With the implementation of the VAT law postponed, what additional domestic revenue mobilization measures could be considered?

Key Messages

The postponement of 2012 VAT Law implementation means that the higher tax revenues expected from the measure will be delayed, and additional sources of revenue need to be considered. Model simulations suggest that implementation of the VAT Law starting July 1, 2017 at the originally proposed rate of 15 percent would have yielded additional tax revenue of about 1 percent of GDP in FY2018, and 0.8 percent of GDP in FY2019. Several measures could be considered to make up this short-fall. Automation and process simplification could bring additional tax revenues ranging from 0.3 to 0.7 percent of GDP in FY2018. There is substantial scope for efficiency gains in shifting from a type-of-tax towards a function-based tax administration, facilitating compliance. Carbon taxes could generate resources equivalent to 1 percent of GDP, and tobacco taxes could raise a further 1 to 2 percent of GDP. Rationalizing tax incentives and exemptions can also generate more revenue. The proposed administrative measures, including expanding tax withholding mechanisms, would not require legislative changes and could be implemented in the short term, boosting revenue during the current fiscal year (FY2018). The other tax policy measures could be considered for implementation in the medium term and would require corresponding legislative initiatives.

Further budget analysis, considering measures to boost revenues, manage expenditures, and broaden financing options, would be useful ahead of the planned revision of the FY2018 budget.

Background

1. **Postponement of VAT Law 2012 implementation for two years from the originally scheduled start date of July 1, 2017 has lowered expected revenue, raising the need to tap additional sources of revenue**. Microsimulation model estimates suggest that the implementation of the VAT Law 2012 at the planned rate of 15 percent would have yielded additional revenue from VAT of 1 percent of GDP in FY2018, and 0.8 percent of GDP in FY2019. With the delay in implementation until FY2020, additional measures will be needed to ensure revenue buoyancy. Greater revenue yield will most readily come from a combination of seeking efficiency gains from automation, making administrative improvements in business processes to facilitate compliance, introducing carbon and tobacco taxes, and rationalizing tax incentives and exemptions.

2. **Automation and process simplification will be instrumental in improving transparency, reducing administration costs, facilitating compliance, and improving the business climate**. In Russia, revenue collection increased by 25 percent in the period 2012-2015 thanks to a combination of enhanced emphasis on e-services, greater client-orientation, increased transparency, and reduced administrative burden through automation.[1] In Bulgaria, the aggregate voluntary compliance rate with tax and social contribution payment obligations increased by 11 percentage points from 74.3 percent in 2002 to 85.7 percent in 2008, and the VAT compliance rate improved to 92 percent, equaling that of advanced EU member countries.[2]

3. **A microsimulation model developed by the World Bank for Bangladesh suggests that automation may bring additional revenues ranging from 0.3 to 0.7 percent of GDP in FY2018.** Annex II presents the results of

[1] Presentation of the Russian Federal Tax Service at the TAXGIP Conference, Saint Petersburg, June 2016.

[2] Republic of Bulgaria, Revenue Administration Reform Project, Implementation Completion Report, World Bank, 2009.

the application of a microsimulation model where VAT tax rates are kept constant (leaving the current VAT Law 1991 tax rates unchanged), while estimating the impact of process improvements and automation that gradually increase VAT compliance rates across sectors. The results show that raising compliance rates would yield significant additional VAT revenues.

4. **There is substantial scope to increase efficiency by shifting from a type-of-tax towards a function based tax administration**. Evidence shows that tax administrations that follow this path save resources in terms of administration costs while providing better services to taxpayers, thereby reducing taxpayers' compliance costs (Bangladesh ranks 151 out of 190 countries on the *Doing Business* 'paying taxes indicator'). For example, in the 1990s, Canada and Portugal moved towards function-based integrated tax administration, and this reorganization yielded immediate efficiency gains. As per the current Bangladesh Budget Speech, consideration could also be given to expanding tax withholding mechanisms.

5. **Carbon taxes could raise additional resources up to 1 percent of GDP.** In addition to boosting revenue, carbon taxes can nudge Bangladesh to a lower carbon and cleaner growth path, helping to make it more sustainable and improving environmental and health conditions for its citizens. Some of the additional resources could be used to reduce taxes on labor or firms. Carbon taxes are much simpler to implement than many other taxes, and most fuel costs would increase by only a few Taka per liter. Effective implementation is essential to underpin the support of citizens and the business community.[3]

6. **Tobacco taxes could generate additional resources equivalent to about 1-2 percent of GDP**. While estimates of revenue gains from tobacco taxes under the new tax framework have yet to be prepared, the rough estimates based on the former tax framework indicate potential revenue gains ranging from 1-2 percent of GDP. Further analysis is needed.

7. **Rationalizing tax incentives and exemptions can also lead to additional revenue while reducing administration costs.** A detailed cost-benefit analysis of existing incentives and exemptions is needed to inform policy decisions. Estimates of the costs associated with these incentives and exemptions need to be updated. A study carried out by Bangladesh Bank in 2006 estimated the total cost of tax exemptions at 2.52 percent of the GDP.[4] A more recent study was undertaken in 2012, but was based on a more limited data set and the estimates are less reliable in this context. In Pakistan, the government succeeded in removing distortionary tax exemptions that yielded cumulative revenue gains of about 0.8 percent of GDP over the past three years.

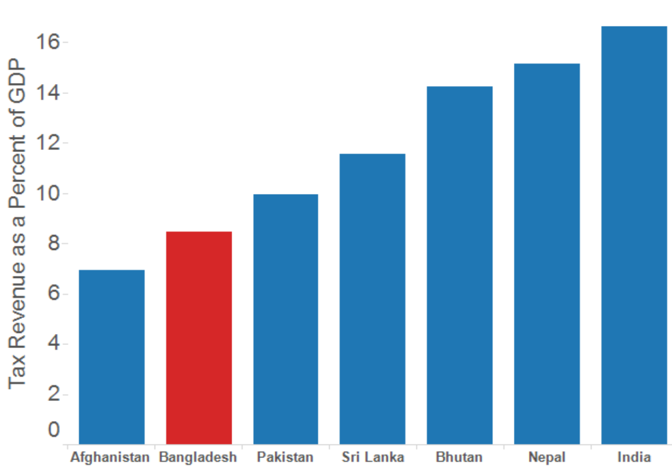
Policy Measures to Consider

- Proceed with ongoing efforts to automate tax administration, based on the 1991 VAT Law, focusing on broadening the tax base, boosting compliance rates, and expanding tax withholding mechanisms.
- Implement carbon and tobacco taxes.
- Prepare a cost-benefit analysis of existing tax incentives and exemptions.
- Develop a time-bound plan with milestones to maintain momentum on these domestic revenue mobilization efforts.

[3] Policy Note on Options for a Carbon Tax in Bangladesh, World Bank, 2017.
[4] Tax Expenditure in Bangladesh: An Introductory Analysis, PAU, Bangladesh Bank, December 2006.

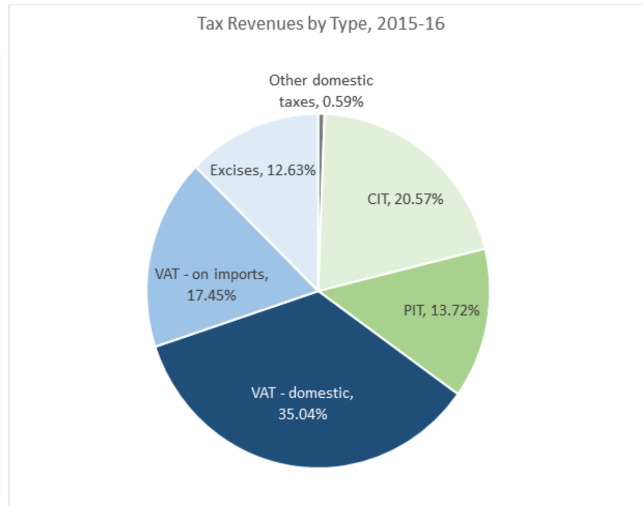
Annex I: Revenue Trends in Bangladesh and Tax Mix

Tax Revenues/GDP SAR Countries



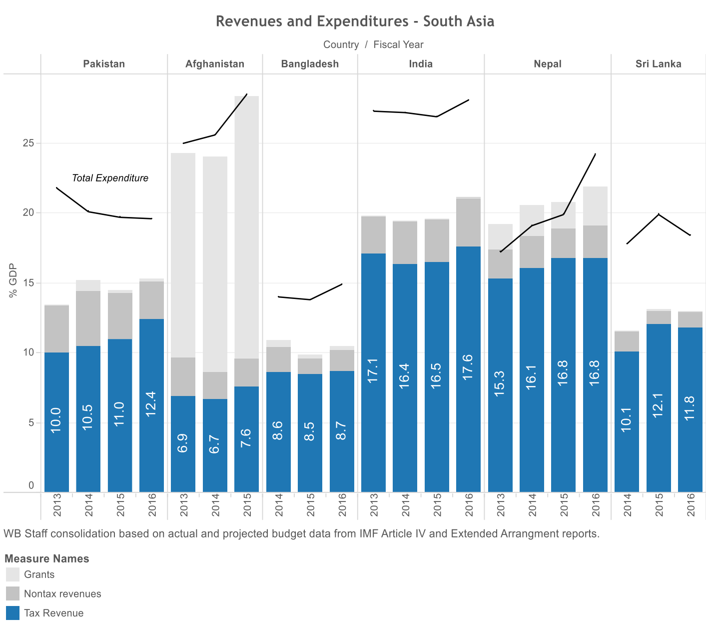
Source: 2013 IMF Data

Tax Revenues by Type



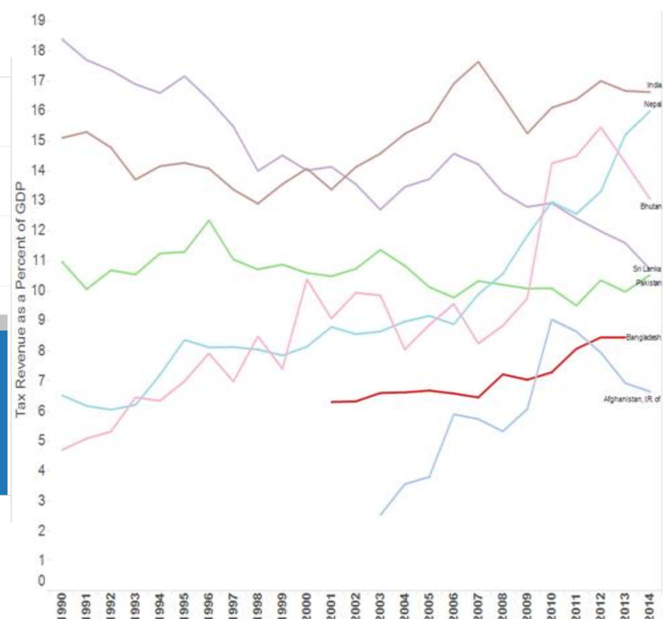
Source: NBR

Fiscal Gaps: Bangladesh vs Regional Economies



Source: World Bank calculations, IMF Article IV

Tax Revenue/GDP Trends in SAR



Source: 2013 IMF World Data

Annex II: Measuring the revenue impact of 2012 VAT Law[5]

Scenario A

Assumptions:

- Single rate 15% and voluntary compliance rate unchanged at current level (54 percent on average for all sectors).

Main results:

	2016-2017	2017-18	2018-19	2019-20	2020-21
VAT REVENUE AS A PERCENTAGE OF GDP	6.8	7.8	8.6	9.1	9.8
EXPECTED REVENUE INCREASE AS A PERCENTAGE OF GDP		1%	0.8%	0.5%	0.7%

Scenario B

Assumptions

1. With 1991 VAT Law tax rates unchanged, increase in the level of sectoral voluntary compliance of 5 percent, raising the average aggregate voluntary compliance rate from 54 percent to 56 percent.
2. With 1991 VAT Law tax rates unchanged, increase in the level of sectoral voluntary compliance of 10 percent, raising the average aggregate voluntary compliance rate from 54 percent to 59 percent.
3. With 1991 VAT Law tax rates unchanged, no change in aggregate levels of voluntary compliance from the current 54 percent.

	2016-2017	2017-18	2018-19	2019-20
1. VOLUNTARY COMPLIANCE RATES INCREASE 5 PERCENT				
VAT REVENUE AS A PERCENTAGE OF GDP	6.8	7.1		
EXPECTED REVENUE INCREASE AS A PERCENTAGE OF GDP		0.3		
2. VOLUNTARY COMPLIANCE RATES INCREASE 10 PERCENT				
VAT REVENUE AS A PERCENTAGE OF GDP	6.8	7.5		
EXPECTED REVENUE INCREASE AS A PERCENTAGE OF GDP		0.7		
3. NO INCREASE IN VOLUNTARY COMPLIANCE LEVELS				
VAT REVENUE AS A PERCENTAGE OF GDP	6.8	6.8	6.7	6.4
EXPECTED REVENUE INCREASE PERCENTAGE OF GDP		0	-0.1	-0.3

[5] Microsimulation Model to Estimate VAT Implementation in Bangladesh, World Bank, July 2017.