

The Potential of Withholding Taxes in Bangladesh in the Collection of Income Taxes

NASIRUDDIN AHMED¹

AMINUR RAHMAN

Abstract

Bangladesh's tax-GDP ratio of Bangladesh is low when compared with neighboring South Asian Countries. One of the major reasons for low tax-GDP ratio is the existence underground economy. Factors contributing underground economy are (a) maintenance of no formal accounts or no accounts, (b) huge non-banking transaction, (c) under-reporting of asset value, (d) illegal income, (e) tax incentives and exemptions, (f) weak enforcement, and (g) agriculture sector remaining outside tax net. To bring the underground economy to surface and under tax net, the National Board of Revenue (NBR) has taken up three prong strategy. They are (a) bring more people under tax net (b) investigate tax evasion (c) expand tax withholding. Imposition of withholding tax (TDS) plays an effective role in combating underground economy. The reasons are (a) income earned is likely to be invested, (b) invested assets generate income, (c) some assets need registration and tax can be effectively levied in return on such investment or its registration. Different government departments, local authorities, local government, banks, Universities, Companies are responsible to collect TDS. To ensure compliance of TDS tax, law made expenses inadmissible if not deducted. TDS with penalty may be collected from deductors. Tax authority may audit TDS. Quarterly return from deductors has been introduced. Collection from TDS has shown steady growth, In FY 2004-5 it was taka 33.50 billion. In FY 2009-10 it raised to taka 88.12 billion. TDS has contributed in the significant growth of revenue.

¹ The authors are, respectively, Chairman and Member (Income Tax Policy), National Board of Revenue.

It also supplemented growth of revenue from non-TDS tax. Automation of tax processes and capacity building of tax officials undertaken up by NBR is likely to enhance tax revenue as well as tax-GDP ratio.

1. Introduction

Bangladesh is a low-income economy of South Asia. With a territory of 147570 square kilometres, it is inhabited by about 150 million people. In FY 2008-09, Bangladesh had a GDP of US\$ 89.55 billion. The real GDP growth rate is 5.9 percent and per capita gross national income (GNI) is US\$ 690. In recent years, Bangladesh has achieved significant gain in human development. Bangladesh aspires to become a middle income economy by 2021.

Raising the tax-GDP ratio is a major fiscal challenge for the economy of Bangladesh. Bangladesh's tax-GDP ratio (9% of GDP in FY2008-09) is 3.5 percentage points lower than the average (12.5%) in developing Asian countries, and the lowest among its South Asian neighbours. This may largely be attributed to the existence of a pervasive underground economy in Bangladesh. However, the purpose of the paper is not to explore ways of raising taxes from the hidden economy but it explores the potential and also identifies the limits of withholding income tax as means of raising taxes from the income tax payers of the country.

The remainder of the paper is organized as follows. Section 2 highlights the dimensions of an underground economy and the salient features of some studies relating to the underground economy of Bangladesh. Information on the tax structure of Bangladesh is presented in Section 3. Section 4 deals with the different aspects of withholding income tax under the Income Tax Ordinance, 1984. Concluding remarks are given in Section 5.

2. The Underground Economy

2.1 Dimensions of an underground economy

An underground economy is the product of illegal economic activities, which are not reported in national accounts (Table 1). Even legally earned incomes become part of the underground economy if the income earner fraudulently evades the payment of taxes.

2.2 Studies on the underground economy of Bangladesh

The findings of available studies show the existence of significant underground economy in Bangladesh (Table 2).

Table 1: Dimensions of an underground economy

Illegal economic activities	Activities not reported in national accounts
Bribery, gambling, smuggling, drug dealing, extortion, work done by illegal immigrants, etc.	Tax evasion etc.

2.3 Factors contributing to the underground economy

Following are the major factors contributing to the tax-related underground economy in Bangladesh:

Table 2: Studies on the Underground Economy of Bangladesh

Name of author	Year	Estimates of the underground economy
Reza	1989	Exceeded one-third of the country's formal GDP in FY 1985-86
Bartlett	1990	Informal sector constituted 65 % of labour force in Dhaka in late 1980s
Hassan	1997	The underground economy averaged about 23.5% of the formal GDP during 1972 -1995
Asaduzzaman	1998	The average size of the underground economy was 21.4% of GDP in FY 1989 -90
Hossain	2003	The underground economy averaged 16.03% of GDP during 1974 -75 to 1999-2000 and 25% of GDP in FY 1999-2000
Austrian University	2003	The informal sector reached 34.9% of the official GDP in FY 2000 -01
Park	2005	The average size of the underground economy was 37.7% of the official GDP in FY 2001-02.

Source: Authors' compilation

- Large number of taxpayers maintain no accounts or non-formal accounts
- Large number of non-banking transactions (cash transaction or barter)
- Under reporting of asset values
- Illegal income remains unreported for obvious reason
- Tax incentives and exemptions leading to tax evasion
- Weak enforcement of laws
- Agriculture sector basically remains outside the purview of the tax net

2.4 Dealing with the underground economy

- National Board of Revenue (NBR) has taken measures to
- Bring more persons under tax net
- Investigate tax evasion cases
- Collect tax from the underground economy through withholding taxes.

3. Tax Structure in Bangladesh

Tax-GDP ratio in Bangladesh is the lowest in South Asia. Tax-GDP ratio in Bangladesh is given in Table 3.

The tax structure in Bangladesh shows the preponderance of indirect taxes over direct taxes (Table 4).

4. Withholding Income Tax

4.1 Potentials of withholding income Tax

The withholding of income tax (WIT) or tax deducted at source (TDS) scheme is the most pervasive measure realizing income taxes on a huge number of items.

Table 3: Tax-GDP Ratio in Bangladesh

Financial Year	Tax-GDP ratio
2004-05	8.60
2005-06	8.70
2006-07	8.30
2007-08	8.89
2008-09	9.0

Source: Government of Bangladesh (2009), Bangladesh Economic Review 009

Table 4: Tax Structure in Bangladesh (in billion Taka)

Financial Year	Direct Taxes	Indirect Taxes	Total
2004-05	58.27 (19.49%)	240.77 (80.51%)	299.04 (100%)
2005-06	74.23 (21.83%)	265.80 (78.17%)	340.03 (100%)
2006-07	90.50 (24.32%)	281.69 (75.68%)	372.19 (100%)
2007-08	121.80 (25.68%)	352.47 (74.32%)	474.27 (100%)
2008-09	142.73 (27.17%)	382.53 (72.83%)	525.26 (100%)

Note: Figures in parentheses indicate share.

Source: National Board of Revenue, Annual Reports (various issues)

The revenue potential of the WIT scheme is very high due to the following reasons:

- any income earned is likely to be invested or saved in some form;
- in many cases invested amount generates interest or return from assets;
- most assets need registration for ownership; and
- tax can be effectively levied on return of assets or at the time of registration.
- The underlying reasons for preferring WIT or TDS are:
 - (a) From tax administration perspective
 - It is an in-built machinery to collect tax where non-compliance is very high;
 - Through WIT, taxes are being collected from organized small number of tax-points rather than from many informal taxpayers from diverse locations;
 - Information regarding parameters of income is also collected in the process for using in future assessment or audit; and
 - Government exchequer gets year-round revenue rather than seasonal revenue.
 - (b) From taxpayers' perspective
 - Easy to pay as taxpayers earn and avoid time-consuming tax deposit to selected banks or treasury;
 - Less pressure on cash flow at the end of the year for reduced tax liability at the time of filing return; and
 - Avoiding arbitrary estimate of income by tax administration.

4.2 Authorities responsible for tax withholding program

Following government or semi-government or autonomous bodies and corporate entities, non-government organizations (NGOs), institutions and in some cases individuals paying the money are working as the withholding agents:

1. Government
2. Director General, Bureau of Manpower, Employment and Training
3. Permitting authority (issuing any permission or renewal of permission for manufacture of bricks)
4. 5.Registration authority (registering any document for transfer or any land or building or apartment)
5. City Corporation or Paurashava
6. Commissioner of Customs

7. Authorized authority (authority duly authorised for a particular purpose, say, for shipping business of a resident under section 53AA)
8. Chief Executive Officer of stock exchanges
9. Company or its principal officer
10. Bank or insurance company or cooperative bank
11. Issuers of securities (Government or companies)
12. Sellers of banderols to any manufacturer of cigarettes
13. Employer (in case of foreign technician serving in diamond cutting industries)
14. Non-government organization (NGO)
15. Film producer
16. Chief executive of any trust
17. University or medical college or dental college or engineering college
18. Auction seller

4.3 Transactions subject to tax withholding

Under the Income Tax Ordinance, 1984, 8 items were subject to withholding income tax (WIT) under 7 sections. From 1998-99, a new provision was introduced with respect to the withholding income tax, which was the 'final discharge of tax liability' (FDTL) under section 82C. From 2001-02, every person required to deduct or collect tax at source (WIT) has been given a tax collection account number under section 184BB and the WIT is the 'final discharge of tax liability' (FDTL). As on July 1, 2009, there are 43 items under 40 sections [2 items u/s 52 and 3 items u/s 52A] subject to withholding income tax (WIT). Besides, 3 more items have been included in the list of withholding income tax by issuing SROs.

4.4 Ensuring tax withholding

- To ensure functioning of tax withholding, the following provisions have been incorporated in income tax code:-
- The related expenditure is not admissible while determining its income if the deduction is not made or the deducted amount is not deposited [section 30];
- The amount deductible plus interest @ 2% per month can be recovered from the paying/ registering authority [section 57];
- Tax authority is empowered to audit tax deduction [section 117A].

4.5 Revenue performance of the withholding income tax scheme

Withholding income tax contributes substantially to total income tax revenue of the government (Table 5):

Table 6 has enumerated 17 individual WIT items from which 95 percent of total WIT was collected in 2007-08. Of these 17 items, first 5 WIT items yielded 75 percent of total WIT and first 10 items yielded around 90 percent of total WIT.

4.6 Limits of withholding income tax

- Income of illegal economy remains outside the mainstream
- Presence of informal accounting records
- Presence of cash basis of transaction
- Inadequate capacity building in tax department
- Lack of incentive of tax deducting authorities

Table 5: Contribution of withholding income tax in income tax revenue:

Financial Year	Withholding income tax	Total tax collected	%
2004-05	33.5	55.8	60.04
2005-06	40.1	71.6	56.01
2006-07	51.6	87.2	59.17
2007-08	61.8	117.4	52.64
2008-09	86.7	138.6	62.55

Source: National Board of Revenue, Annual Reports (various issues)

5. Concluding Remarks

The withholding income tax (WIT) has helped significantly in raising the income tax but the problem is to bring the indirect taxpayers through this scheme into formal legal channel through submission of income tax return. Still the scheme has been working with high revenue success due to the counter provision of 'final discharge of tax liability' (FDTL).

Along with withholding taxes, the following policy recommendations are made to tax the activities of the underground economy:

- Implementing the reform agenda initiated at the NBR;
- Simplification and fully automating tax collection system under a central database;

Table 6: Item-wise Revenue Performance of WIT
(Figures in million Taka)

Sl.	Head of withholding	2003-04	2004-05	2005-06	2006-07	2007-08	
						Amount	%
1	Contractors/Suppliers Interest on Saving	9,257.2	11,088.0	13,354.8	12,906.7	16,317.6	26.4
2	Deposits and Fixed Deposits	5,122.8	6,228.8	7,070.8	9,183.0	11,129.5	18.0
3	Import of Goods Interest on	6,047.6	6,097.3	6,720.0	7,911.7	10,442.1	16.9
4	Securities/Treasury Bond	3,113.1	1,709.9	3,172.5	9,103.2	4,371.9	7.1
5	Transfer of Property	1,071.1	2,119.4	2,387.3	1,714.7	4,230.9	6.9
6	Salaries	745.6	1,580.9	1,329.3	2,485.6	2,804.2	4.5
7	Dividends	163.2	252.4	31.3	2,969.6	2,379.9	3.9
8	Exporters Distributors'	0.0	3.6	640.4	951.7	1,522.6	2.5
9	Commission or Fees	229.3	254.1	472.0	420.4	1,311.9	2.1
10	Export of Manpower	155.4	131.1	191.6	91.7	768.1	1.2
11	Interest on Bank Deposit	0.0	1.6	63.0	172.4	730.3	1.2
12	Indenting Commission or Shipping Agency Commission	169.5	362.6	272.9	427.8	596.8	1.0
13	Professional Fees or Technical Services Fees	42.6	0.0	128.2	130.0	560.1	0.9
14	Insurance Commission	37.4	100.2	72.3	167.0	558.7	0.9
15	House Rent	104.6	246.3	245.6	462.1	391.2	0.6
16	Commission of Letter of Credit	0.0	0.0	172.7	335.8	337.6	0.5
17	Remuneration of Film Actors and Actress	1.3	2.6	98.8	0.0	240.1	0.4
18	Others	2,672.5	3,321.2	3,695.9	2,116.3	3,062.4	5.0
	TOTAL SOURCE TAX	28,933.2	33,500.0	40,119.4	51,549.7	61,755.9	100.0

- Launching continuous taxpayers' awareness programs for broadening tax-net;
- Enhancing the capability of the NBR officials for combating tax evasion;

- Rewarding the taxpayers who pay considerable amount of taxes so that other people feel encouraged to pay taxes; and
- Establishing tax information management and research centre to collect income related information of taxpayers from both primary and secondary sources.

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