Research Design Document
on
TAX POLICY AND ENTERPRISE DEVELOPMENT IN SOUTH ASIA
Bangladesh Case Study

Institutional Information

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THEME 1: THE IMPACT OF TAX EXEMPTIONS AND CONCESSIONS ON ENTERPRISE DEVELOPMENT

Literature Review: Data Source & Key Knowledge Gaps

Tax Exemptions and Concessions: Bangladesh, like other developing countries, provides various supports to major and emerging industries with a view to enhance industrialisation in the country. Tax exemption and concession related measures are provided under the directives of *Industrial Policy 2010*, *Export Policy 2009-12*, *Import Policy Order 2009-12*, *SME Policy* and Fiscal Policy. According to Mortaza and Begum (2006), there were a total of 106 measures under direct (55 measures) and indirect taxes (51 measures) for providing various kinds of tax exemptions and cash incentives. Direct tax exemptions/incentive measures are: tax holiday, exemptions and deductions, tax rate reductions, deferrals, tax credits and others; on the other hand, indirect tax measures are: exemptions and deductions. Tax holiday facility is provided to newly set up firms, physical infrastrucutre, tourism etc.; where as exemptions and deductions are applicable to enterprises located in EPZs, power generation companies, agriculture related industry etc.; on the other hand, concessionary rate is applicable to textile, jute industries and those who do not enjoy tax holiday facility. SMEs in Bangladesh enjoy tax waiver in case of turnover for up to Tk.7 lakh and provide reduced taxes for turnover up to Tk.24 lakh at a rate of 2 per cent, up to Tk.60 lakh at a rate of 3 per cent and for above 70 lakh at a rate of 15 per cent. The amount of minimum package VAT applicable for small business has been increased from Tk 6,000 to Tk. 9,000 in the national budget FY13. Exemption of VAT includes products under the categories of food and agriculture, poultry, and agricultural inputs etc.

Contrary to Bangladesh, major tax exemptions in India and Pakistan in case of direct taxes are: infrasrture development, SEZs and scientific research etc; while in case of indirect taxes major exepmtions are applicable to small-scale industry, fertiliser, agriculturat products, pharmaceutical products, IT, constructions materials, toruism, energy sector and exploration of companies (Mortaza and Begum, 2006). Both India and Paksitan appear to use tax exemptions for small enterprises on a targeted manner. An analysis of 40 developing countries studied in 1990 found that 50 per cent countries used temporary tax expenditures in order to attract investment, 31 per cent granted tax incentives for enhancing exports, 40 per cent used reduced taxation rates and 18 per cent had free trade zones to increase trade (Intriago, 2011).

Major institutions which deal with tax exemptions and incentives in Bangladesh such as National Board of Revenue (NBR), Tariff Commission, Ministry of Commerce, and Bangladesh Export Processing Zone Authority (BEPZA) have information on tax structure and its changes over the years. However there is no enterprise-level information available to these organisations particularly number of enterprises enjoyed those facilities every year, their sector wise, location-wise distribution etc. Even there was no impact assessment for the government in order to appreciate its necessity, required changes, institutional weaknesses and challenges to implement these measures etc. Recently NBR has carried out such study; however, the focus of the study and its findings are not made public so far. Centre for Policy Dialogue (CPD) has carried out a perception survey to understand the rationale, selection criteria and the impact of tax exemptions and other support measures on the development of enterprises. It is found that there are concerns as regards rationale, justification and criteria for selection of sectors/enterprises, period for which those support measures are provided and bureaucratic hassles to get the benefit etc (Moazzem, et al., 2012).

Tax Expenditures: Tax expenditure in Bangladesh is accounted for a significant share of GDP which is to the tune of 2.52 per cent in 2006; major share of the expenditure is related to indirect taxes (88 per cent of total expenditure) particularly value added taxes at domestic and import stage (63 per cent and 19 per cent of total tax expenditures in 2006). The overall tax expenditures are widely varied between countries- for example, tax expenditures in India and Pakistan are accounted for 4.5 per cent and 0.4 per cent of GDP in FY2005 respectively (Itriago, 2011; Mortaza and Begum, 2006). Moreover, distribution of tax expenditure is also not same- the share of indirect taxes in India and Pakistan is 55 per cent and 82 per cent of total tax expenditures in FY2005. There are year on year fluctuations in the tax expenditure depending upon the changes in the coverage of sectors and enterprises eligible for those support measures. In Bangladesh disbursement of cash incentive (in nominal term) has increased from Tk.800 crore to Tk.1500 crore between FY2007 and FY2009 (Bakht & Ahmed, 2011).

There is no information available on distribution of tax expenditures in terms of categories of firms in Bangladesh. Such information is important to understand the possible impact of various tax expenditures on the dynamics of growth of different categories of enterprises and also to understand the possible implications on the enterprises which are outside the tax net and are not eligible for those exemptions and incentives. Needless to say, gender focused information on tax expenditures are also not available.

Biasness of Tax Expenditures: SMEs operating in the undocumented economy face different kinds of biasness in case of tax expenditure provided to the enterprises of the organised sector. This may happen in number of ways which include non-eligibility of undocumented SMEs due to lack of formal registration, exclusion of certain SME-oriented sectors from the preference list, and exclusion of SMEs located outside preferential areas (EPZs and SEZs). SMEs may be disproportionately affected further due to poor institutional mechanism to ensure compliance requirements of firms. Mortaza and Begum (2006) reported that exemptions of salaries of foreign technicians working in local firms often fraudulently done to extend the exemption benefits illegally. Similarly, tax exemptions provided to illegal income for investment in certain sectors distort the practice of equity which is likely to be maintained through the tax system. Tax holiday facility has been misused by entrepreneurs of different sectors (Mortaza and Begum, 2006) which also have adverse impact on small enterprises. On the other hand, there are certain provisions in the tax exemptions which are particularly targeted to the SMEs such as waiver/reduced tax in the turnover of small enterprises, application of package VAT for small businesses and waiver of VAT at domestic stage etc. Despite various institutional measures, a large part of small enterprises are operating outside the formal organized institutional structure without having registration, license, tax identification number (TIN) and other necessary documents. These undocumented/informal enterprises are usually not eligible for any government incentives and supports including tax waiver and other incentives. At the same itme, these enterprises may not be interested to get such benefits in order to avoid high costs for becoming eligible and compliant.

Biasness of tax expenditure is discussed on developing countries focusing on the nature and extent of biasness on small enterprises. Beck, Kunt and Maksimovic (2005) studied the impact of subsidy provided to different categories of 4,000 firms in 54 countries and found that small firms are disproportionately affected due to lack of subsidy. Boadway, Flatters and Wen (1996) analyse the effectiveness of investment incentives for new firms in Thailand, and found it relatively unfavorable to small firms. Pope and Abdul–Jabbar (2008) discussed the

tax compliance burden for SMEs in Malaysia, and found that performance of enterprises is significantly affected by the existing financial, legal and regulatory framework within the economy. Complex rules and regulations is another important factor for SMEs for not being compliant (IFC, 2007). Khan (2010) has identified constraints experienced by SMEs due to complex regulatory framework prevailing in Bangladesh and suggested for simplification in the tax procedures and rationalization of tax rates for SMEs. Khan, Azim and Muzaffar (2004) has analysed impact of income tax regulations for new entrepreneurs of Bangladesh and showed that these regulations are not favourable in facilitating new investments and inducing new entrepreneurs to setting up businesses. Most of the incentives are mutually exclusive, and number of tax incentives has increased over the years which increase the complexity of the tax laws and increase the tax compliance costs (Abdul-Jabbar and Pope, 2008). It is claimed that a simple tax system is more favorable to small business instead of too many special provisions, which actually increase complexity in the tax system (Freedman, 2003). Huq and Moyeen (2006) explored how the gender issues have been reflected in the available business development services in Bangladesh. However, there is dearth of information about the issue of biasness of incentives and exemptions for enterprise development in Bangladesh especially those operated by women entrepreneurs.

Impact of Tax Exemptions and Concessions on SMEs: Statutory tax provisions may not always considered sufficient to understand the impact of tax provisions on SMEs. Literatures show the impact of tax provisions along with regulatory practices and monetary measures on firm's productivity and profitability (Beck, T, A.D. Kunt, and V. Maksimovic, 2005). It is found that smaller firms are more affected by the financing and other regulations compared to that of large firms. Because of being non-compliant, SMEs may be affected if a VAT exempted firm could sell the product at the same price as that of the non-compliant firm (IMF, 2007a). It is said that a heavy enforcement focus on large firms may induce some firms to operate below the threshold level in order to avoid taxes. However, there is no available information with regard to impact of tax exemptions and incentives on SMEs particularly on their productivity, efficiency and profitability.

Impact of Biased Tax Regimes on Emigration of Entrepreneurs and Skilled Labour: In the context of Bangladesh, the relationship between biasness of tax regimes and emigration of entrepreneurs and skilled labourers in the form of 'brain drain' perhaps not so strong. Such relationship is found be significant in case of Pakistan (Dawn, October, 2004). There is anecdotal information with regard to changing professions and become wage workers (both at home and abroad) perhaps because of high cost for maintaining tax compliance of the enterprise.

Overall, there is dearth of firm-level information about incidences tax exemptions and cash concessions in Bangladesh. Similarly, there is no breakdown of tax expenditures in terms of sectors, size and location of firm etc.; information on tax expenditures is available only at a gross level. The biasness of tax exemptions and incentives and their impact on productivity and efficiency are not considered seriously by the policy makers of Bangladesh, and therefore those are less discussed issue here. Thus the nature, extent and types of impact and implications of tax exemptions and incentives on SMEs/unorganized sectors as well as on female-operated enterprises are almost unknown. Present study will attempt to fill a part of the knowledge gap on tax incidences and entrepreneurship development in the context of Bangladesh.

Conceptual and Theoretical Framework

There are four key research questions to analyse the structure and composition of tax exemptions and incentives in Bangladesh and their impact and implications on SMEs/undocumented enterprises. Each of the research questions could be divided into several sub-questions in order to answer all related aspects. Following are the key questions and related sub-questions.

Research Questions

a. What is the extent to which small enterprises face biases in tax exemptions and concessions?
   - What are provisions of tax exemptions and concessions currently applicable to different categories of firms in Bangladesh? Are there specific exemptions and incentives for SMEs?
   - What is the total tax expenditure of Bangladesh? Is it increasing over the years? Which are the major forms of tax expenditures?
   - How different is the structure and composition of tax exemptions and concession structure of other developing countries particularly those of South Asia? What is the total tax expenditure in other developing countries? Is it increasing in those countries?

   - What is the perception of the SMEs with regard to the compliance requirements, complexities of the tax structure of Bangladesh? How much is the compliance cost for SMEs?

b. What is the extent to which these biases disproportionately impact small enterprises operating in the undocumented economy and/or those owned/managed by women?
   - What is the nature and extent of biasness of tax expenditures in Bangladesh? What is the distribution of tax expenditures in terms of size, location and type of firm?
   - Which issues of compliance in the tax system are of particular consequence to small business?
   - What specific initiatives government should take to minimize compliance problem for small business?
   - Does the existing structure of tax expenditure and concessions have disproportionate impacts on women working in the informal entrepreneurs?

c. What are the impacts of tax exemptions and concessions on entrepreneurs and SMEs in terms of enterprise performance and productivity, (including any disproportionate impacts on women informal entrepreneurs)?
   - What are the likely impact of exemptions and concessions on different categories of firms in case of their sales and earnings?
   - What are differential impacts of different kinds of exemptions and concessions on different kinds of firms?

d. What are the impacts of biased tax regimes on emigration of entrepreneurs and skilled labour, the extent to which this contributes to 'brain drain' in South Asian countries?
   - Are the small entrepreneurs shifting from one sector to another due to biasness in the tax exemptions and concessions, high compliance cost and complex tax structure?
   - Do the entrepreneurs quit and work as wage labourers due to biasness in tax exemptions and high compliance cost etc.?

Key Concepts and their Translation into Measurable Parameters

Definition of Firm: The target group of enterprises needs to be defined well and thereby needs to be translated into measurable parameters. There are a number of groups which are close to undocumented/unorgansied sectors. It is often called informal sector in Bangladesh. Unfortunately, there is no official definition on 'undocumented'/ 'unorganized'/ informal sectors of Bangladesh and there is no secondary data available on these enterprises. Available information is mostly on SMEs, which covers both documented and undocumented enterprises. The definition of SMEs as mentioned in the Industrial Policy is not followed by other implementing agencies such as (Bangladesh Bank, World Bank etc.). The definitions are varied for using different benchmark level in case of size of employment, land and other assets and volume of sales etc. Thus a working definition of target group of enterprises needs to be decided for the study in order to ensure consistency in different thematic parts. For convenience, only enterprises operating in the manufacturing sector will be taken into account for this study. More over the differences in the definition at the cross-country level should be addressed properly.

Tax Exemptions and Concessions: All kinds of tax exemptions and concessions which are officially entitled by different categories of firms will be considered for analysis. Thus non-tax monetary support such subsidized credit provided to different categories of firms will not be taken into consideration for this study. Tax exemptions and incentives need to be calculated in terms of size, location and type of firm etc.

Tax Expenditures: Tax expenditure is defined as the revenue forgone due to reduction of tax from the benchmark rate. Tax expenditure will be estimated in terms of size, type of firm and location of firm etc.

Compliance Cost: Compliance cost is defined as the burden that enterprises face in terms of time and expenses involved in meeting their tax obligations. There are three major components which are included in the compliance cost, namely money costs, time costs and psychological costs to the taxpayers (e.g. Pope et al. 1991, p.7, Sanford et al., 1989; IMF 2007b). Monetary costs include the amount spent on tax professionals such as tax agents and accountants and expenses which are relating to taxation guide, books, communication and other incidental costs. Time cost is incurred by the taxpayer, usually on record keeping for tax purposes, completing tax return and/or in preparing tax details for the tax professionals as well as time spent on dealing with the tax authorities. The effects upon a taxpayer having to deal with his/her tax affairs include in the last component of the compliance costs, psychological costs.

Marginal Effective Tax Rates: Marginal effective tax rate (METR) indicates how the tax system affects incentives to invest. The METR is actually the share of investment's pre-tax required rate of return needed to cover the tax cost. According to Stern and Barbour (2005) METR measure four types of distortions which are caused by business taxes: the higher the METR the greater the disincentive to invest (i.e. inter- temporal distortion); it may vary across industries (i.e. inter-sector distortion; may vary across types of capital (i.e. asset distortion) and across jurisdictions (i.e. inter-jurisdiction distortion).
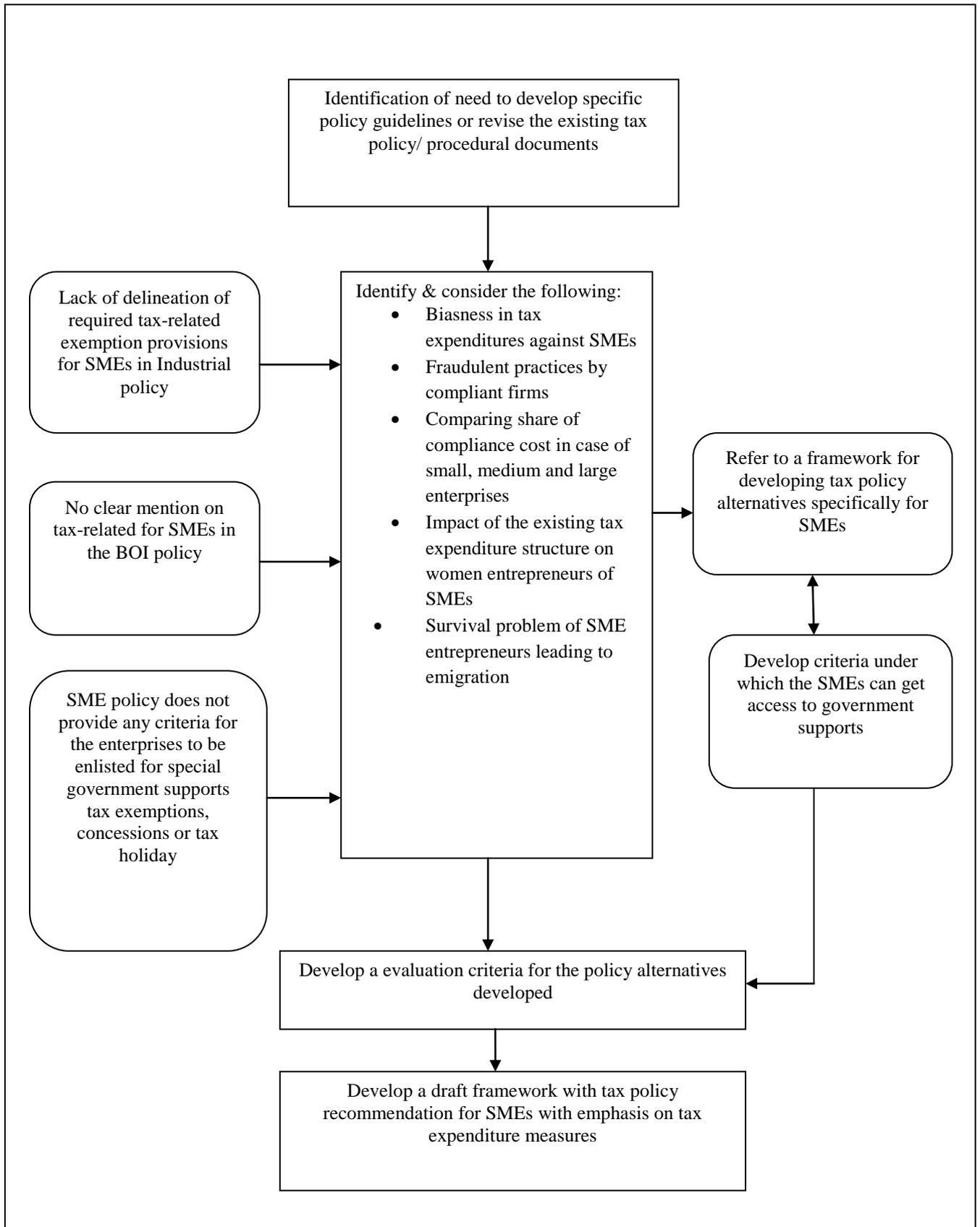
Hypothesized Relationship among Parameters

a. Tax exemptions and concessions are disproportionately favoured large enterprises particularly operate for the export markets. Tax exemptions for small enterprises are limited and are not sufficient enough to outweigh the disproportionate benefit enjoyed by large enterprises.
b. The burden of tax exemptions and concessions might be higher for small enterprises if those benefits are illegally used by large enterprises for a long period of time.
c. Tax exemptions and concessions may adversely affect small firm's sales, productivity and income if they are not entitled to those benefits.
d. The high cost of tax compliance might discourage small firms to operate outside the tax net.
e. Female-headed small enterprises may more affected compared to those of male-operated small enterprises due to the biasness in the tax exemptions and tax concessions.

Analytical Framework

Policy Analysis Framework

The study will analyse the existing policies regarding tax expenditure of the Bangladesh. This analysis will help to identify the weakness of the existing policy structure in order to ensure long term development of enterprises and entrepreneurship in Bangladesh. Figure 1 shows the policy analysis framework to be developed from this study. The policy analysis framework will include the problems identified within the existing policies that are incapable of providing guidelines for extending support to the SMEs. It would further include the features of the existing tax regime that is assumed to be biased against the SMEs, focus will also be given to the women entrepreneurs and the small entrepreneurs incapable of surviving in the competitive market. The policy analysis will develop a framework with relevant alternative policy measures for the growth of small enterprises and the framework would finally suggest some recommendation for the development of these enterprises.

FIGURE: POLICY ANALYSIS FRAMEWORK

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                          ┌─────────────────────────────────────┐
                          │ Identification of need to develop    │
                          │ specific policy guidelines or revise │
                          │ the existing tax policy/ procedural  │
                          │ documents                            │
                          └─────────────────────────────────────┘
                                          │
                                          ▼
┌──────────────────────┐    ┌─────────────────────────────────────┐
│ Lack of delineation  │    │ Identify & consider the following:  │
│ of required tax-     │───▶│  • Biasness in tax expenditures     │    ┌──────────────────────┐
│ related exemption    │    │    against SMEs                     │    │ Refer to a framework │
│ provisions for SMEs  │    │  • Fraudulent practices by          │───▶│ for developing tax   │
│ in Industrial policy │    │    compliant firms                  │    │ policy alternatives  │
└──────────────────────┘    │  • Comparing share of compliance    │    │ specifically for     │
                            │    cost in case of small, medium    │    │ SMEs                 │
                            │    and large enterprises            │    └──────────────────────┘
┌──────────────────────┐    │  • Impact of the existing tax       │              ▲
│ No clear mention on  │───▶│    expenditure structure on women   │              │
│ tax-related for SMEs │    │    entrepreneurs of SMEs            │              ▼
│ in the BOI policy    │    │  • Survival problem of SME          │    ┌──────────────────────┐
└──────────────────────┘    │    entrepreneurs leading to         │    │ Develop criteria     │
                            │    emigration                       │    │ under which the SMEs │
┌──────────────────────┐    │                                     │    │ can get access to    │
│ SME policy does not  │    │                                     │    │ government supports  │
│ provide any criteria │───▶│                                     │    └──────────────────────┘
│ for the enterprises  │    │                                     │              │
│ to be enlisted for   │    │                                     │              │
│ special government   │    │                                     │              │
│ supports tax         │    │                                     │              │
│ exemptions,          │    │                                     │              │
│ concessions or tax   │    │                                     │              │
│ holiday              │    └─────────────────────────────────────┘              │
└──────────────────────┘                  │                                      │
                                          ▼                                      │
                          ┌─────────────────────────────────────┐               │
                          │ Develop a evaluation criteria for    │◀──────────────┘
                          │ the policy alternatives developed    │
                          └─────────────────────────────────────┘
                                          │
                                          ▼
                          ┌─────────────────────────────────────┐
                          │ Develop a draft framework with tax   │
                          │ policy recommendation for SMEs with  │
                          │ emphasis on tax expenditure measures │
                          └─────────────────────────────────────┘
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Analytical Approach
The study will firstly identify the existing tax expenditure measures provided to the enterprises under different laws and regulations. These expenditures will be categorized according to the firms of three categories of small, medium and large. The complexities of tax structure and biasness of tax exemptions and concessions which led SMEs to operate outside the tax net is a major area of focus of this analysis. The compliance cost will be estimated with respect to three cost component. The study will estimate the biasness of tax expenditures in case of small and undocumented enterprises through analyzing firm level data to be collected by field survey. The impact and implications of existing tax expenditure measures on the enterprise development particularly on sales and income of SMEs and undocumented enterprises will be analysed through econometric tools and techniques. In the study compliance cost estimation will follow similar approaches used by earlier studies in other countries. Based on the analysis, the study would like to suggest alternative policy tools in order to undertaken necessary reforms in the tax structure to reduce the biasness on SMEs.

Analytical Tools and Techniques
A number of analytical tools will be used to find the impact of tax expenditure measures on the entrepreneurs of SMEs and women entrepreneurs. We discuss below the various tools to be used for our analysis in steps according to the research questions formulated for the study.

Revenue foregone
Revenue foregone method is the most reliable method for estimating the level of assistance the tax system providers to taxpayers. Tax expenditure literature usually presents three different approaches to estimate the cost of tax expenditures and the approaches are revenue foregone, revenue gain and outlay equivalence method. Revenue forgone is a static estimate of the loss of tax revenue. The cost of a tax allowance can be obtained by the product of tax rate and the observed amount of the allowance. The revenue foregone is available on the expenditure side of the government budget.

In case of Value Added Tax (VAT)
Usually an input and output table is used to estimate tax expenditure under VAT. For unavailability of data, VAT expenditure can be calculated as an aggregate basis using information obtained from returns submitted by VAT registered persons or enterprises.

Tax Expenditure under Customs Duty (CD) and Excise Duty (ED)
Tax expenditure of customs duty is revenue foregone from exemptions provided to importers. It can be expressed as the difference between customs duty payable and the amount actually paid. Again excise duty is applicable to both imported and locally manufactured goods, which include mainly motor vehicles, petroleum products, cigarettes, alcoholic beverages and plastic products.

In case of ad valorem rate under Customs Duty, the calculation can be written as:

Revenue foregone = Value × (Tariff rate of duty – Effective rate of duty)

Revenue forgone = (volume of imports × the tariff rate applicable) – customs duty paid

In case of ad valorem rates under Excise Duty
Revenue forgone = (value of imports/value of locally manufactured goods × the tariff rate applicable) – excise duty paid

Compliance Cost
Compliance costs of taxation are costs which are incurred by taxpayers, including their tax liability, for conforming to the tax requirements or otherwise businesses incur costs to obey with tax requirements, which are additional to their tax liability. There are three major components which are include in the compliance cost, namely money costs, time costs and psychological costs to the taxpayers (e.g. Pope et al. 1991, p.7, Sanford et al., 1989, pp 11-12).

Regression Analysis
Regression analysis will be carried out as follows.
With regression estimate we observe the effects of various tax expenditures on the firms of three categories, small, medium and large. In addition to the various tax expenditure measures, other factors affecting the performance of firm are included in the regression model. A tentative model is proposed based on Beck, Kunt and Maksimovic (2005) which is as follows:

Firm Performance= β_1 Exporter+ β_2 Subsidized+ β_3 Inflation+ β_4 Tax Holiday* Small+ β_5 Tax Holiday* Medium+ β_6 Tax Holiday* Large+ β_7 Duty Waiver* Small+ β_8 Duty Waiver* Medium+ β_9 Duty Waiver* Large+ β_{10} Number of Measures* Small+ β_{11} Number of Measures * Medium+ β_{12} Number of Measures* Large+ β_{13} Tax rate reductions* Small+ β_{14} Tax rate reductions* Medium+ β_{15} Tax rate reductions* Large

Firm performance is the percentage change in firm sales over the past several years. Exporter is included as dummy variable in the model indicating if the firm is exporting or not. Small, Medium and large are dummy variables. They take the value of 1 if the firm is small (or medium or large) and 0 otherwise. Inflation is the log difference of the consumer price index. Number of measures would include the number of tax expenditure measures in case of two broad categories of direct and indirect taxes. The variables of tax holiday, duty waiver and tax reduction rate are included in the model as amount of the expenditure given to the firms for the three categories of firms including small, medium and large.

THEME 2: THE IMPACT OF THE VALUE-ADDED-TAX (VAT) ON ENTERPRISE DEVELOPMENT

Literature Review

In Bangladesh SMEs are recognised as one of the most important drivers of poverty reduction (Bhattachrya and Khan, 2008 and Murgai and Zaidi, 2005). Non-farm SMEs also played an important role in accommodating rising demand for employment opportunities which also helped to achieve structural changes during 2000s (Rahman et. al. 2011). However, development of SMEs is often affected by taxes such as the Value Added Tax (VAT). Bangladesh has one of the lowest revenue-GDP ratios (12.6 per cent in FY2012) in South Asia. Moreover, the revenue generation is highly dependent on indirect sources, such as VAT. In recent years significant efforts have been given to raise the revenue-GDP ratio by the government. As a result the distributional impact of fiscal policy is often not taken into consideration (CPD, 2012). Indeed, the tax structure in Bangladesh is found to be regressive (Khatun, Khan and Nabi 2012). As SME development is adopted as one of the core policy objectives of the ongoing Sixth Five Year Plan (SFYP), the impact of VAT on SME development needs to be reviewed cautiously.

The regeneration of the old Sales Tax Act 1951 had initially been done through injunction of Sales Tax Ordinance 1982, effective from FY1982. Draft of VAT Act 1990 was prepared keeping a provision to introduce a single rate VAT system at import and manufacturing stage under the tax reform agenda. The Parliament House proclaimed the final version of the VAT Act as a bill in mid-1991. The bill came into effect as Value Added Tax Act 1991 from July 1991. Since then VAT remains the single largest source of revenue from the government. About one-third of the total government revenue is collected in the form of VAT in Bangladesh. The key authority to collect mostly all the taxes, including VAT in Bangladesh is the National Board of Revenue (NBR); it collects almost 75 per cent of the total revenue. At present, VAT is collected on manufacturing goods and services both at import and local stage. It also needs to be mentioned that VAT has been exempted for a number of necessary items. Furthermore VAT is zero-rated on exportable goods to support export oriented sectors. Hence, it has estimated, NBR collected just 61.0 per cent of potential VAT in FY2009 (Faridy and Sarker, 2011).

VAT Act 1991 is going to be replaced by new VAT Act 2012 to add a number of major reforms to remove austerity and maintain uniformity in the current VAT regulations. A draft of this new VAT Act has already got approval from the Cabinet and will be placed before the parliament any time soon. The new VAT Act is expected to come into effect from 1 July 2015. However, during the last three years a number of adjustments were made in the present VAT law as part of preparing the relevant stakeholders for the proposed new one. The NBR is also implementing a 5-year strategic plan starting from 2011 to encompass a common goal of modernisation of the NBR. The area of modernisation plan includes digital NBR agenda, reform in business processes, different tax policy reform, improvement in tax compliance and tax services and, overall capacity building and institutional development of the NBR. These institutional reforms will also have a significant impact on tax compliance of SMEs. Thus assessing the impact of VAT provisions and its institutional aspects on SME development have a long-term policy relevance for Bangladesh.

Data sources

NBR remains as a core source of data and information. NBR prepares the VAT collection data. NBR along with Ministry of Finance (MoF) will also be source of VAT provisions and regulations.

As a non-profit organisation, SME Foundation established through a gazette notification in 2007 under *Companies Act (Act XXVIII), 1994* and registered with both the Ministry of Industries and the Registrar of Joint Stock Companies and Firms with a vision to promote SMEs for alleviating poverty, generating employment and thereby accelerating economic growth. SME Foundation publishes periodical reports on SME.

Economic Census 2001/03 is the most recent full-fledged statistics of industries at national level. The latest Survey on Manufacturing Industries 2005-06 (SMI 2005-06) will also be a major source of information on SMEs. Moreover, Manufacturing Industries Survey 2012 (MIS 2012) being conducted by Bangladesh Bureau of Statistics (BBS) will shed light on a number of aspects of SMEs in Bangladesh.

The latest input-output (I-O) table for 2007 will be required to carry out VAT incidence. At present I-O table for 2007 prepared by the Planning Commission of Bangladesh is available. The I-O table for 2007 includes 86 sectors in the economy.

Key knowledge gaps

As mentioned earlier, the preparation of VAT provisions in Bangladesh often undermines the implications on SME development. Through progressivity analysis it is required to undertake the impacts on VAT burden on SMEs' performance and productivity. At the same time compliance cost and institutional bottlenecks often prohibit SMEs to comply with tax provisions. It can be argued that presence of indirect taxes such as VAT can drive small entrepreneurs toward non-compliance with the taxation system, particularly when compliance cost is high and cumbersome (Spiro1993). This also creates barrier for SMEs to access various policy supports provided by the government including targeted credits at a lower interest rate. Indeed, the fiscal policy framework often creates barriers for mainstreaming SMEs' economic activities and their contributions to national economy. While crafting policies these aspects require careful consideration. Since evidence cased research in this area is not available, policymakers in Bangladesh also face constraints to accommodate special attentions needed by the SMEs. At the same time a study can also provide South Asian experience and best practices for crafting VAT policy for SME development.

Conceptual and Theoretical Framework

Research questions

The study is expected to focus on the issues of small and medium enterprises growth, development and their sustainability. Indeed it can also incorporate the unavoidable issues of revenue generating tax policy measures with SME development, an important driver for poverty reduction and employment generation.

The study will essentially concentrate to explore the impacts of VAT burden on SME developments and its coherence. Priority choice would be to construct a progressivity measure of compliant small enterprises under existing VAT law compared to that of a non-compliant one (those operating out of tax-net). The inherent research question would be whether the existing VAT regulations are instrumental or detrimental towards the desired growth of SMEs, their sustainability and their productivity- in terms of creating job opportunity and income generation.

Alongside the study will also seek the behavioural response of the VAT administration system towards small businesses. Particular focus will be given to women headed small enterprises operated in the undocumented economy. Impact of discrimination (if any) by the system regarding the growth of small firms will be a matter of policy interest. Opportunity costs to create productive job that emerged from unfriendly tax rules and high compliance cost will also be addressed.

For further enquiry, it would have been interesting to measure the degree of departure arise from administration's side towards large firms and small enterprises. While implementing a major VAT reform in Bangladesh, an analysis on the impact of changes on creating productive job and inclusive growth by small enterprises captured by the proposed changes in the Act will also be assessed.

Overall, the study will seek answers of two broad research questions:

1. What are the progressivity impacts of VAT burden on small enterprises in Bangladesh and how do they affect enterprise performance and productivity?

2. How are entrepreneurs, particularly those owning/managing small enterprises in the undocumented economy of Bangladesh, especially women entrepreneurs treated by VAT administration systems, against indicators of compliance costs and taxpayer friendliness, and how does this treatment affect enterprise performance and productivity?

Definitions of key concepts and their translation into measurable parameters of enquiry

Enterprise: the enterprise is the administrative and financial decision making unit of an establishment. For a single establishment, the enterprise and establishment is the same. But there may be more than one establishment under a single enterprise. The enterprise is a legal entity of corporate and quasi corporate bodies. An enterprise may provide service or goods both manufacturing and finished as its outcome. Prolifically an enterprise produces non-firm activities.

SME: The definition itself of SME varies widely across countries, even within the trans-boundary or even it could be time variant (UN 2009). While defining an SME some countries just use the number of employees as the sole criterion. Other countries add criteria of either the value of the firm's assets or the size of revenues it gathered. In Bangladesh definition of SME varies among the relevant institutions. The present study will accept the definition of present VAT Act.

VAT: The present VAT Act covers three types of taxes – turnover tax (particularly relevant for SMEs), VAT and supplementary duties. There is a provision of exempting VAT for cottage industries will also be considered during the study.

Employment: The study will define employment as the services provided by employed person(s) in full time basis. To measure progressivity of small enterprises, employment generation capacity can be regarded as one of the key parameters of choice. Any unpaid household labour or any sort of unpaid apprenticeship will not be considered as employment.

Hypothesized relationships between parameters
Economic development in developing countries critically hinges on high economic growth with meaningful employment. However, there is a growing realisation and empirical evidence, that economic growth alone may not guarantee the desired objective of growth with equity (Islam 2004).

It is evident that, a large proportion of small enterprises operate in undocumented or underground economy in developing countries such as Bangladesh being non-tax compliant. But it is argued that the prevalence of underground economy may stimulate economic development in transition countries (Enste 2003). It has been argued that this undocumented economy can turn out to be an incentive to develop both the entrepreneurial spirit and a constraint to limit excessive growth of government activities.

It is also argued that SME development is affected by taxes like VAT. Relevant studies also found that given the presence of a large undocumented economy, VAT reform reduces both welfare and revenue (Emran & Stiglitz, 2003). However, assuming complementarities between the undocumented economy and the official GDP, research claims that the unofficial activities, by boosting economic growth, are also able to generate additional tax revenues (Schneider 2005). In contrast, examining the undocumented economy in 24 transition countries, an inverse relationship between the official economy and the undocumented economy is found (Eilat and Zinnes, 2000). They estimated that a one-dollar fall in official GDP was associated with a 31 per cent increase in the size of the undocumented economy.

Empirical evidence suggests that women's SMEs tend to grow more slowly than those owned by men. For example, that employment in male-headed SMEs grows an average of 11 per cent a year, versus 7 per cent for female-headed SMEs found (Mead and Liedholm, 1998). The result suggests that this is due to the fact that, women typically face asymmetrical rights and obligations. This constraint limits their labour mobility and burdening them with disproportionate household responsibilities (Downing & Daniels, 1992). Kevane & Wydick(2001), based on Guatemalan data found that the high marginal value of home time for women during certain periods of their lives is the principal constraint to the growth of female-owned firms. In some countries, women face relatively greater problems with innumeracy, illiteracy, and a lack of business skills (ILO, 1999). In addition, women commonly have unequal access to markets. As a result, women headed SMEs are limited to a relatively narrow range of economic activities.

Analytical Framework

Policy analysis framework

The key focus of the policy analysis will be the VAT policy and institutional framework that can be constructed to support SME development. The basis of the policy analysis will be the results of the survey and key informants' interviews. The result of the econometric analysis

will also be translated into policy recommendations. While preparing policy suggestions to the policymakers the analysis will consider the impacts these policies on other aspects of economy including revenue mobilisation. The policy analysis will be prepared for short term and medium term separately.

Level of analysis

Bangladesh is a small country and ruled under a uniform jurisdiction. Due to resource constraints as well as limited accessibility, perhaps it may not be possible to conduct analysis beyond national level. The study, however, will put emphasis on women headed SMEs.

Analytical approach and assumptions

The literature on the key determinants of the growth of existing small enterprises in economic theory is surprisingly inadequate and is of only limited assistance. The theoretical insights and from available empirical evidence, it may be possible to sketch some key variables of interest that should be incorporated into the analysis.

a) Farm size and farm age
Two key determinants small enterprise growth can be the age and initial size of the enterprise in terms of employed persons. An *inverse* relationship between these two variables and enterprise growth can be expected as suggested by "Learning models" of enterprise growth along with empirical evidence from the United States and the developing world (Jovanovic 1982).

b) Sector
Enterprise growth can be varied among the various sectors. From the theoretical perspective, it is likely that firms in different sectors would face different product demands and encounter different cost structures on the supply side, depending on the economy. Liedholm and Mead (1999) suggested that sectoral differences in SME growth can be quite extensive.

c) Location
Location of a particular SME can also be important for its growth. Complementary enterprises situated close together or SMEs located close to the final demand sources may be expected to grow more rapidly than their more isolated counterparts. For example, empirical evidence from Africa indicated that urban enterprises typically grow more rapidly than their rural-based counterparts (Liedholm and Mead 1999).

d) Other socioeconomic variables
Various socioeconomic variables relating to the entrepreneur may also be expected to influence enterprise growth. Economic theory suggests, for example, that increases in "human capital," such as through increases in the experience or education of the entrepreneur, are more likely to support enterprise growth. The empirical evidence of this relationship, however, has been mixed (Liedholm and Mead 1991). In addition to "human capital," gender of the proprietor may also be an important determinant of enterprise growth. Downing and Daniels (1992), for example, posit that female entrepreneurs in Africa are more risk averse and thus less like to grow in comparison with their male counterparts.

Analytical tools and techniques to be applied

a) Tax progressivity Analysis

A tax incidence analysis of VAT on small compliant and non-compliant enterprises will be conducted. It will enable us to see the distributional disparity between the tax compliant and non-compliant small entrepreneurs. As mentioned I-O data of 2007 for Bangladesh will be used to carry out the exercise.

To analyse the nature of the tax system index of progressivity can also be measured for VAT compliant small enterprises with more recent available data. It will address the situation whether current VAT regulations are favourable for enterprises to comply with VAT regulations or not. A regressive nature of taxation will require an alternative policy package chosen on the basis of remaining distributional characteristics. The welfare consequences of alternative package will make ways to increase VAT-base of small enterprises.

b) Econometric analysis

Initially consider to keep the econometric model as simple as possible. As a standard statistical procedure simplest Ordinary Least Square (OLS) model is considered to find the determining factors of a firm's ability to growth. For the model of interest, the underlying factors are considered which may adequately capture the gender dimension as well as the friendliness of the VAT administration.

$$GROWTH\ OF\ SMEs = \alpha + \beta_1(INITIAL\ SIZE) + \beta_2(ENTERPRISE\ AGE) + \beta_3(SECTOR) + \beta_4(LOCATION) + \beta_5(GENDER) + \beta_6(PERCEPTION\ TO\ VAT\ ADMINISTRATION) + \beta^-_6(COMPLIANCE\ COST) + \varepsilon$$

Where,

GROWTH OF SMEs	= enterprise's growth of employment or its annual turnover adjusted to inflation
INITIAL SIZE	= number of employees with which the enterprise kicked off
SECTOR	= three dummy variables representing the nature of industries. (i. e. trading, manufacturing, services)
LOCATION	= dummy variables representing various aspects of the SME's location.
GENDER	= two dummy variables representing male and female small entrepreneurs.
COMPLIANCE COST	= the other costs of entrepreneurs related to VAT
PERCEPTION TO VAT ADMINISTRATION	= dummy variables representing favourable or unfavourable administration

A sample survey shall be conducted to acquire primary level data for the variables of interest. The target respondent group for this analysis is all the non-firm enterprises who are non-compliant to VAT.

The growth of employment as a choice of dependent variable will be used for enterprise's ability to grow. Vis-à-vis inflation adjusted annual turnover of the enterprise can be another proxy of an enterprise's growth. A number of recent studies, however, suggested that there can be biases from using employment as a measure of expansion. It is suggested that alternative indicators such as changes in sales, output, or assets can be better indicators of an enterprise's growth. Parker's (1994) analysis of the growth in Kenyan SMEs, for example, indicated that net increases in real sales were almost double of the growth in employment. A similar pattern was also detected by Gustafson and Liedholm (1995) for Jamaica. Such findings highlight the lumpy nature of employment creation by SMEs, which appears to increase with a lag after a sizeable growth in real sales, and indicates that the employment growth measure may provide an under-estimation of enterprise growth. At the same time, it is argued that female entrepreneurs keep their enterprises small in terms of employees due to administrative constraints.

Policy implications and recommendations will be drawn from these analyses for VAT administration to ensure greater equity and compliance. This is expected to reduce disincentives for informal firms to join the mainstream economy.

THEME 3: THE IMPACT OF PROPERTY TAX ON ENTERPRISE DEVELOPMENT

Literature Review

Data sources

For the purpose of the study on the impact of property tax on enterprise development, sources of data and other information on regulatory framework initially used include: the constitution of Bangladesh, various statutes under which property taxes are imposed and collected, the annual reports of the National Board Revenue (NBR), the apex tax authority in Bangladesh, relevant fiscal policy documents of the Government of Bangladesh such as the Report of the Taxation Enquiry Commission (1979) and the Report of the Revenue Reform Commission (2003), the World Bank's *An Agenda for Tax Reform* (December 1989) for Bangladesh and the IMF's *Tax Policy Handbook* (Shome 1995). For literature purpose, available research publications have been consulted.

Key knowledge gaps

There are three types of land-related property taxes in Bangladesh – one *local* tax (holding tax) and two other *central* taxes (land development tax and immovable property transfer tax) [CARE Bangladesh 2003; Stotsky and Yücelik 1995]. Holding tax is currently being collected by the local governments at different strata of public administration–City Corporation, Municipality (*Pourashava* in vernacular language), or Union Council (*Union Parisad* in vernacular language). In accordance with the provision of Article 60 of the Constitution of the People's Republic of Bangladesh, local government bodies have been provided, under law to be enacted by the Parliament, the power to impose taxes for local purposes, to prepare their budgets and to maintain funds. Legal sources of collecting this holding tax by local governments include the Local Government (City Corporation) Act 2009, the Local Government (Pourashava) Act 2009 and the Local Government (Union Parisad) Act 2009.

The Land Reform Board (LRB), in the Ministry of Land (MOL), through *Upazilla* (sub-district) Land Offices and Union *Tehsil*[*] offices collects the Land Development Tax (LDT) under the Land Development Tax Ordinance 1976. The LDT refers to land revenue and other taxes (development and relief tax, and local rates) previously collected in a scattered way under different tax statutes. The Department of Land Registration in the Ministry of Law, Justice and Parliamentary Affairs collects the Immovable Property Transfer Tax (CARE Bangladesh 2003). Immovable Property Transfer Tax consists of non-judicial stamp duty under the Stamp Act 1899 and capital gain tax under the Income Tax Ordinance 1984. Here, immovable property mainly includes land in urban and rural areas. But capital gain tax on rural agricultural land is usually exempted. 'Land revenue' provides only 0.52 percent of total taxes (BDT 6.08 billion targeted in the budget of 2012-13) and revenue from 'stamp duty (non-judicial)' is around 2.38 percent of total taxes (BDT 27.85 billion targeted in the budget of 2012-13). The share of 'immovable property transfer tax' in total income tax is about 7.5 percent, which is around 0.93 percent of total tax (NBR's Annual Report 2008-09). Agricultural income tax is related to agricultural produce from land or any nearby building used for agricultural outhouse or storehouse. Since agricultural income tax is within the ambit

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[*] Lowest union-level revenue unit comprising several *mouza* (revenue village).

of overall income taxation of a taxpayer and there is no separate statistics on the tax on agricultural income, it is difficult to evaluate its impact on employment or labour-migration. In Bangladesh, any person having other taxable income in addition to agricultural income is usually supposed to pay agricultural income tax, because the normal initial exemption limit for total income for a pure cultivator will be BDT 50,000 more and due to absence of any enforcement on rural inhabitants by income tax department, there is no effective tax on the agricultural income.

The study by CARE Bangladesh (2003) has discussed land taxation in Bangladesh as a supplemental issue in relation to land policy and administration in Bangladesh. Bhowmik and Bala (2010) have mentioned the changes in property-related capital gain tax regime in a particular fiscal year (2010-11). Exclusive study on property taxation is almost absent except some commentaries published in periodicals and dailies, even without having broad-based idea on existing property taxation in Bangladesh. For instance, Ahmed (2007) has argued "the critical need for introducing this taxation not only with a view to making this a potent source of revenue for urban financing, but even more importantly to correct the severely distorted incentives for resource allocations and also to moderate the spiraling urban land prices," although there is holding tax per se.

Thus, the knowledge gap is substantial and the ongoing study would fill up the gap with a clear policy direction in this regard.

Conceptual and Theoretical Framework

Research questions

1. What are the weaknesses in property tax systems that create and/or sustain informal land markets at the local levels, (including weaknesses in policy, administration, capacity and resources)?

2. What is the nature and magnitude of impacts of land informality on entrepreneurs (owning/managing small enterprises) and workers (employed by small enterprises) operating in the undocumented economy (especially women)?

Definitions of key concepts and their translation into measurable parameters of enquiry

Property tax: This is obviously a tax on property, but the property does not include only land. But as envisaged in the research design, it would cover primarily land-related property taxes.

Small firm: In the context of rural area in Bangladesh, small firm covers any temporary or permanent establishment to run a business on a regular or seasonal basis.

Hypothesized relationships between parameters

In Bangladesh, land acquisition for constructing a permanent establishment for operating a business venture by a small firm is not a frequent event. But an organized market, where many small firms operate, is usually a government property. The vacant land may be leased

to small firms against a periodic rent, where they may run their business on a specific *hatbar* (market day) or even they may be allowed to establish a permanent establishment for longer-term contract. In urban area, the type of business operations is almost daily except a pre-declared holiday. In rural area, it is infrequent but at a regular interval. However, there are regularity is presence by small firms. Since there are no such previous studies, the implications of taxes/fees/tolls/rates on small firms are yet to be predictable. But on the experience survey, it is observed that if all the authorized taxes are properly being collected by a local government, it would cause severe impacts. Usually, the local governments are reluctant for political reasons (or for largely funded by central government) or incapable in imposition and collection of all property-related taxes they are allowed to do under their statutes. Following are some important statutory taxes under the local government Acts, of which very few are really collected or if collected, the gravity is usually bearable:

- Tax on annual value of land and buildings;
- Tax on transfer of immovable property;
- Tax on application for erection or re-erection of building;
- Tax on professions, trades and callings;
- Tax on animals;
- Tax on vehicles other than motor vehicle and boats;
- Fees for markets; and
- Fees for granting licence, sanctions or permits.

Based on above facts, following null hypotheses will be tested:

H_0-1: Property tax will have no significant negative impact on small enterprise development in Bangladesh.

H_0-2: Inter-size impact of property tax across small enterprise is insignificant in Bangladesh.

H_0-3: Differences between a small enterprise operated by a woman and that operated by a man are insignificant with reference to burden of property tax in Bangladesh.

Analytical Framework

In Bangladesh, there are lot of problems with respect to property taxation on small firms, particularly with respect undervaluation, absence of self-assessment scheme, discretionary exemptions, favoured treatment to some groups for personal reason or incapability of administration due to lack of efficient and dedicated revenue officers, etc. Based on survey findings in terms of revenue performance of property taxes, revenue assignment among different tiers of government (central, city corporation, municipality, and union council), revenue collection, and patterns of land acquisition, ownership and control, the depth and breadth of the problems will be found out with reference to differences in various aspects of the firms such as size, age, revenue volume, productivity, self-managed/employee-managed, etc.

Data Collection Methodology

Data collection for the study will be done in two ways. First, interviews will be conducted with a number of key informant stakeholders including relevant government officials, both current and retired, particularly from NBR, MoF and Ministry of Finance. The list may also include elected representatives from the Parliament and local government bodies. Consultation with academics, civil society organisation representatives and tax practitioners will also be conducted. Other non-state actors such as officials at SME foundation, representative from international development partners and various business chambers may also contribute to the data collection. A number of instruments may be used to conduct the key informant interviews including telephone, email, one-to-one response in person, focus group discussion (FGD). For the purpose of the study under theme 3, initially key informant interviews (KIIs) will be taken from the Government officials working in land administration and land revenue collection. Few bank officials will be interviewed where land is used as collateral against loan to small business entities by means of depositing the land-ownership documents to the bank. The list will also include (i) other Government officials involved in assessments and evaluations of tax bases, setting and revising of rates, and administering property taxes at the local and central levels; (ii) other Government officials involved in land administration, governing aspects such as land registration and record-keeping, tenure, use, rights, markets, etc. at the union, upazilla, district, other pourashava and city corporation levels; (iii) non-state stakeholders of land markets, including land developers, real-estate agencies, banks, non-banking financial institutions (NBFIs) and other lending institutions, informal leasing firms or persons, NGOs advocating for land rights, etc.

Second, a national representative survey will be conducted which can cover all three studies under the research theme. The most recent sample frame available at national level is the Economic Census 2001/03. The census will be used as the sampling frame to assess the key parameter of interest required for the study. Alternatively BBS regulated SMI 2012 sampling frame may be used which will additionally require a separate frame for services sector. To fulfil the requirements, a population will be organised targeting large, medium, small and micro level enterprises excluding women headed enterprises. A separate population with female-headed enterprises may be drawn to capture the gender dimension. Sample for the first list frame will be drawn by stratified single stage sample design with probability proportional to size (PPS) while for the second frame a two-stage sample design will be used. For 'female-headed' frame, the enumeration area will be selected with PPS and the unit will be selected using systematic sampling method.

Reporting Formats

Deliverables	Deadline
Developing Initial Research Design Documents	30 June, 2012
Draft Literature Review	30 September, 2012
Draft Conceptual and Theoretical Framework	31 October, 2012
Draft Analytical Framework	30 November, 2012
Conduct Key Informant Interviews	31 March, 2013
Conduct Survey	30 September, 2013
Conduct Data Analysis	31 March, 2014
Conduct Policy Analysis	30 June, 2014
Finalization of Draft	30 June, 2014
Organize Policy Engagement Workshop	31 December, 2014

Team Composition

Name and Designation	Academic Qualification and Experience	Responsibilities
Team Leader		
Professor Mustafizur Rahman, Executive Director, CPD	Phd in Economics Experience: 27 years	Overall supervision Preparing policy analysis Finalisation of draft
Theme 1		
Dr Khondaker Golam Moazzem, Senior Research Fellow, CPD	Phd in Economics Experience: 12 years	Supervising theme 1 study Analysing Data Preparing Draft
Ms Mehruna Islam Chowdhury, Research Associate, CPD	Post-graduation in Economics and Development Studies Experience: 4 years	Preparing literature review Conducting survey and interviews Analysing data including econometric analysis Preparing first draft
Ms Saifa Raj, Programme Associate, CPD	Post-graduation in Applied Statistics Experience: 1 year	Data collection Preparing literature review Conducting survey and interviews Analysing data including econometric analysis
Theme 2		
Mr Towfiqul Islam Khan, Senior Research Associate, CPD (Institutional Focal Person)	Post-graduation in Economics Experience: 6 years	Supervising theme 2 study Analysing Data Preparing Draft
Mr Md. Zafar Sadique, Research Associate, CPD	Post-graduation in Applied Statistics Experience: 3 years	Data collection Preparing literature review Conducting survey and interviews Conducting data analysis including econometric analysis Preparing first draft
Theme 3		
Professor Swapan K Bala, Dhaka University	Phd in Public Finance Experience: 21 years	Preparing literature review Analysing Data Preparing Draft

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