publication of tax manual and forms is being taken away from this directorate, to be assigned to the proposed new directorate of survey, and the work pertaining to complaints against officers is being taken away from the Directorate of Complaints (Investigation). The Directorate of Inspection will also not look into any

Figure 7.5

Proposed Organisation of Director of Inspection (Taxes)

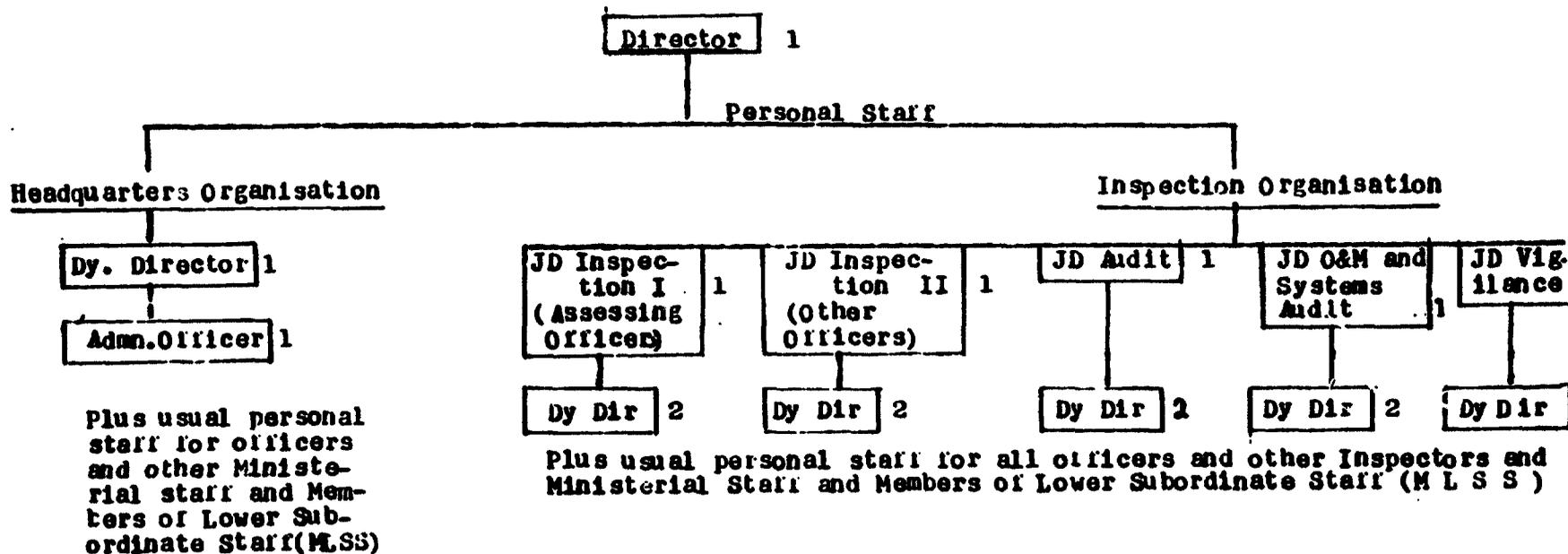
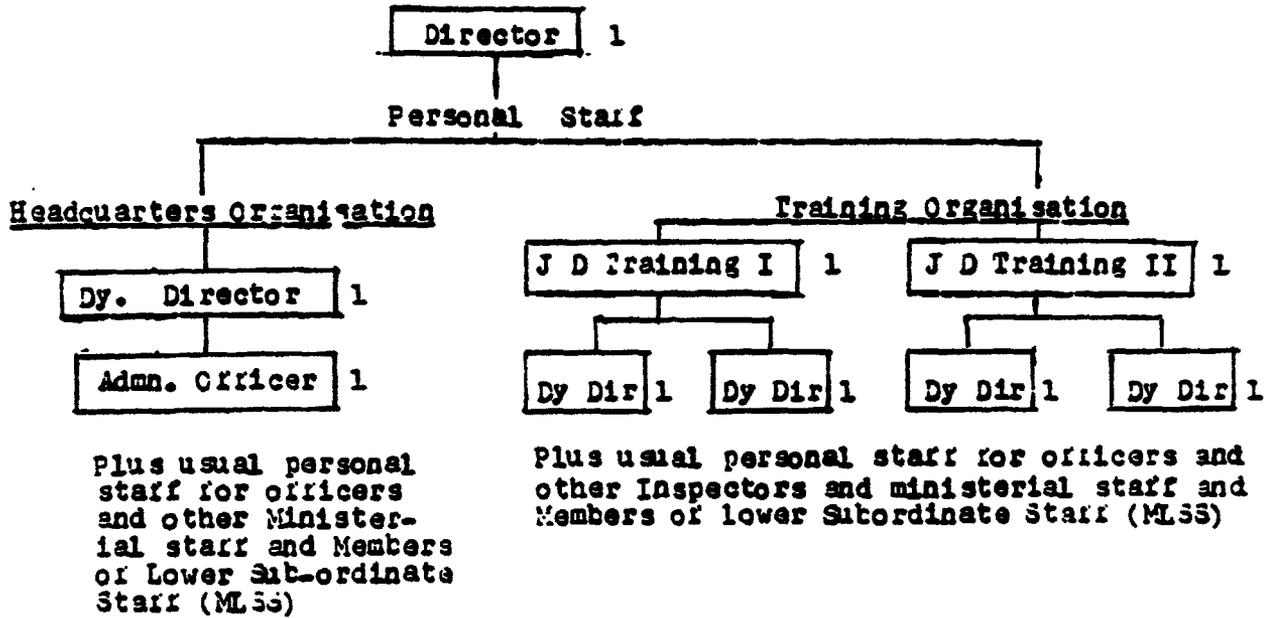


Figure 7.6

Proposed Organisation of Director of Training (Taxes)



complaints against taxpayers or work connected with dissemination of information to tax officers relevant for completion of tax assessments. These tasks are being assigned to the other directorates. It is recommended that the directorate of inspection be headed by one of the most senior Commissioners.

7.46 Training has been recognized to be one of the most important functions of any organization. Ill-trained personnel of a tax administration has adverse effects on its revenue effort and its effectiveness. A training policy is inextricably linked with the growth and changing functions of the tax administration. In Bangladesh, in the indirect taxes wing, the existing Directorate of Inspection, Training and Drawback has been recommended to be divided, based on functions to be performed, into three Directorates of (i) Training, (ii) Inspection, etc. and (iii) Drawbacks, etc. This was to ensure that each of these functions receives the attention that is clearly required to "create a viable tax administration" (para. 1.80). Without a separate Directorate of Training, the training functions will remain confined to conducting some courses which may not be responsive to the broad range of existing and emerging functions of the direct tax administration. A systems approach to training requires building training infrastructure, identification of training needs at the individual and group levels, designing and conducting courses on the basis of identified needs, developing the training personnel, building course material and evaluating the training programs. All these functions can be performed by a Directorate exclusively in charge of training to be established within two years. This Directorate should have its headquarters at a separate Direct Tax Academy, with regional Training Centers coming up in due course, say five years. This proposal commends itself also for the reason that virtually the entire additional manpower requirements are being found from the existing resources. The Directorate of Training needs not only to be strengthened but also to be provided with adequate facilities. At present there is one classroom, so that only one training course may be conducted at a time. A full-fledged residential training institute needs to be created at Dhaka so that all officers and staff could be periodically called for induction and in-service training as well as refresher courses. Till such time as this facility is created, the directorate should have its regional units located at all four cities where there are Commissioners' Headquarters headed by ACs/EACTs who would be in charge of training of all Class III and IV staff locally. These regional units will be assisted by a suitable number of inspectors who will also function as instructors. The manpower for this could also be found from the EACTs/Inspectors rendered surplus by reorganizing the field formations. Alternatively, the Directorate could consider organizing training for outstation Class III and IV staff through correspondence courses, a method successfully used, for example, in Japan.

7.47 The syllabus for the departmental examinations that officers are required to pass after their induction training or to qualify for promotion as EACT needs to be enlarged. It should cover subjects like commercial law (e.g., law of contracts, sale of goods, partnership, etc., which have a bearing on all tax assessments), economics, management and public administration, tax policy, valuation of properties and public relations.

This will imply an increase in and, preferably, doubling of the duration of training courses. It is also noted that the marks required for qualifying at the departmental examination was reduced in 1984 from 60 percent to 50 percent for qualifying by higher standard and from 45 percent to 40 percent for qualifying by lower standard. The mission noticed that this affected the quality of work and would suggest upgrading the percentages to the original level so that the quality of staff assigned to the all-important assessment function is improved.

7.48 The mission has identified broadening of the tax base as one of the continuing objectives of the tax administration. There was a widespread feeling at all levels of the administration that the number of non-filers is very large and that the increase in the number of taxpayers is not commensurate with the incomes generated as a result of the substantial development expenditure incurred by the government. There seem to be three reasons for this state of affairs. First, since the creation of the organization of Senior Commissioner (Survey, Search and Seizure) in 1986, the field officers have the impression that all survey work stands transferred from the Zonal Commissioners to the Senior Commissioner. On the other hand, the impression of those in the NBR who dealt with the creation and notification of the organization of Senior Commissioner was that the latter would be responsible for the special surveys in individual cases envisaged under Section 115 of the Income Tax Ordinance, 1984 and not for the internal survey or external house-to-house or shop-to-shop survey. In any case, the outcome has been that virtually no survey work has been done since 1986. Second, there is an acute shortage of manpower. Third, the survey function was included with all other functions of the assessing officer and was neglected in part because of work pressures (see Appendix 7.2) and in part because of the lack of monitoring of this task. Experience suggests that this could be remedied by creating a special organization for this priority area. A ready example is provided by the creation of the organization of Senior Commissioner. Even though the Zonal Commissioners had powers of search and seizure for 10 years, not a single search was carried out till the Senior Commissioner's office was created. Since then, some 18 searches have taken place though much still remains to be done. The mission recommends the creation of a separate Directorate for Internal and External Survey, which will be responsible for carrying out survey operations in all the zones as detailed in Chapter V of the Income Tax Office Manual issued by NBR in 1980. These operations cannot be carried out by the Zonal Commissioners since they are over-worked and under the pressure of their day-to-day work, survey operations get neglected. Secondly, these operations are a specialized function and do not mix with normal assessment and collection functions. Hence the need for a separate Directorate for Internal and External Survey which will also improve the monitoring of this important aspect of work. This directorate will execute both internal and external surveys. It may be clarified here that the responsibility for conducting survey under Section 115 of the Income Tax Ordinance, 1984 in the cases of existing assesses will continue with Zonal Commissioners and their officers. Staff in this new directorate will be

located at all the stations where Headquarters of Zonal Commissioners or IJCTs are located. The required manpower, mainly at the EACT and Inspectors levels, will be found from the surplus following reorganization of field formations proposed later in this chapter.

7.49 It is also appropriate to sound a note of warning with regard to the proposed centralized survey operations under the new directorate. Experience in developing countries shows that such organizations ultimately suffer from "information - overload", because much time is spent collecting large quantities of data as opposed to matching it with the taxpayer's records and in taking necessary follow-up action. Therefore, the rule for survey parties doing internal survey and gathering data from various sources of information should be to gather a limited amount of data, cross-check it themselves with the existing records of taxpayers and ensure initiation of follow-up action before further data is collected. A change of attitude is also required with respect to external surveys. The usual tendency is to visit the premises of the taxpayers, to report that his income is estimated to be above the taxable limit and therefore, to issue a notice calling for a the return. This "law enforcement" approach needs to be replaced by a "service" approach so that the success of a survey party should depend not on the number of reports of estimated taxable income but on the actual number of signed new taxable returns brought in. For this purpose external survey operations should be attempted with the cooperation of the trade and residents' associations who should be addressed by the senior officers of the directorate before the survey parties go there. In turn the survey parties should function as taxpayer education/assistance units and try to help new taxpayers prepare their returns. This approach is essential because no special provision is being made for auditing even of new returns in the reorganization of assessment work suggested below. Continuance of the old method would otherwise burden the administration with non-taxable returns filed by the alleged new taxpayers whose incomes have been estimated, by the survey party to be taxable, often on inadequate data, and which returns will be accepted under the liberalized self-assessment procedure in due course.

7.50 The area of tax withholding has been enlarged in the FY89 budget proposals. Even before this enlargement, the revenue collected by deduction of tax at source was substantially in excess of Tk 500 million. With the recent measures, this revenue is expected to go well beyond Tk 1 billion. In addition, the mission has recommended the imposition of a withholding tax on interest and dividends. It is, therefore, necessary to identify those responsible for the withholding tax, and to ensure that tax is withheld and deposited to the credit of the Government. The mission feels that if this work is left with the assessing officer, it is liable to suffer the same kind of neglect as survey, search and seizure activities. Since it can be easily combined with the survey work assigned to the new directorate, it is recommended that the new directorate of survey also be responsible for tax-withholding. It should further be provided with sufficient powers to take penal action directly against defaulters. This proposal also receives support from the fact that in the present system when tax withholding is attended to by the field assessing officers, those not on the records of the Department, not only fail to pay their own taxes but can also safely ignore to withhold taxes.

7.51 The mission proposes below that the administration move to a regime of large-scale self-assessment and selective scrutiny. In the context of a situation where much of the paperwork connected with assessment of taxes is being passed on to the taxpayer, it is imperative that the administration spend time and effort in educating the taxpayer about the latter's rights and obligations and in providing assistance where it is most needed. Since the directorate of survey will have its offices all over the country and will meet the taxpayer at his own premises, it is appropriate that the directorate be responsible for taxpayer education and assistance. It should produce printed material for the guidance of the taxpayers and use the media not only to remind taxpayers of their time bound obligations but also to inform them of changes in laws and procedures. The Extra Assistant Commissioners presently attached to each Zonal Commissioner for this work can be shifted to the Centralized Directorate of Survey which will ensure uniformity of approach and economies-of-scale. Such centralized functioning will also have the benefit of a clearer and more exact perception of the objectives of changes in law and procedures and thus help in educating the taxpayers in the right perspective. Decentralization of tax offices also has a role in promoting such taxpayer education. Past experience shows that it also improves tax collections, as seen after the opening of local offices in Serajganj, Kishnaganj, Moulvibazar, etc. It is understood that the NBR is presently considering proposals for opening 13 new tax offices in the recently created districts, whose number has gone up from 20 to 64.

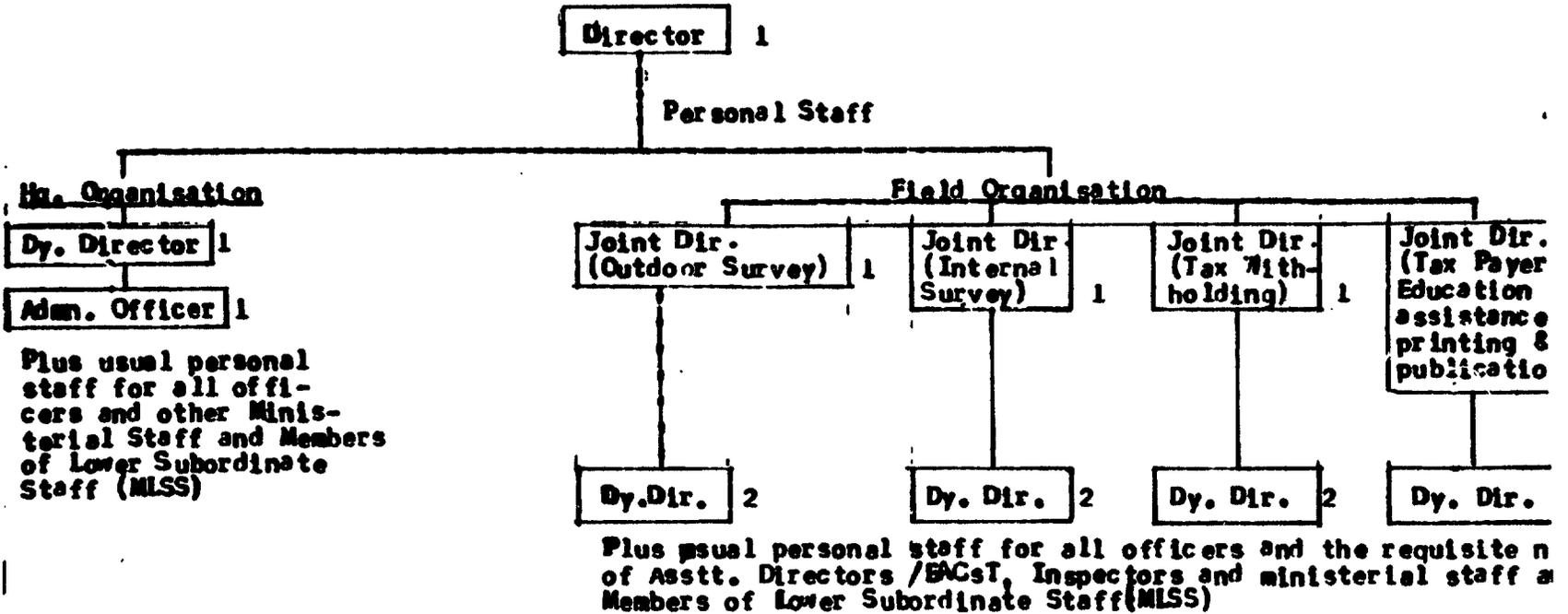
7.52 Since this directorate will be required to bring out several publications for the purpose of taxpayer education, it is proposed that it also be made responsible for other printing and publication work in connection with direct taxes. Accordingly, the post of Joint Directors (Manual), presently with Directorate of Inspection and Training (Taxes), should be attached to this directorate. The incumbent will be responsible for producing all necessary publications for the use of the officers of the department and the public. Figure 7.7 presents the organization of the new Directorate of Survey, Tax Withholding and Taxpayer Education.

7.53 An examination of Figures 7.5, 7.6 and 7.7 shows that the mission proposes 11 Joint Directors (JDs) to support the 3 Directors of Inspection, Training and Survey. At present there is sanction for only 4 such posts in the existing combined Directorate of Inspection and Training. The remaining 7 posts of JDs will be created by upgrading an equal number of existing posts of Deputy Commissioner that are lying vacant.

7.54 The Director of Complaints (Investigation) is largely staffed by police officers at senior levels. However no anti-corruption work has come to its notice during the last two years. Even before that, the number of complaints received against the officers was minimal. Thus, the reason for posting the police officers at senior levels in this Directorate no longer survives. The direct tax as well as customs and excise officers are better equipped, by virtue of their experience and expertise, to inquire into tax evasion petitions and supervise follow-up measures. In the local environment, considerable awe may accrue to the position while a police officer might be held in considerable awe in the local environment, he is unlikely to be able to supervise inquiries into activities dealing with tax evasion petitions. This is due to lack of knowledge of tax laws and procedures, investigation of accounts and techniques to collect evidence

Figure 7.7

Proposed Organisation of Director of Survey (Taxes)



necessary to verify whether there was tax evasion or avoidance. The mission therefore recommends that this directorate should be staffed, not by the police, but by both direct tax as well as customs and excise officers. It should confine itself to activities dealing with tax evasion petitions received against taxpayers. It should be given concurrent jurisdiction over all taxpayers with powers to authorize survey, search and seizure operations anywhere in the country. All tax evasion petitions received at any level in the field or in the NBR should be transferred to this directorate to keep it fully occupied; at present it deals with barely 100 petitions in a year. For this purpose the directorate should be suitably strengthened. More zonal offices may be opened outside Dhaka and Chittagong, depending on its workload. Present experience shows that there is substance in about 70 percent of the complaints received by the directorate against taxpayers. Investigations should be made independently by calling for records of taxpayers from the field instead of passing the complaints on to the field officers for report. This should provide the directorate with substantial meaningful work. To enable NBR to assess its performance, suitable feedback should be received by the directorate from the field after follow-up action is taken on its investigation reports, a feature that is absent from the present system. It may be noted that this recommendation permits suitable coordination between the direct and indirect tax wings in the matter of tax evasion. The work of complaints received against officers has already been recommended to be assigned to the Director (Inspection) (paragraph 7.45 supra). The complaints of tax evasion are a separate category and are better handled by those responsible for searches of taxpayers premises, etc. as such complaints very often lead to searches.

5. Field Level Organizations

A. Senior Commissioner

7.55 The mission has proposed the creation of a separate self-contained directorate for survey largely through redeployment of existing staff resources. It has also recommended strengthening the existing Directorate of Complaints (Investigation) which is expected to take over all work connected with tax evasion petitions received against taxpayers. The director would have concurrent jurisdiction over all taxpayers, with the authority to conduct search and seizure operations without regard to territorial limits of Zonal Commissioners. Thus, there would be no justification for continuing the organization of Senior Commissioner (Search, Seizure and Survey), as all its existing functions will be taken care of by the two above-mentioned directorates. It has already been suggested that the present Senior Commissioner's post be converted into one of the two proposed new members of the NBR, as both carry the same scale of pay.

B. Commissioners

7.56 The mission believes that there is considerable scope for economy in the Headquarters establishment of the Commissioners. The present Headquarters establishment includes a DC Headquarters (Administration), a DC Headquarters (Technical) and a Tax Recovery Officer (TRO). Besides, there is an Intelligence and Investigation Cell usually consisting of an IJCT and two Deputy Commissioners. The mission takes the view that these

Intelligence and Investigation Cells have not justified their creation and it is suggested below that they be turned over for normal assessment work, particularly in view of the fact that the two directorates of Survey and Complaints (Investigation) will be looking after those important functions. Even without these cells, the Zonal Commissioners are left with two Deputy Commissioners and a TRO. The DC Headquarters (Administration), in turn, is assisted by several class II officers, for example, one administrative officer, one information officer, four superintendents and four inspectors. In view of the severe shortage in the cadre of Deputy Commissioners, the mission recommends that Zonal Commissioners be provided with only one Deputy Commissioner (Headquarters) and that the number of inspectors assigned to him be reduced to one or, at the most, two. Some of the Zonal Commissioners' charges have, at present, become unwieldy and might require more personnel at headquarters. But with the rationalization and workload recommended in this chapter, it will be possible for the Commissioners to operate with a single Deputy Commissioner. In any event, in view of the recommendation to resort to selective scrutiny, the technical work coming up to the Commissioner will be considerably reduced. Furthermore, since the proposals in that area will come from the higher level of IJCT, they would need the personal attention of the Commissioner without the intervention of a more junior officer such as the Deputy Commissioner Headquarters.

7.57 The manpower assigned to the 8 zones varied widely as is evident from the following examples:

Cadre	Zone	Number of Posts Sanctioned
Inspector	Rajshahi	39
	Chittagong South	71
EACT	Rajshahi	10
	Dhaka West	10
	Dhaka North	19
ACT	Khulna	13
	Rajshahi	13
	Chittagong South	31
DCT	Rajshahi	5
	Dhaka West	5
	Khulna, Dhaka East and Dhaka North (each)	15
IJCT	All zones except Chittagong South and Dhaka North	3
	Chittagong South	5

In turn, the revenue collected from the various zones are also uneven. While this is, to some extent, unavoidable, especially in outlying zones such as Rajshahi and Khulna, there is no reason why wide variations in these matters should continue in the several zones located at Chittagong and Dhaka. The mission therefore recommends that some areas in Chittagong be transferred from the South to the North zone so that manpower and revenue collections assigned to the two zones are more or less similar. There is no need to add to the number of Executive Commissioners, except at Dhaka as discussed below.

7.58 At present, Dhaka has four zones which account for a collection of over Tk 5 billion. However about Tk 1.5 billion is collected from a single Government owned company -- Bangladesh Petroleum Corporation -- by the Commissioner Dhaka North Zone. That zone also centrally collects tax withheld at source of about Tk 500 million. Even after excluding these two collections, the revenue collected at Dhaka exceeds Tk 3 billion. This, in view of the norms cited earlier, would justify the addition of two more Commissioners at Dhaka. It is noted that the bulk of the present work at Dhaka is concentrated in the North and South Zones. The mission proposes that some of the work areas from these two zones be transferred to the East and West zones of Dhaka, and excluding the two special collections referred to above, that the revenue potential and the manpower allocation across the zones at Dhaka be made more comparable.

7.59 There are cases, particularly, groups of cases, having widespread ramifications of tax evasion needing coordinated investigation. Secondly, there are industrial houses, with a large number of connected cases which are assessed with different assessing officers/Commissioners. Thirdly, there are connected cases of search and seizure requiring an integrated investigation. Identification of all such cases and their centralization with the Commissioner (Intelligence and Investigation) will facilitate effective and expeditious assessment and collection of taxes. This useful organization needs to be sustained and enlarged. Given that this office has been in existence since the 1960s, it is also necessary that an early evaluation be undertaken to enhance its usefulness which is evident even from the very limited data available about its functioning. Since 1983 this office has imposed penalty in 8 cases involving an amount of Tk 6.4 million. Three other proposals of penalty amounting to Tk 30.7 million are under process and one case of prosecution is pending in the Supreme Court. There were voluntary disclosures under the Martial Law regulation (1982) in 327 cases, involving a tax of Tk 26.4 million. Thus, almost 50 percent of taxpayers under this Commissioner made voluntary disclosures in 1982, a percentage that was considerably higher than that prevailing in other zones. Much, however, remains to be done. First, the span of control of the Commissioner is very limited. Instead of one IJCT supported by 4 DCs, it is suggested, with a view to providing sufficient work, that there should be 4 IJCTs, each supported by 4 DCs/ACs. Some of the IJCTs and their assessing officers could be located outside Dhaka, depending on the location of the cases assigned to this Commissioner. Second, the manner in which taxpayer cases are assigned for investigation to the Commissioner does not appear to indicate any method or system. It would be preferable if only such cases were sent to this Commissioner as required coordinated investigation in a group which, under normal circumstances, would be assessable with different assessing Officers/Commissioners. Examples are provided by the BEXIM Group, Bhaiya Group, Phoenix Group, J. Islam Group, etc. Third, care should be taken to ensure rotation of groups in this

charge so that no file remains with the Commissioner for more than five years. Fourth, the level of assessment in these cases should be raised to IJCT and the number of files assigned to the IJCT and his four DCs/ACs should be 750, i.e., a rate of 150 files per officer. Each IJCT with the help of his four assessing officers would be expected to complete between 750 to 1000 assessment in a year. This is discussed in further detail in Section C on assessing officers below, where the manpower requirements are also worked out.

7.60 The mission recommends the creation of 3 posts of Commissioners (Appeals) in Section "D" below. These posts will also be created by upgrading vacant posts of Deputy Commissioners.

C. Assessing officers

7.61 Reference was made in paragraph 7.8 above to the key role of the assessing officer in the entire system. The mission believes that available manpower can only be matched against the ever increasing workload in this area by (i) enlarging the area of self-assessment considerably; and (ii) resorting to selective scrutiny of a higher percentage of the larger tax returns together with a lower percentage of the smaller ones.¹⁰ This will limit abuses and enhance taxpayer's confidence in the tax administration. The present self-assessment procedure (see Appendix 7.3 and Rule 38 of the Income tax Rules and Table 7.5) covers neither a large majority of taxpayers nor a substantial part of revenue. Besides there are major weaknesses on the enforcement side. Tables 7.3 and 7.4 show that in the year 1986/87, concealment penalties were initiated only in 78 cases after scrutiny and audit of 359,858 returns. Search and seizure operations have been conducted only in 18 cases in over 12 years. The effective number of these penalties and searches will get further reduced when the corresponding appeals are decided. Even though it is widely suspected that undisclosed incomes/wealth find their way into real estate where there is substantial scope for understatement of prices, the mission did not notice any case of pre-emptive purchase by Government of such property, despite the clear provisions of Section 32(4) and Rule 42 and the fact that a Tax Clearance Certificate is an essential requirement before any such deal can be registered. The quality of audit and scrutiny of returns is perfunctory, in part because the resources of the administration are spread thinly over a large and virtually unmanageable area of taxpayers. The mission therefore recommends the following. First, Rule 38 should be replaced by a much broader procedure under which all noncompany returns showing incomes up to Tk 80,000 are accepted under Section 82 of the

10/ The percentage of self-assessment assesseees in Pakistan, when the scheme was introduced there in 1979/80, was 55. The total number of taxpayers increased from 273,113 to 669,139 in that year. Later these figures almost doubled as in 1984/85, of the total of 1,096,078 assesseees, 611,563 (56 percent) were covered by the self-assessment scheme. Taxation in Pakistan: Self Assessment Scheme of Income Tax, M. M. Younos; 7 Tax Observer No. 9, (September 15, 1986). In India the monetary ceiling of income upto which returns are accepted under a similar scheme has been raised over the years from Rs. 25,000 to Rs. 200,000. The most recent amendment allows all returns to be automatically accepted, subject to selective scrutiny.

Income-Tax ordinance. Second, only 5 to 10 percent of all such returns should be selected every year on a random sample basis for detailed scrutiny, taking care to ensure that no assessing officer has to make more than 250 scrutiny assessments after due audit. Third, the object of this scrutiny should be to establish concealment of income. To help accomplish this, an element of field audit should be introduced by administratively laying down that such scrutiny assessments will be completed invariably after exercising powers of survey under Section 115 of the Income Tax Ordinance, 1984. Such a feature should have an impact on the large amount of undisclosed income/wealth which presently finds its way to understated inventories. Fourth, all returns under the first recommendation should be assigned for assessment only to junior AC or EACs by transferring all Category I cases (with returned income above Tk 80,000) and all company cases out of their jurisdiction to newly created Inspecting Joint Commissioners Taxes (Assessment)(IJCT(A)) Ranges. Fifth, such separation of the bigger revenue yielding cases should allow the level of assessing officer for such cases to be raised to IJCT(A). Each IJCT(A) will be in charge of about 750 taxpayers and will be assisted by four Deputy Commissioners or Senior Assistant Commissioners. While all five officers will exercise concurrent jurisdiction over the 750 cases, all assessment orders should be issued under the signature, of the IJCT(A) only, who will be responsible for the quality and quantity of the output of the entire Range. Sixth, all the bigger cases should be subjected to detailed scrutiny every year by the IJCT(A) and his team, and the third recommendation above should equally apply to the scrutiny assessments to be made by the IJCTs(A). Seventh, each of the 10 Zonal Commissioners should have two IJCT(A) Ranges supported by 4 DCs/ACs each dealing with 1500 larger taxpayers (at 150 files per officer) and one IJCT (Territorial Range) supported by 12 ACs/EACTs dealing with about 42,000 smaller taxpayers at 3500 files per AC/EACT. Eighth, supporting inspectors and lower subordinate staff should be suitably reduced in IJCT(A) ranges and increased in IJCT (Territorial Range), as the number of files rather than the number of scrutiny assessments better reflects the workload of the supporting cadres. Finally, the present provisions of the law permitting concessionary taxation of any amount of hitherto undisclosed income under the head "Other Sources" should be deleted, as such schemes undermine voluntary compliance on the part of taxpayers and demoralize the investigative agencies.¹¹

7.62 The benefits of the proposed system are as follow. First, about 5 percent of the taxpayers that contribute over 80 percent of revenue will be subject to continuous scrutiny at a higher level by more competent and experienced officers who are actually available but not currently used for direct assessment work. Second, 95 percent of the taxpayers that contribute less than 20 percent of the revenue will have the benefit of the self-assessment procedure subject to random scrutiny every year in about 7

11/ The mission noted that the Finance Ministers' FY90 Budget Speech categorically states that "this facility of payment of income tax at concessional rate under this measure will be the last opportunity".

percent (30,000 assessments) of those cases, a feature that should encourage voluntary compliance. Third, the reduction in the number of scrutiny assessment should lead to improvements in the quality of output. The increased sanctions on fraudulent taxpayers should act as a deterrent to abusing the new regime. Fourth, the aforementioned reduction will diminish the number of further appeals on disputed points. Fifth, with reduced appeals, the settlement of disputes will be expedited, thus reducing tax arrears.¹² Sixth, the proposals accommodate the needs of officers who have neither the desire nor the aptitude to perform intensive audit and scrutiny work. They could now be utilized in Territorial Ranges providing them with job satisfaction as good managers, without risking revenue in the process. Seventh, enlarging the area of self-assessment in a larger number of cases will create a climate of trust. On the other hand, an intensive investigation of fewer selected cases will improve the quality of assessment and also the effect of deterrence. The unearthing of concealed income in such cases will create a desirable impact and will bring more persons to the tax net. Thus, enlarging the area of self-assessment will also lead to more people coming into the tax net. Finally, the number of contact/harassment/corruption points between the tax collector and the taxpayer will be reduced automatically, thus improving the image of the administration and relations with the taxpaying public.

7.63 The present deployment of the sanctioned strength of the assessing officers, their immediate superiors, viz., IJCTs and AJCTs and their immediate subordinates, viz., Inspectors (See Table 7.12) are as follows.

Deployed with	Cadre					
	Inspector	<u>EACT</u> I.O.	ACT/TRO Ast.Dir	DCT/ DD	AJCT	IJCT
1. Senior Commissioner	23	-	-	10	-	3
2. Commissioners (Int.& Inv.)	7	-	1	4	-	1
3. Eight Zonal Commissioners	<u>432</u> 462	<u>115+8</u> 115+8	<u>153</u> 154	<u>76</u> 90	<u>21</u> 21	<u>27</u> 31
4. Directorate of Inspection and Training (Taxes)	<u>10</u> 472	<u>-</u> 115+8	<u>6</u> 160	<u>8</u> 98	<u>-</u> 21	<u>-</u> 31

With the implementation of the proposals contained in the preceding paragraph, the deployment will be changed to the following.

12/ The mission was given to understand that 80 percent of the taxes in arrears are outstanding on account of pending appeals.

Redeployed With	Inspector	EACT Inf. Officer (I.O)	ACT/TRO	DCT	AJCT	IJCT(A) IJCT(R)
1. Senior Commissioners (recommended abolition)	-	-	-	-	-	-
2. Commissioner (Int.& Inv.)	23 _{a/}	1(I.O)	8(A) _{b/+} 1(TRO)	8(A) + 1(Hq)	1	4(A)
3. Ten Zonal Commissioners	270 _{a/}	80(R) _{c/} + 10(I.O)	40(A) + 40(R) 10(TRO)	40(A)+20 + 10(Hq)	20	20(A) 10(R)
TOTAL	293	91	99	59	21	34
Sanctioned Strength	462	115 + 8(I.O)	154 _{d/}	90	21	31
Working Strength (on proportionate basis)	N.A. _{e/}	121	119	36	21	32

a/ One Inspector for every officer (other than AJCT) and two Inspectors for each TRO to strengthen recovery efforts.

b/ For Assessment Ranges to be newly created under the ten Zonal Commissioners and under Commissioner (Int. and Inv.).

c/ For Territorial Ranges.

d/ Excluding 16 leave reserve posts.

e/ Not Available.

7.64 Compared to the existing sanction, the proposals fall short by 3 in the Cadre of IJC and are in excess to the extent of 31 DCs, 55 ACs, 32 EACs and 169 Inspectors. Turning to the working strength, there is a shortage of 23 in the Cadre of DCs but a surplus of 20 ACTs. The following actions therefore need to be carried out.

(a) Defer the expansion of the organization of Commissioner (Int. and Inv.) till 3 more posts of IJCTs become available. Till that time, the number of DCs and ACs in that office will also be reduced by 6 each. (b) Initiate action to upgrade 3 posts of DCs to IJCs to strengthen the organization of Commissioner (Int. and Inv.). (c) Implement the proposals of the mission but substitute 17 DCs (23 short less 6 not presently needed by Commissioner (Int. and Inv.) by ACs. (d) Initiate action to upgrade another 7 posts of DCs to Commissioner/Director to fill the proposed two new posts of Executive Zonal Commissioners at Dhaka, two new Directors (Inspection) and (Survey) at Dhaka and three new Commissioners (Appeals) - two at Dhaka and one at Chittagong (as proposed later while dealing with

the appellate structure). Another 7 posts of DCs should be upgraded to Joint Director and 1 post to Member, NBR as proposed earlier. (e) Initiate urgent action to fill the existing large scale vacancies in the cadres of DC and AC. Present estimates of the administration are that of the 64 vacancies of DCs, not more than 20 might be filled in the normal course of events by June 1989. Some extra steps are therefore necessary. Rules presently require that only ACs with 5 years' service who are confirmed as ACs and who have passed the Common Public Service Commission (PSC) Examination for promotion can be considered for promotion to DC. The major bottleneck holding up the largest number of officers is the Public Service Commission examination. While that examination may be justified as a precondition in the case of several other segments of the civil service where, on promotion to DC, an officer oversees the work of ACs or EACs, there is little justification for forcing it on the Bangladesh Civil Service (Taxation), merely in the name of uniformity. Conditions here are radically different inasmuch as, officers continue to do the same kind of assessment work even upon becoming DCs and furthermore, do not oversee the work of any other Class I or Class II officer. Keeping this factor in view, a special dispensation should be sought by the NBR in respect of the Taxes Department. The Government would be well advised to consider such a request sympathetically. There are 36 vacancies of ACs. In addition 16, leave reserve posts were created in March 1988 which are yet to be filled. Present estimates of the administration are that about 14 (11 by PSC recruitment and 3 by promotion) of these posts may be filled by February 1989 and another 22 (17 by PSC recruitment and 5 by promotion) by February 1990. It is proposed that the intake from PSC be suitably increased urgently so that the 16 posts created in March 1988 can also be filled by February 1990, if not earlier. Anticipatory action also needs to be taken to fill the vacancies of ACs that will arise on filling the large present gap in the Cadre of DCs. This should further increase the intake from PSC both in 1989 and 1990. The mission suggests that the intake from PSC be increased to 50 each for 1989 and 1990, which figure, together with promotions to ACs and DCs, will close the gap fully by 1990. If such increase in PSC intake is not considered feasible, the government should consider modifying the recruitment rules for ACs as a one time exception and try and fill the gap with meritorious EACTs by holding a limited competitive examination/interview (with which PSC may also be associated) open only to the EACTs. This would have the additional advantage of providing faster promotions to others down the line as well.

7.65 On completion of the above actions, the administration would still be left with an immediate surplus of 32 EACTs and 169 Inspectors. When vacancies in the cadres of ACs and DCs are filled, there will be a further surplus of 13 DCs (31 less 18 posts recommended for upgradation) and 55 ACs over the next two years. About 10 percent of this surplus could be absorbed by smaller outlying offices with a small number of taxpayers where it may not be possible to go strictly by the revised norm of 3500 files per AC/EACT. Another 20 percent of this surplus should go to strengthen the two existing Directorates of Training and Complaints (Investigation). The remaining 70 percent of the surplus should go to the two important new Directorates of Inspection and Survey. That would give the directorates about 11 EACTs and 60 Inspectors each immediately and another 5 DCs and 20 ACs each over the next two years.

7.66 Ministerial Class III and IV staff (member of lower subordinate staff - MLSS) are at present provided in the field on the basis of the number of assessing officers in a Tax Circle. The existing number of tax circles is 165, divided into 42 single officer circles, (including 4 in the office of Commissioner, Intelligence and Investigation), 78 two-officer circles and 45 three-officer circles. The reorganization proposed above will require the equivalent of 40 single officer circles, 80 two-officer circles and only 24 three-officer circles (including 4 in Commissioner Intelligence and Investigation, of which three circles will be created in due course after availability of 3 posts of IJCTs via upgradation). That will leave a surplus that is the equivalent of the staff of at least 21 three officer circles. Such staff should be diverted to the directorates to suitably strengthen their working and to provide them with Class III and IV manpower, in proportion to the augmentation in Class I and II categories proposed for them above. No additional staff is thus needed even at these lower levels for the present.

7.67 In the process of reorganization, care should be taken to keep the movement of files and other records to the minimum. In the territorial ranges it may not be necessary to create or abolish any circles, if the assessing officers can be given additional charge of another local or adjoining circle, with a view to placing each assessing officer in charge of about 3500 files. This will ensure that too many new registers do not have to be written up and that only the bigger files move out to the newly created circles under the IJCT(A). In the redeployment scheme provision is made for 15,000 bigger files in the ten territorial zones. The number of such cases is not expected to go beyond this if it is noted that the total number of 11,240 category I files (Table 7.4) plus 10,102 company files (Table 7.3) equals 21,342 files. In this there is an overlap of company cases which are also category I cases. Besides, if necessary, salary cases of category I or cases of Government-owned companies (where no private motive exists for tax evasion or avoidance) and cases of smaller companies could also be left with the territorial ranges. In addition, there will be quite a few category I as well as company cases that will be centralized with the Commissioner (Intelligence and Investigation).

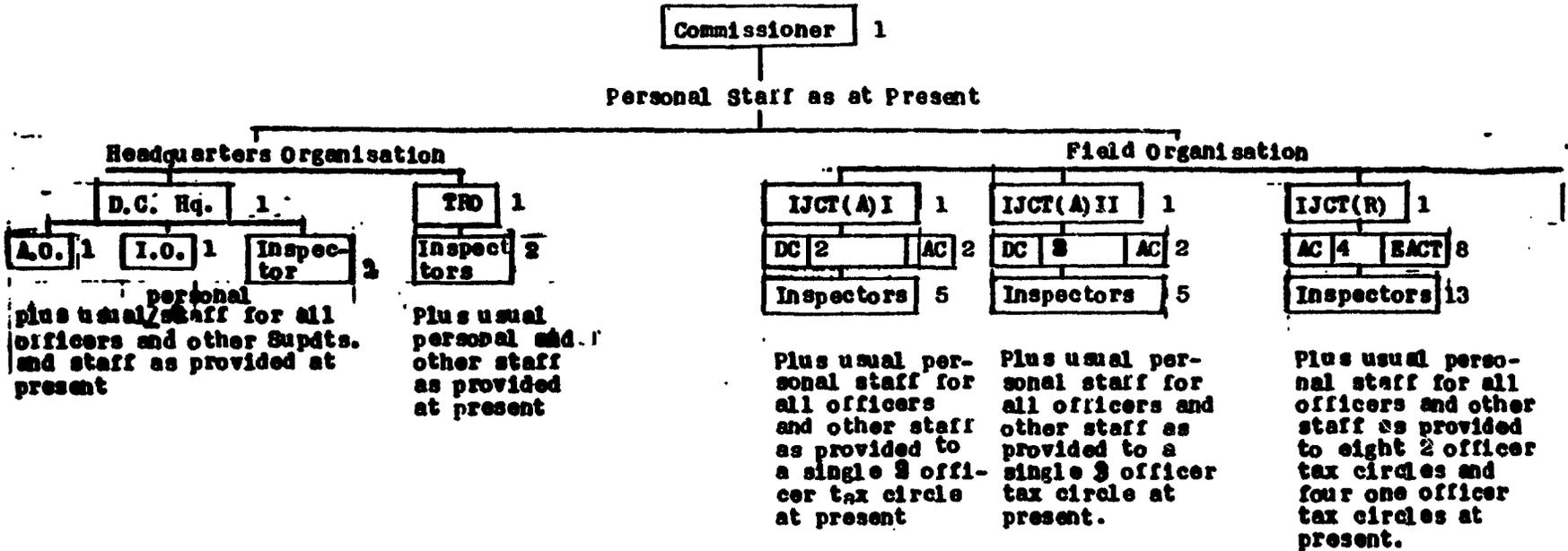
7.68 The reorganization should be made effective from July 1990 and reviewed annually thereafter with a view to ensuring that the increasing workload is tailored to the capacity of the available manpower. This could be achieved, if necessary, by raising the threshold for acceptance of noncompany returns beyond the Tk 80,000 limit now proposed, with the ultimate objective being acceptance of all returns, subject to selective but very effective scrutiny of a small percentage of the returns. The proposed organization of a Zonal Commissioner is indicated in Figure 7.8.

D. Appellate Organizations

7.69 The existing situation with respect to AJCTs and the Taxes Appellate Tribunal has been discussed in paragraph 7.11 and Tables 7.7 and 7.8. The redeployment of the existing 21 AJCTs in the expanded 10 zones of Commissioners, at two per zone (one AJCT has in addition been provided for the Commissioner, Intelligence and Investigation, (Dhaka) has already been recommended in Section (C) above. Beyond that no other immediate change is called for so far as this cadre is concerned. However, since all sizeable and important assessments numbering about 24,000 per year will be made by 24 IJCTs, the first appeal against this order could not go to an AJCT who is of equivalent rank. It is therefore necessary to create some posts of

Figure 7.8

Proposed Organisation of a Zonal Commissioner of Taxes



Commissioner (Appeals) whose jurisdiction will extend to the assessment and other appealable orders passed by those 24 IJCTs. (They may be expected to dispose of appeals at 1000 per head per year). This could be effected by upgrading the existing surplus and vacant posts of DCs. By not transferring any of the existing workload of appeals to Commissioners (Appeals) these numbers could be kept small, possibly three to begin with. Two of them could be posted in Dhaka and one in Chittagong to take care of the appeals arising from all 24 IJCTs. Over the next 2 or 3 years this number will have to be increased. By then the workload with AJCTs will have drastically shrunk and the administration could consider upgrading some of those posts to Commissioner (Appeals) and converting others to IJCT(A). Thus the cadre of AJCT can be phased out over the next five years or so.

7.70 The Commissioner (Appeals) should have the same status as other commissioners. He should be treated as head of department and provided such transport and housing facilities as are enjoyed by other heads of departments, particularly as these posts will be interchangeable with those of Zonal Commissioners. Since these incumbents will bring greater experience to bear on their tasks, it is hoped that many more cases will become final at their level than those at the lower level of AJCT.¹³ This should reduce the number of second appeals to the Appellate Tribunal specially by the Zonal Commissioners. In fact, unless an order passed by the Commissioners (Appeal) is considered perverse, no appeal should be filed against it by the Zonal Commissioners on facts. Such early resolution of disputes will also have a salutary effect on the outstanding tax arrears. The creation of this new post may require some changes in the tax, e.g., in Section 10 which permits exercise of assessment functions by IJCs and Section 158 dealing with appeals to the Tribunal.

7.71 The mission found the Appellate Tribunal to be a relatively neglected institution. Conditions prevailing there have not improved even after administrative control over it was transferred from the Ministry of Law to the Ministry of Finance (Internal Resources Division). The recommendation made above should ensure that the intake of appeals of the tribunal goes down in future. However, the mission also examined the other

	Judicial Member	Accountant Member	Registrar	Assistant Registrar	Stenographer/ Steno/Typist	UDA	MLSS
Khulna Bench	1	1	-	1	3	-	-
Dhaka Division Bench	1	-	1	-	3	-	-
Dhaka Single Bench	-	-	-	-	2	3	2
Chittagong Bench	-	-	-	1	1	1	-

13/ About 80 percent of the appeals to the Tribunal are presently filed by the Zonal Commissioners, of which 80 percent are subsequently dismissed by the Tribunal, so that reduction of such unproductive work would be highly desirable.

main problem facing the tribunal, viz., large scale vacancies which have not been filled despite repeated efforts to do so. The following posts were found to be vacant. It was noted that because of the downgrading of the status of the Tribunal after 1971, no applications for posts of members had been received despite several advertisements by Public Service Commission (PSC). As a result, the PSC would now like to see qualifications for these positions to be relaxed. In view of the important functions of the tribunal which is the final fact finding authority, the mission believes this would be an unfortunate step. The solution therefore has to be found elsewhere. The salary scale of members of the tribunal prior to 1971 was better than that of district judges or Commissioners of Taxes. They were also retained in employment on contract basis for a few years after the usual age of superannuation. As a result, senior district judges and commissioners used to be extremely interested in serving on the tribunal. Not only has this situation been reversed, it is additionally the case that the members do not even enjoy facilities such as rent free residence or a full time government car to which district judges/commissioners are entitled. It is therefore not surprising that the tribunal has been without three out of its six members for a long time and that efforts to fill those posts have failed repeatedly. Keeping this in view and considering the mission's recommended upgradation of the assessment and first appellate levels, it is suggested that the situation prevailing before 1977 be re-established. The mission therefore recommends the following.

7.72 First, the status of the Member of the Tribunal should be raised to that of Member of the NBR viz., Additional Secretary to the Government. (This upgradation is (i) the logical corollary of the upgradation of the first appellate level and (ii) to ensure that all the posts of Member, Tribunal are filled. These vacant positions are resulting in increasing pendency of appeals leading to delay in the collection of disputed taxes and proliferation of repetitive appeals on the same issues for several later assessment years). Second, the status of the President should be raised to that of Chairman of NBR, viz., Secretary to the Government. Third, the age of superannuation for this important quasi-judicial assignment should be raised to at least 60, if not 62.¹⁴ If there are constitutional hurdles to doing so, the President and Members should routinely be re-employed on contract basis for at least 3 years after their retirement at the age of 57 years. If these suggestions are implemented, the existing vacancies could be promptly filled as is the position in the neighboring countries where the conditions of service in the tribunal continue to be as recommended above. It would also be helpful if the facilities enjoyed by officers in the feeder cadres (viz., district judges and commissioners) were automatically made available in the tribunal as well, so that the better officers are encouraged to serve in this institution. As matters currently stand, all senior posts are filled on a deputation basis by officers, some of whom are not only junior, but also admit to being reluctant deputationists. The proposed upgradation will also enable second appeals against orders of Commissioner (Appeals) to come to this tribunal. The power of revision of assessment and other orders which are found to be prejudicial to revenue, presently given to the IJCs

14/ The Ministry of Establishment had earlier agreed to 60 years but the Ministry of Law had not.

under Section 120, could also go to the Zonal Commissioners. Appeals against such revisions could then be filed under Section 158 to the upgraded tribunal.

7.73 Since the general embargo on filling vacancies applied as a result of orders of the Ministry of Finance (Expenditure Control, Section I) dated August 17, 1987 does not extend beyond June 30, 1988, the other lower posts in the tribunal could also be filled soon. In addition, the tribunal has been asking for 3 posts of Superintendents for its 3 benches for a long time. In view of the workload on the administrative side in the tribunal's offices, this demand is considered reasonable, particularly when the strength of the Headquarters offices of the Zonal Commissioner is compared with that of the Headquarters offices of the Tribunal. The Taxes Department has 69 superintendents on its rolls. It is suggested that three of them be released and suitable adjustments made so that this requirement of the Tribunal can be met without additional expenditure.

7.74 It is expected that implementation of these recommendations will halve the intake of the tribunal whereas its output will more than double (see Table 7.8). This should allow it within three years to reduce pending appeals to only about one year's workload. Such a development would not only help reduce arrears of taxes but also restrict generation of appeals on the same issue in the same or similar other cases.

6. Financial Implications and Revenue Effects

7.75 The recommendations made by the mission require the following additional posts:

Post		Remarks
1. Member, NBR	2	(one post to be filled by converting the existing Senior Commissioner's post and the other by upgrading 1 post of Deputy Commissioner)
2. Zonal Commissioners	2	(By upgrading 2 posts of Deputy Commissioners)
3. Commissioners (Appeal)	3	(By upgrading 3 posts of Deputy Commissioners)
4. Directors	2	(By upgrading 2 posts of Deputy Commissioners)
5. Joint Directors	7	(By upgrading 7 posts of Deputy Commissioners)
6. IJCs(A)	3	(By upgrading 3 posts of Deputy Commissioners)

This will mean the reduction of the Deputy Commissioner Cadre by 18 to 80. Going by the mid-point of the scales of pay of Deputy Commissioner and these upgraded posts, the salary costs of the upgradation will be Tk 20,000 per month or Tk 240,000 per annum. Including the salary costs of the upgradation by one step of the posts of Members and President of the Appellate Tribunal (see paragraph 7.72), the total salary costs of the upgradation will not exceed Tk 300,000 per annum. The following additional costs will also be incurred:

I. Non-Recurring Expenditure	Costs of Additional Amenities Recommended	
<hr/>		
A. <u>For 2 New Members of NBR</u> <u>(Based on Existing Scales)</u>		
1. Office furniture & equipment	Tk 1,000,000	
2. Two staff cars	Tk 1,100,000	
B. <u>For Appellate Tribunal</u>		
1. Seven staff cars for seven Members (after upgradation of their posts)	--	Tk 3,850,000
C. <u>For 7 New Commissioners/Directors</u>		
1. Office furniture & equipment	Tk 3,500,000	
2. Seven staff cars	Tk 3,850,000	
3. Seven jeeps	Tk 5,950,000	
4. Eight staff buses (at the rate of two per Commissioner/ Director, excluding 3 Commissioners/Appeals)	Tk 6,000,000	
5. Four minibuses (at the rate of one per Commissioner/ Director excluding 3 Commissioners (Appeal) for Transport of officers	--	Tk 4,000,000
D. <u>For Existing 8 Zonal Commissioners</u> <u>and 2 Directors</u>		
1. Ten minibuses as at C5 above	--	Tk 10,000,000
E. <u>For Director (Survey)'s Field</u> <u>Organization</u>		
1. Twenty jeeps at 2 per zone	--	Tk 17,000,000

I. Non-Recurring Expenditure (Cont.d)	Costs of Additional Amenities Recommended
<hr/>	
F. <u>For 25 Circle Offices Located Outside the 4 Zonal headquarters of Commissioners</u>	
25 jeeps at one per station	-- Tk 21,250,000
G. <u>For Inspectors on Outdoor Duty (Including Survey & Enquiry)</u>	
472 inspectors need 472 motorcycles Presumably sanction exists for 65 motorcycles. Hence additional cost of 407 motorcycles.	-- Tk 16,300,000
<u>TOTAL NON-RECURRING COSTS</u>	<u>21,400,000</u> <u>Tk 72,400,000</u>

II. Recurring Expenditure Per Annum	Costs of Additional Amenities Recommended
<hr/>	
A. <u>Additional Salaries for Upgraded Posts as Detailed Above</u>	Tk 300,000
B. <u>Office Costs of Two New Zonal Commissioners at Dhaka (Rents, Travel, Telephone, Transport and Other Contingencies (Dhaka South Zone Spent over Rs 1,000,000 in 1986-87)</u>	20,000,000
C. <u>Office Costs of Two New Directors (Survey & Training) and 3 New Commissioner (Appeals)</u>	Tk 10,000,000
D. <u>Office Costs of 2 New Members</u>	Tk 1,000,000
<u>TOTAL</u>	<u>31,300,000</u>

The above recurring costs of Tk 31 million would be more than justified by the additional revenue collections. As the cost of collection of direct taxes has been consistently under 2 percent of income tax revenue,¹⁵ the additional recurrent expenditure could be justified if tax collections were to go up by Tk 1.5 billion. The mission expects its recommendations to lead to increases in revenue in excess of that figure. Precise estimates of additional collections are not possible at this stage, as much will depend upon the administration's capacity, in the new set up, to establish the rule of law.

7.76 The suggested expenditures are also more than justified from the point of view of cadre management. The present and proposed strength of the cadre of Bangladesh Civil Services (BCS) (Taxation) and of two other comparable Class I cadres and the number of higher posts available in each is indicated below:

Service/Cadre	Total Strength	Number of Heads of Dept. Post	Number of Higher Posts
BCS (Audit & Accounts)	285	2 (7.4%)	5 (1.8%)
BCS (Customs & Excise)	129	10 (7.8%)	4 (3.1%)
BCS (Taxation) Existing	358+	10 (2.8%)	3 (0.8%)
BCS (Taxation) Proposed	358+	17 (4.8%)	4 (1.1%)

+ Including leave etc., reserve posts created in March 1988.

It is clear that the taxation service is still the worst off in this list and, purely from the point of view of promotional aspects, could do with more higher posts at the level of the Head of the Department and above. This provides further justification not only for the mission's proposals for immediate expansion but also for its suggestions that over the next 2 to 5 years more posts of AJCTs may be upgraded to Commissioner (Appeals) and the lower cadre abolished. It is the mission's view that there is sufficient justification, even from the functional point of view, for the creation of additional higher-level posts.

15/

Fiscal Year	Direct Tax Collections	Cost of Collections
1985/86	Tk 4.622 billion	Tk 83.5 million
1986/87	Tk 5.333 billion	Tk 102.7 million
1987/88	Tk 6.44 billion	Tk 111.2 million

7. Timeframe for Implementation

7.77 It is suggested that the recommendations made so far in this chapter be implemented with effect from the fiscal year 1990/91.

8. Miscellaneous

7.78 Over a longer time horizon, the effectiveness of the proposed methods of work would improve considerably if the administration could examine the following matters in depth and take suitable action to modify the Income Tax Law, keeping in view the specific conditions prevailing in Bangladesh.

(1) Tax Audit. Rules 7 and 8 of the Income Tax Rules provide for compulsory maintenance of accounts by firms seeking registration under the Income Tax Ordinance and by professionals like doctors, legal practitioners, accountants, auditors, architects and engineers, etc. Bigger firms are also required to get their accounts audited by Chartered Accountants. The objective of such audit should not merely be to draw up accounts according to Companies Act or the Cooperatives Societies Act or the concerned statute so as to present a true and fair view of the state of affairs of the concern. The objective of tax audit report, on the other hand, will be to enable the assessing officer to compute the total income under the Income-tax Ordinance and rules thereunder on the basis of such books of accounts and documents as may be prescribed under the rules. The forms of tax audit report will contain items of allowances and disallowances under the Income-tax Ordinance. Thus, the format and scope of audit report under the Companies Act etc. and the Income-tax Ordinance are entirely different. However, the law provides for no special form in which this Tax Audit report is to be prepared and submitted. In view of the limited resources of the administration, many more cases should be covered by such auditing requirements and its form and manner should be prescribed in the Rules with suitable sanctions for non-compliance.¹⁶

(2) "Income Year". This is defined in Section 2 (35) of the Income Tax Ordinance, 1984 and, in cases that really matter, leaves the taxpayer the option of adopting any "Income Year" ending before the beginning of the next assessment year (i.e., July 1) for which he will uniformly declare his income in the returns to be filed. Different "income years" may also be adopted for different sources of income for the same taxpayer. To facilitate matching of information and building up of a data base on a uniform basis, it would be helpful, if all taxpayers were to show their incomes for the same "Income Year" for all sources. The perception that the cross checking capacity of the administration has improved will in itself serve as a deterrent to understatement of incomes in the returns,

16/ The experience of India, for example, in this regard may be of interest to the authorities. Cf., Extract from Explanatory Notes to Finance Act, 1984, Government of India, Ministry of Finance (Department of Revenue) Central Board of Direct Taxes Notification, Income Tax, New Delhi, 31 January 1985; Guidance Note on Tax Audit Under Section 44AB of the Income-Tax Act, The Institute of Chartered Accountants of India, New Delhi.

particularly in a regime where most returns are going to be accepted at face value. What that "Income Year" might be should be decided on the basis of a study.

(3) Reopening of Assessments. The present provisions for reopening completed assessments with a view to assessing income escaping assessment are contained in Section 93 of the Income Tax Ordinance, 1984. These provisions evolved in the context of a regime of 100 percent scrutiny of all returns and are designed to ensure that assessments are not reopened based on the same facts merely because of a change of opinion on the part of the assessing officer. This is done by postulating that before reopening any assessment, the assessing officer should have come across definite information which provides reason to believe that income has escaped assessment. These provisions may need to be liberalized, specially in respect of cases where returns are accepted without any scrutiny and therefore without the assessing officer forming any opinion at all, so that the question of change of opinion does not arise. To what extent such reopening should be made easier, for how many years the power to reopen should be available and what safeguards need to be provided so that these liberal powers are not abused are some of the matters that require study.

(4) Penal Provisions. The present provisions for levy of interest and penalty and for prosecution may also need to be reviewed. As stated earlier, the success of a liberal self-assessment procedure depends to a large extent upon the system's capacity to take effective deterrent action in the few cases that are scrutinized and audited. It may therefore be desirable to introduce an element of automaticity in the levy of interest and penalty (especially in such routine areas as late filing of return, etc.,) so that the discretionary element is reduced and the burden is seen to fall on everyone without discrimination. Not only the tax but also the interest due till the time of filing the return should be made payable with the return¹⁷ so that petty unpaid demands for interest do not survive a summary self-assessment. The automatic levy of an additional tax or a penalty may also have to be considered on income which is not shown as income in the return but which is brought to tax on assessment, even if it be a case of mere neglect and not of concealment, all relevant facts having been shown in the return. Ways and means may have to be found to activate the useful provisions of Section 32(4) of the Income Tax Ordinance read with Rule 42, so that the government is seen to be acting against the widespread practice of transferring properties at nominal declared values when fair market values are much higher. The experience of India in respect of the preemptive purchase of such properties is contained in Appendix 7.4 and may be considered useful in the course of the proposed study of this subject.

(5) Presumptive Taxation. Many countries encounter considerable difficulty in taxing the large proportion of self-employed in business and the professions. The need to tax those segments assumes added urgency in a regime where most returns are expected to be accepted. This calls for implementing rough justice in preference to unattainable perfection, particularly if the weaknesses of the tax administration and of the

17/ Section 74 of the Income Tax Ordinance may need elaboration in this matter.

education and accounting standards of taxpayers are kept in view. Such taxation requires the estimation of taxable income on some basis that is more readily verifiable by the tax authorities than is the taxpayer's own declaration of income. Developing countries rely on various "external indicators" or standard assessment guidelines instead of going by accounting data which, more often than not, is incorrect or incomplete. In the presumptive taxation system, there is a presumption of a certain amount of taxable income on the basis of indicators like turnover, consumption of raw material or electricity, etc. The principle of progressive income-tax is applied on the income thus "presumed". Many countries, namely France, Israel, India and Cyprus have found this system to be suitable for taxpayers who have income from identified sources. This is quite distinct from the uniform provisions of tax deduct'ion at source in certain cases and from the assessing officers' powers to reject the accounted version and then estimate a higher income after scrutiny/audit of individual Returns of Income. Economic analysis and statistics can serve as a useful supplement here. So can the involvement of the concerned trade associations or chambers of commerce. Such presumptive taxation is presently resorted to in Bangladesh only in the case of some non-residents. Similar legislative provisions may be needed for "hard to tax" residents so that they do not escape taxation under the proposed liberal self-assessment procedures. How far Bangladesh can go in this direction should be studied in detail.¹⁸

7.79 The mission expects the reorganized Directorate of Research, Statistics and Tax Analysis to be responsible for such studies so that necessary amendments to law can be introduced in the Budget proposals.

9. Avoidable Paper Work

7.80 The mission identified the following areas where minor modifications in existing procedures could effect considerable economies. Some of these may require amendments to the law.

(a) Accounting for Advance Tax. When Advance Tax is collected under the "pay as you earn" principle, it is credited to a "Deposit" head of account and not a "Revenue" head of account. Subsequently when an assessment is completed, the deposit is adjusted towards the tax demand by issue of an adjustment memo random to the Treasury Office. This mode of accounting was started when part of the income tax collected by the federal

18/ Such a study could be aided by consulting (i) "The Use of Presumptive Income in Modern Tax Systems" by Vita Tanzi and Milka Casanegra de Jantscher (Fiscal Affairs Department, International Monetary Fund), International Institute of Public Finance, 42nd Congress Athens, Greece, August 24-29, 1986 (Changes in Revenue Structures); (ii) "Use of Presumptive Tax Assessment Techniques in Taxation of Small Traders and Professionals in Africa" by I. A. Malik (The Economic Commission for Africa (ECA); Senior Regional Adviser in Public Finance and Budgetary Management), 33 Bulletin for International Fiscal Documentation 162 (1979), International Bureau of Fiscal Documentation, Amsterdam, Netherlands, and (iii) "The use of Estimation for the Assessment of Taxable Business Income" by A. Lapidoth 30 (1977) (Joint Effort of the Harvard Law School International Program and the International Bureau of Fiscal Documentation).

government had to be shared with the state governments. The amount actually shared was not the "Deposit" but only that finally adjusted towards the tax demand. That situation no longer obtains in Bangladesh. In neighboring India, which has a Federal structure, the system was given up in 1969/70 as it unnecessarily complicated the accounting process and generated avoidable paperwork in every case of payment of advance tax. The mission recommends that Bangladesh credit all advance tax payments to a "Revenue" account, thus eliminating the paperwork connected with the issue and processing of thousands of adjustment memos every year. It may be noted that in the year of change over, the government will get the additional incidental collection of the entire unadjusted advance tax to date.

(b) Certificate to the Recovery Officer (TRO). Under Section 138 of the Income Tax Ordinance, 1984, the assessing officer is required to issue a certificate to the Tax Recovery Officer which constitutes the basis for the TRO to enforce recovery of tax in default, if necessary by use of coercive measures listed in Section 139. This procedure is again rooted in history. Such certificates used to be issued to the District Collector to enable him to recover tax in default as arrears of land revenue. The issue of a certificate was justified as giving jurisdiction to a functionary outside the tax administration to enforce recovery of taxes due. Now that the tax administration has its own recovery machinery and its own TROs, there appears to be little justification for continuing with the old procedures. The individual certificates could be dispensed with if the TRO were to be given concurrent jurisdiction in the matter of recovery in all cases of arrear tax demand appearing on the Demand and Collection Register of the Assessing Officers. This will also eliminate the problems of coordination that frequently arise between the TRO and the assessing officers, specially where the certified amount is changed by the assessing officer, without the TRO being aware of the fact. The proposed change will entail amendment to the law.

(c) Assessment Order. The tax law is currently based on the concept of assessment of income in every case. Once a return of income is filed or called for, the proceedings can conclude only with the issue of an assessment order under Section 82, 83 or 84 of the Income Tax Ordinance, 1984. This requirement was appropriate where the system envisaged scrutiny and audit of each return filed. With the recommendation to move towards a regime in which almost 90 percent of returns will never be audited, it would be preferable to switch to the concept of assessment only for additional tax or refund and not of income. Thus the issue of an assessment order should be obligatory only where consideration of prepaid taxes leads to a further tax demand or issue of a refund. When that is not the case, no useful purpose is served by issuing cyclostyled two-line assessment orders of income (accepted as returned), merely informing the taxpayer that the prepaid taxes are in order. Its abolition would save a considerable amount of time for officers in the territorial ranges. Instead, it would be desirable to issue a more elaborate acknowledgement for the return of income (which will serve the purpose of the present assessment order) and to lay down a time limit in law before which a notice of hearing will be issued under Section 83 for scrutiny of the return. From the taxpayers' point of view such a change would advance the time by which this return automatically becomes final in the absence of such a notice, say within a year of filing the return.

(d) Returns Showing Income Below Taxable Limit. The mission estimates that 20 to 25 percent of the assessment workload is based on returns where the income returned is below the maximum amount which is not chargeable to tax (presently Tk 36,000). This covers all cases of Category IV (income not exceeding Tk 30,000) and some others (see Table 7.4). While some of these returns have to be entertained (e.g., where specifically called for by the assessing officer under Section 77 or Section 93, or a return of the partner of a firm, a return of loss to be carried forward or a return furnished to support a claim for refund, etc.,) the others serve no purpose. This situation also provides assessing officers with a tool to help boost their statistical output, even though it is meaningless in terms of quality or revenue. Frequent administrative measures to weed out such avoidable work have met with little success. The only remedy appears to be to make such return nonest in law so that they are deemed never to have been furnished. This will again need an amendment to the law which needs to be examined urgently.

(e) Date of Effect of Finance Acts. It is the understanding of the mission that the provisions of each Finance Act have effect for the immediately following assessment year. Thus, the provisions of the Finance Act 1988, which was introduced in June 1988, takes effect for the assessment year 1988/89 starting on July 1, 1988. Since incomes earned in "Income Years" ending prior to July 1, 1988 are liable to be taxed for Assessment Year 1988/89, this amounts to retrospective legislation. While that may be within the competence of the legislature, the mission's concern is largely with the generation of avoidable paperwork under this system. An example will help clarify this concern. The Finance Act of 1988 levied a surcharge of 10 percent on income tax (paragraph 7.15(f).; This applies from the assessment year 1988/89. Thus in all cases where advance tax was paid or tax was deducted at source within the financial year 1987/88, an additional demand would now arise on account of this surcharge. Similarly, if a tax concession were to be granted by the Finance Act 1988, the same advance taxpayers would be able to file a claim for refund. This could be avoided if changes effected through a Finance Act were to be made operative prospectively in respect of incomes to be earned in "income years" ending upto a year later. Thus, the Finance Act of 1988 would lay down the advance tax and tax-deduction-at-source rates for financial year 1988/89 separately (as also rates of tax applicable for assessment year 1988/89 which should be the same as the advance tax, rates notified for financial year 1987/88 in the earlier Finance Act of 1987). The Finance Act of 1989 should similarly adopt the advance tax, etc., rates of financial year 1988/89 as the tax rates for assessment year 1989/90 and so on. Other amendments having a bearing on tax liability should also be made applicable prospectively. This would be particularly desirable in the missions recommended regime where almost 90 percent of the returns would be accepted and not generate avoidable paper work.

10. Computerization

7.81 Computerization provides considerable scope for improving the administration of taxes. However, its introduction has to be carefully planned and studied in detail. One common requirement in any form of computerization will be the need for a unique taxpayer identification number to help distinguish one taxpayer from another. Despite initial teething and technical problems, computers ultimately offer the best way of

coping with the expanding workloads. Computers are currently being set up in India, Indonesia, Jamaica, Malawi and Morocco among the developing countries. They are already partially or fully operational in Brazil, Ecuador, Honduras, Korea and Nigeria. Experience elsewhere suggests that after preliminary studies and preparation, it is better to introduce computers gradually rather than attempting computerization in all operations in the first phase. Experience also suggests that computerization can increase the efficiency of well-run administrations but can also create problems if it is super-imposed on badly run operations. Since the mission has proposed switching over to a new regime of selective scrutiny, it would be preferable if computerization is introduced on the direct taxes side after the new regime has become operational. That period of time could be utilized to make the necessary feasibility and detailed studies for computerization, with a view to improving the quality of administration, collection of revenue, quality of statistical data and building up an information system that can allow the tax administration to conduct effective auditing of tax returns. The process of computerization will also involve a review of existing forms and procedures to make them computer-compatible. Joint Director, (O&M) under the Director, (Inspection), should be responsible for project "computerization", including availability of appropriate hardware and software and the needed trained personnel.¹⁹ India's experience with computerization in the Tax Department is detailed in Appendix 7.5.

11. Morale and Motivation of Officers

7.82 The mission believes that a case could be made for improving the emoluments of staff in the direct taxes. However, since salary scales were doubled in 1985, it is suggested that instead of addressing the larger question of salary structure, the Government consider looking into other amenities such as housing, transportation and office equipment so that the officers of the tax department do not suffer from a perpetual feeling of grievance in such matters. Some suggestions in this regard have already been made in this regard in paragraph 7.75 above, together with details of the costs involved.

19/ The experience of other countries with computerization may be consulted (1) "Automatic Data Processing and Tax Administration: The Potentialities of ADP and Factors Involved in Its Adoption" by Stanley S. Surrey, Assistant Secretary, U.S. Treasury Department. (Problems of Tax Administration in Latin America 178 (1965), (Papers and Proceedings of a Conference held in Buenos Aires, Argentina, October 1961); (2) "Computers in Tax Administrations", by M.A. Majeed (7 Tax Observer No. 12 at 3 (December 1986) (The Journal of Pakistan Taxation Club), and (3) "EDP and Tax Audit", by Revenue Canada, Taxation (Fundamental Tax Audit Considerations: Technical Papers and Reports of the 14th General Assembly of the Inter-American Center of Tax Administrators (CIAT) 84 (1981).

7.83 There is an existing reward scheme for detection of concealments by the officers and staff of the tax department (see C. No. 8(53)T-III/78 dated November 21, 1980 as modified on August 19, 1984 and July 8, 1986). However, hardly any instance of rewards earned by the staff was brought to the notice of the mission. Such a paper reward scheme needs to be replaced by a much more liberal arrangements which ensures that quality work in any field is rewarded promptly and adequately. There could, for example, be rewards for the largest cash collections by tax recovery officers, for search parties for substantial seizure of prima facie unaccounted/undisclosed assets, for survey parties bringing in the largest number of new taxable returns, for inspection work uncovering new modes of tax evasion or other abuses of the system and other such quality work. Correspondingly, penalties should be instituted for unsatisfactory performance noticed as a result of revitalization of inspections and audit. The mission also suggests that Information Officers attached to the Headquarters of each Zonal Commissioner should function as Grievance Redressal Cells. This will also help uncover examples of poor performance and laxity and strengthen accountability within the administration.

12. Timeframe for Implementation

7.84. It is suggested that the studies recommended under Sections 8 to 11 above be completed within one year and that their recommendations be implemented soon thereafter.

APPENDIX 7.1

Extracts from Budget Speeches for FYs 87, 88 and 89
Regarding the Voluntary Disclosure Scheme

- 1986 47. A number of inducements have been provided by the Government in the past few years to encourage assesses to disclose their correct income voluntarily. Rates of income tax for individuals were substantially reduced last year and the highest quantum of tax was fixed on one-third of income. However, it appears that taxpayers still have certain hesitance about these measures. Many of them consider it unlikely that the tax authority would accept a return even if it discloses the correct income and may, instead, question the bona fide of such declaration. In this context, it may be mentioned that under the tax laws, the sources of income are (a) salaries (b) interest on securities, (c) income from house property, (d) agricultural income, (e) income from business profession, (f) capital gains and (g) income from other sources. Sources of income, other than the last named one, are tied to a specific activity or vocation, such as business, service, profession, etc. For income tax authority, it is rather difficult to assess income from these sources without asking questions. But "income from other sources" stand on a different footing. Taking relevant factors into consideration, it has been decided that to induce assesseees to disclose correct income, income declared under the head "income from other sources" by individual assesseees in the income tax return for 1986/87 would be accepted without any questions being asked. This facility will be available only to those individual assesseees who declare at least Tk 2,50,000 as "income from other sources" and pay the tax on the declared income at the time of filing the return. However, assesseees against who notices have been served for taking penal measures for tax evasion, will not qualify for this benefit.
- 1987 42. The Third-Five Year Plan envisages investment in industries from private sector at Tk 3200 crore. This estimate is based on 1984/85 prices. If normal annual inflation is considered, this amount will stand at Tk 5100 crore at the end of the Plan period. During the period from July 1, 1985 to December 30, 1986, investment of about Tk 1338 crores was sanctioned in the private sector. Actual investment in the same period was only Tk 304 crores. This means, that to achieve the plan target for private investment, during the remaining years of the plan period, private investments must increase substantially. In order to help achieve this objective, following measures are proposed to be taken:

- (a) If an assessee, of other than a company, declares any income under the head "Income from other sources" in his return of income for the assessment year 1987/88 and pays income tax at the rate of 20 percent on it, his return will be accepted without any questions being asked.....

1988 b36. In the interest of economic development and creation of new employment opportunities, it is necessary to increase investment. In order to achieve the target of private investment in the industrial sector, an opportunity was given for the assessment year 1987/88 to assessees, other than companies, to declare income of any amount by paying income tax at the rate of 20 percent under the head "income from other sources". The reasonings for and the circumstances under which this opportunity was given for the assessment year 1987/88 are there for the assessment year 1988/89 also. Therefore, with a view to stimulating industrial development and creating new employment opportunities, the following measures are proposed to be taken:

- (a) If an assessee, other than a company, declares any income under the head "income from other sources" in his return of income for the assessment year 1988/89 and pays income tax at the rate of 20 percent on it, that income will be accepted without any question being asked;
- (b) If, however, 90 percent of the amount declared is invested within two years in specified industries, then the declarant will pay income tax at the rate of 10 percent in place of 40 percent.

APPENDIX 7.2

Workload of Officers of Taxes Department, Dhaka (South) Zone
Discussions with World Bank Mission on August 15 and August 23, 1988

1. On the basis of performance of officers during 1986/87 (July 1, 1986 to June 30, 1987), and the daily workload between August 16, 1988 and August 21, 1988 (5 working days) the following position emerges.

2. There are 3 Companies Circles, viz., Companies Circle-I, Companies Circle-II and Taxes Circle-I, whose jurisdiction is distributed alphabetically.

3. Deputy Commissioner of Taxes, Companies Circle-I has 249 current and 405 pending, total 654 Category-I cases, 141 current 244 pending total 385 Category-II cases, 259 current and 412 pending, total 671 Category-III cases, besides 1885 Category IV cases (current 776 plus pending 1100 cases). Disposal of effective cases (Cat.I,II, and III) during 1986/87 is 634 and total disposal is 897.

3.1 On the basis of daily workload between 16th and 21st of August, 1988 his daily dictation, hearing and entry in Registers average 4 (four).

3.2 During 1987/88 his office received 685 and issued 4855 correspondence - assessment orders, notices, reminders for tax payment, etc. On the staffing side he is assisted by 2 inspectors, 1 Supervisor, 2 U.D.As, 2 Steno-typists, 1 L.D.As, 1 Daftry and 3 M.L.S.E.

3.3 The daily average of all communications during 1987/88 come to 18.59.

3.4 On the basis of actual number of working days during 1986/87 the daily disposal of effective cases came to 2.09, and considering all cases, it came to 2.97.

4. As regards D.C.T. Companies Circle-II disposal of effective cases during 1986/87 is 351, and the total is 611. He had the following cases:

	Current Cases	Pending Cases	Total
Category - I	88	76	164
Category - II	70	116	186
Category - III	112	126	238
Category - IV	517	680	1197

4.1 He is assisted by 2 Inspectors, 1 Supervisor, 1 U.D.A., 1 Steno-typist, 1 L.D.A., 1 Daftry and 3 M.L.S.S.

4.2 Total number of incoming and outgoing correspondence during 1987/88 is 690 and 415 respectively, total 1105. The daily average comes to 3.7.

4.3 On the basis of actual number of working days daily average disposal of effective cases come to 1.16, and considering all cases it comes to 2.02.

5. D.C.T. Taxes Circle-I had following cases:

	Current	Pending	Total
Category - I	97	148	245
Category - II	62	99	161
Category - III	77	125	202
Category - IV	671	1180	1851

5.1 Her disposal of effective cases during 1986/87 was 294, total 914 cases. Average daily disposal on the basis of actual number of working days was 0.97. The disposal is 48.3 of effective cases.

5.2 The office received during 1987/88, 393, and issued 1404 correspondence. On the basis of actual working period the daily average come to 6 (six).

5.3 The D.C.T. is assisted by 3 Inspectors, 1 Supervisor, 2 U.D.A., 1 Steno-typist, 1 L.D.A., 1 Daftry and 4 M.L.S.S.

6. To take the case of a general circle (having jurisdiction over a fixed area) Circle "A", it has the following cases (in Section I and Section II):

I	Current	Pending	Total
<u>Section - I</u>			
Category - I	41	37	78
Category - II	71	40	111
Category - III	672	350	1022
Category - IV	403	261	664
<u>Section - II</u>			
Category - I	5	10	15
Category - II	4	2	6
Category - III	254	74	328
Category - IV	548	640	1188

6.1 Total number of effective cases disposed of during 1986/87 was 821. The daily average (basis actual working days) come to 2.72.

6.2 During 1987/88 the circle received 1627 and issued 1635 correspondence, total 320-62. The daily average comes to 10.95.

6.3 This is a 2 officer Circle and they are assisted by 2 Inspectors, 1 Supervisor, 1 U.D.A., 1 Steno-typist, 2 L.D.A., 1 Daftry and 4 M.L.S.S.R.

6.4 Taking into consideration work done between 16th and 21st of August (5 working days) the daily average of cases heard is 3.4 (number of cases heard during this period of the year is rather less, in view of the backlog of cases relating to the immediately proceeding financial year), daily average of self assessment cases completed is 7, that of Ship tax cases is 10.2. Thus the broad spectrum of average daily output is:

(a) assessment of I.T. cases:	2.72
(b) hearing of I.T. cases:	3.4
(c) completion of Self assessment case:	7.0
(d) completion of shop tax cases:	10.2
(e) the daily average of all correspondence:	10.95

Besides, there are other cases like clearance for Transfer of Property, issue of GIR certificates, entries in various Registers and some administrative work.

6.5 While the circle has 3412 current and pending cases including about 1600 effective cases, the workload is just manageable. However little time is left for:

- (a) Collection of information about assessee
- (b) Collection information about tax dodgers
- (c) Proper survey of locality
- (d) Starting of new file

- (e) Proper utilization of information received from other circles

- (f) In depth scrutinizing of files which can ensure correct assessment

APPENDIX 7.3

Government of the People's Republic of Bangladesh
National Board of Revenue, Dhaka

C. N. 6(28)T-III/81(Pt-I)/

August 6, 1988

CIRCULAR NO. 5 I.T. OF 1986

Subject: Self-Assessment Scheme - Assessment year 1986/87 - Clarification
Regarding.

1. Self-assessment scheme has been continued for the assessment year 1986/87 also with the existing ceiling of Tk 1,25,000/. However, there is no ceiling for an assessee whose income is chargeable under the head salaries and such income is more than 80 percent of his total income. Such assessees many submit income tax returns under self-assessment procedure irrespective of the quantum of their total income.

2. For a new assessee deriving income from business or profession, the existing condition of investment of initial capital without any question being asked as respects the source thereof, provided at least 25 percent of the said investment is returned as profit continues with ceiling of Tk 1,50,000/r¹ for the assessment year 1986/87 in place of Tk 5,00,00/r for the assessment year 1985/86.

3. As in the last year, this year also, return under self-assessment scheme may be submitted by old or new assessees for the assessment year 1986/87 only on or before the September 15, 1986.

4. An existing assessee, deriving income from business or profession will be eligible to submit return under the self-assessment scheme only if his return for the assessment year 1986/87 is submitted showing at least 10 percent higher income than the last assessed income. But if the assessee's last assessed income is not the income of the year immediately preceding the assessment year 1986/87 then the return for the assessment year 1986/87, in order to qualify for self-assessment procedure should show at least 10 percent higher income for each of the preceding assessment years for which the assessment is pending, in a gradual calibrated manner as illustrated below.

Mr. "X", an assessee deriving income from business was last assessed for the assessment year 1983/84 on a total income of, say, Tk 60,000/-. Assessments on his returns for the assessment years 1984/85 and 1985/86 showing income of say Tk 20,000/- and Tk 22,000/- respectively, are pending. If Mr. "X" now wishes to avail of the benefit of self-assessment scheme for the assessment year 1986/87, his eligibility for self-assessment for the said year should be calculated in the following manner:

1/ The limit of Tk 1,50,000 referred to in para. 2 has since been raised by the Finance Act of 1988 to Tk 2,00,000 in all cases and to Tk 3,00,000 if investment is made in small and cottage industry. In respect of new assessees referred to in para. 3 they are now required to submit a Bank Certificate also.

- (a) 10 percent higher for assessment year 1984/85 on the last assessed income of Tk 60,000/- which comes to Tk 66,000/-;
- (b) further 10 percent higher income for assessment year 1985/86 on Tk 66,000/- which comes to Tk 72,600/-;
- (c) further 10 percent higher income for assessment year 1986/87 on Tk 72,600/- which comes to Tk 79,860/-.

So, Mr. "X" will qualify to submit this return for the assessment year 1986/87 under the self-assessment scheme only if he returns a total income of at least Tk 79,860/- for 1986/87. However, it may be mentioned here that, since Mr. "X" is eligible for submitting return under the self-assessment scheme for the assessment year 1986/87 only, his pending assessments for 1984/85 and 1985/86 will be completed under the normal I.T. Law. The quantum of income determined subsequently for these two years under the normal I.T. law will have not effect whatsoever on the self-assessment return of Mr. "X" for 1986/87.

5. As in last year, those who have already filed normal return for the assessment year 1986/87, can also file revised return under the self-assessment scheme within September 15, 1986, if other conditions laid down in Rule 38 of the I.T. Rules 1984 under the I.T. Ordinance, 1984 read with this circular are fulfilled.

6. Return of income filed under self-assessment scheme shall have to be accompanied:

- (a) Where the assessee derives income chargeable under the head "income from business or profession", by a Trading and Profit and Loss Account and Balance Sheet; or
- (b) Where the assessee has not maintained proper books or accounts by a statement showing the particulars of his income and expenditure as well as a statement of assets, liabilities and expenses; and
- (c) Where the return income exceeds Tk 80,000/- by a statement of assets, liabilities and expenses.

7. Since under the self-assessment scheme the assessee are expected to declare their true income, it is once again clarified that any addition over and above of what has been disclosed as net profit in the profit and loss account of the assessee, "in order to obtain the benefit of self-assessment scheme," is not permissible.

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Dated the 6th August 1986.

C. N.6(28)T-III/781(Pt-I)/

APPENDIX 7.4

The Experience with Preemptive Purchase of Property in India

1. The Direct Taxes Administration Enquiry Commission appointed by the Government of India in March 1970, under the Chairmanship of ex-Chief Justice K. N. Wanchoo expressed the view that understatement of prices in transactions of transfer of immovable property had become widespread method of tax evasion and a major source and channel for the generation and circulation of black money. The Committee, therefore, recommended that the Government should be empowered to acquire property where the consideration is found to be understated with a view to evading tax, on payment of disclosed sale consideration and solatium of 15 percent thereof, in addition.

2. As a result of this recommendation, Chapter XXA was inserted in the Income-Tax Act, 1961 by Taxation Laws (Amendment) Act, 1972 with effect from 15th November 1972. This Chapter provided for acquisition of immovable property on payment of the disclosed sale price and 15 percent thereof in addition in cases where the Competent Authority as prescribed under the Income-Tax Act was satisfied that the fair market value of the property exceeded the apparent consideration thereof by more than 15 percent of such apparent consideration and that the consideration for the transfer as agreed to between the parties has not been truly stated with the object of tax evasion. The provisions of this Chapter applied to such cases of transfer which were registered under the Registration Act, 1908 and also to cases of transfer of flats, etc. In Housing Co-operative Societies where only shares were transferred, which did not require registration.

3. The provisions of Chapter XXA did not meet with the desired amount of success to counteract tax evasion and to check circulation of black money due to the onerous burden placed on the Competent Authority to establish that the consideration for transfer had not been truly stated with a view to evading tax. This was invariably challenged in courts of law resulting in a lot of litigation.

4. Long-term fiscal policy announced by the Government of India in December 1985, took stock of the situation and observed that these provisions had not proved to be effective and had generated a great deal of litigation and harassment. It was, therefore, proposed to confer on the Government pre-emptive right to acquire any immovable property undergoing transfer.

5. Accordingly, a new Chapter XXC was inserted by the Finance Act 1986, in the Income-Tax Act, 1961. Further by insertion of a new sub-Section 269RR, the Finance Act 1986 has also provided that the provisions of earlier Chapter XXA shall not apply in relation to the transfer of any immovable property made after the 30 September 1986.

6. The provisions of Chapter XXC as enacted by the Finance Act, 1986, have done away with the elaborate procedure of initiation of acquisition proceedings for immovable property and onerous burden of proving that

consideration as agreed to between the parties has not been truly stated in the instrument of transfer with a view to evading taxes. The new provisions have also done away with long-drawn legal battles in as much as there is no right of appeal against the order of purchase which is issued by a high powered Appropriate Authority (AA) consisting of two Commissioners of Income Tax and a Chief Engineer of Public Works Department. The earlier provision pertain to "Purchase of immovable property". The material difference is that under the earlier provisions the property was compulsorily acquired by the Central Government after a particular transaction had already taken place. It, therefore, had the effect of divesting the owner of his rights in property. Under the new provisions, the Government steps in pre-emptively even before the completion of transaction. It does not divest the transferee of any rights in property, only diverting the vesting of property in the Central Government instead of the proposed transferee.

7. The provisions of Chapter XXC have been made effective from 1st October 1986. Under Section 269 UC (1) of the Income-Tax Act it was provided that notwithstanding anything contained in the Transfer of Property Act, 1982 (4 of 1882), or in any other law for the time being in force, no transfer of any immovable property of such value exceeding five lakh rupees as may be prescribed shall be effected except after an agreement for transfer is entered into between the person who intends transferring the immovable property and the persons to whom it is proposed to be transferred. Rule 48K of the Income-Tax Rules provides that the value of the immovable property for the purposes of sub-Section (1) of Section 269 UC shall be the apparent consideration of that property exceeding ten lakh rupees. Provisions of Chapter XXC were made effective from October 1, 1986 in the metropolitan cities of Delhi, Calcutta, Bombay and Madras. These were subsequently extended to cities of Bangalore and Ahmedabad. Appropriate Authorities have been constituted at the four metropolitan cities. It is under consideration of the Government to extend these provisions to other major State Capitals and trading centres in the country.

8. The transfer and the transferee are required to file a statement giving details of the agreement for transfer before the Appropriate Authority and in suitable cases, and for reasons to be recorded in writing, the Appropriate Authority make an order for the purchase by the Central Government of such immovable property at an amount equal to the amount of apparent consideration. A very significant feature of these provisions is that all actions to be taken are under a time-bound frame; that under Rule 48L the transferor and the transferee have to furnish a statement before the expiry of 15 days from the date on which the agreement for transfer is entered into. Further, the Appropriate Authority has to pass an order of purchase before the expiration of a period of two months from the end of the month in which the statement is received. The amount of consideration is to be paid within a period one month from the end of month in which the immovable property concerned becomes vested in the Central Government.

These properties are subsequently sold in public auction. So far the sale consideration (Rs. 16.11 crores) as a result of public auction has

far exceeded the apparent consideration (Rs 10.58 crores) in 34 cases of action.

9. As a result of orders of pre-emptive purchase of properties by the Appropriate Authorities there has been a sharp rise of 100 to 300 percent in the declared consideration in the agreements to sell. The rise in the real estate prices indicates that the action under Chapter XXC is having its impact and the black money component in sales transactions is gradually appearing as "white" money.

APPENDIX 7.5

Computerization in the Income Tax Department in India

The use of computers, as an aid to modern administration, has received universal recognition and acceptance. The Electronic Data processing systems have revolutionized the concept relating to storage of Data, its interpretation and retrieval for various useful purposes in management.

The Income Tax Department in India has introduced computers for use in various fields of its activities for (a) reducing clerical and paper work and thus improving the tax administration in general; (b) maximizing tax collections; and (c) improving service to taxpayers.

In India, the approach of the Department towards computerization in tax administration has been one of great care and caution. It is so because, (a) The computer culture in the country has still to take its roots; (b) There is a resistance from the staff side as they apprehend that there would be consequential loss of jobs and reduction in promotional prospects; (c) There is acute shortage of qualified manpower in the country to handle data entry and other computer work; and (d) there were not training facilities available in the Department. In substance the Department had to think of and build up necessary infrastructure for bringing in computerization in the Department.

As a matter of policy it was thought to have computer systems at more places in the country with an eye on decentralization rather than to install computers at limited places. Accordingly, computer systems have been installed at the headquarter of each Commissioner of Income-Tax who is the head of Department and has been assigned certain jurisdictional areas in the country. Accordingly, 36 Computers Systems have been established, one each at the headquarter of a Commissioner of Income-Tax who have been made fully responsible for control and supervision of these computer centres and for implementation of various software programs centrally prepared.

The selection of hardware has been done keeping in view the basic approach, above mentioned and with an eye on economy to incur minimum expenditure to start with. After technical evaluation of various computer systems, the Department selected SN-73 Computer Systems which is an Indian version of PDP-11 manufactured by DEC-USA (a company internationally known for computers). The computer configuration has been kept to the minimum, initially with scope for further augmentation with increase of load. This ensures minimum investment to start with. This also ensures benefit in reduction of costs in the prices of hardware with passage of time which were anticipated. To illustrate, for major cities the computer systems have one MB Memory, eight Terminals, 168 MB Disc, one 330 MB removable disc drive, two floppy drives and one console. This capacity can be augmented from time to time when considered necessary and the optimum capacity can go upto four disc of 330 MB, 16 Terminals/PCs (Personal Computers), 4 MB Memory, one Printer, two Floppy Drives, two Tape Drives and one Console. The systems carry one year warranty and are required to be maintained subsequently by the Vendors for seven years on annual maintenance contact which roughly cost 10 percent of the purchase price.

To build in proper infrastructure for computerization the Government had a package deal with the vendors of computers and asked them to provide software support service of one year at each computer centre, to conduct training courses for bringing in computer awareness in the Department and for training the officers in Co'ol Language, System Analysis and Design.

The data entry work is being handled on Personal Computers (PCs) which are IBM compatible and universally well known.

All the developed countries initially started with batch processing system in computerization before they finally moved on to on-line retrieval systems. In batch processing system the computer jobs are executed in batches, for example processing of Challan (tax receipts) in batches, processing of Income-tax returns in batches, etc. In an on-line system the relevant data is captured from different sources and is stored in the computer to be available for retrieval through a query system as and when required. The Income Tax Department also has started with the batch processing system on 36 Computer Systems which are compatible with each other to facilitate implementation of standardized softwares prepared centrally.

The software programs have taken into account the immediate as well as well as long-term requirements. For computerization, it is necessary that each taxpayer be given a unique number for purposes of identification. Accordingly, Permanent Account Numbers have been allotted to taxpayers by each computer centre. This system would be available on line to answer relevant queries about identification of taxpayers.

The important areas for computerization pertain to collection of taxes and completion of assessments. The direct tax payments in India are made in the authorized banks by Challans as token of such payments. Software systems have been developed to prepare daily record of payments received from the taxpayers through these challans and also of records of refunds due to taxpayers. Computer sheets of collections are prepared for each Assessing Officer under Commissioner of Income-tax. This enables the Department to find out total net collection for a particular period for prompt reporting of figures to high authorities and also for reconciliation of collection figures with the Zonal Account Officers who keep a parallel record of such receipts.

A system has also been developed to keep computerized record of demand and collection of each taxpayer to expedite recovery of arrears of taxes as manual system was found to be unsatisfactory.

A software package has been developed for checking of total income and tax due for completing income tax assessments. Under this system the computer also checks the various statutory deductions and rejects excess claims and thus ensures payment of taxes found due. Under the manual procedure such claims remain unverified.

The Department has also made several other software programs such as monitoring of taxes withheld (tax deduction at source from salaries), monitoring for redressal of public grievances, career management system for officers, pay roll system and statistics in search and seizure cases.

To facilitate easy access to Government's instructions on legal and technical points and judicial authorities a Judicial Reference System is under development. Systems are also under development for (a) evaluating search and seizures, (b) dossiers in large industrial houses, (c) research in the tyre and tea industries, etc., (d) storage of data pertaining to all important transactions relevant for determination of income of taxpayers and matching the same through computer.

The major bottlenecks which the Department had to overcome were preparation of air-conditioned sites for installation of computers, creation of technical posts to man the computer centres, finalization of Recruitment Rules for these posts, recruitment of technical personnel, training of staff and officers in computerization and the overcoming staff resistance. All these have successfully been tackled to a large extent.

The Department is now planning in terms of having a network for all the computer systems set up in the country and to connect them with a Host Computer at a central place. The setting up of the Host Computer with a vast data base would bring a switch over from batch processing to on-line retrieval system.

The *raison d'être* for computerization is to have the relevant data stored for detecting tax evasion, identifying new taxpayers through a matching system and on-line retrieval of data for meeting the requirements of (a) department MIS, (b) answering Parliament questions, and (c) satisfying Parliamentary Committees, etc. The Department is moving rapidly in that direction and is confident of entering an advanced stage of computerization during the course of the next five years.