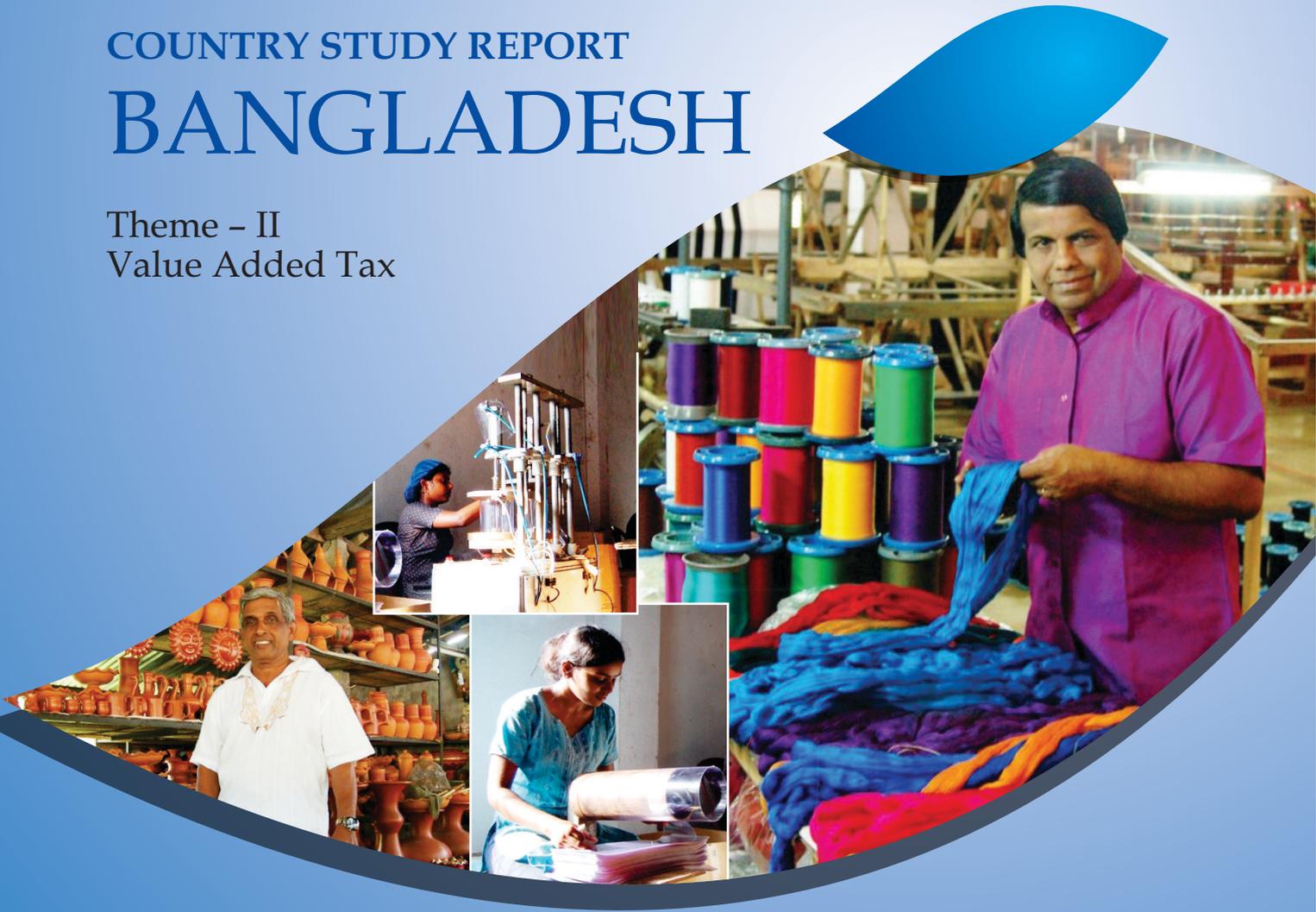




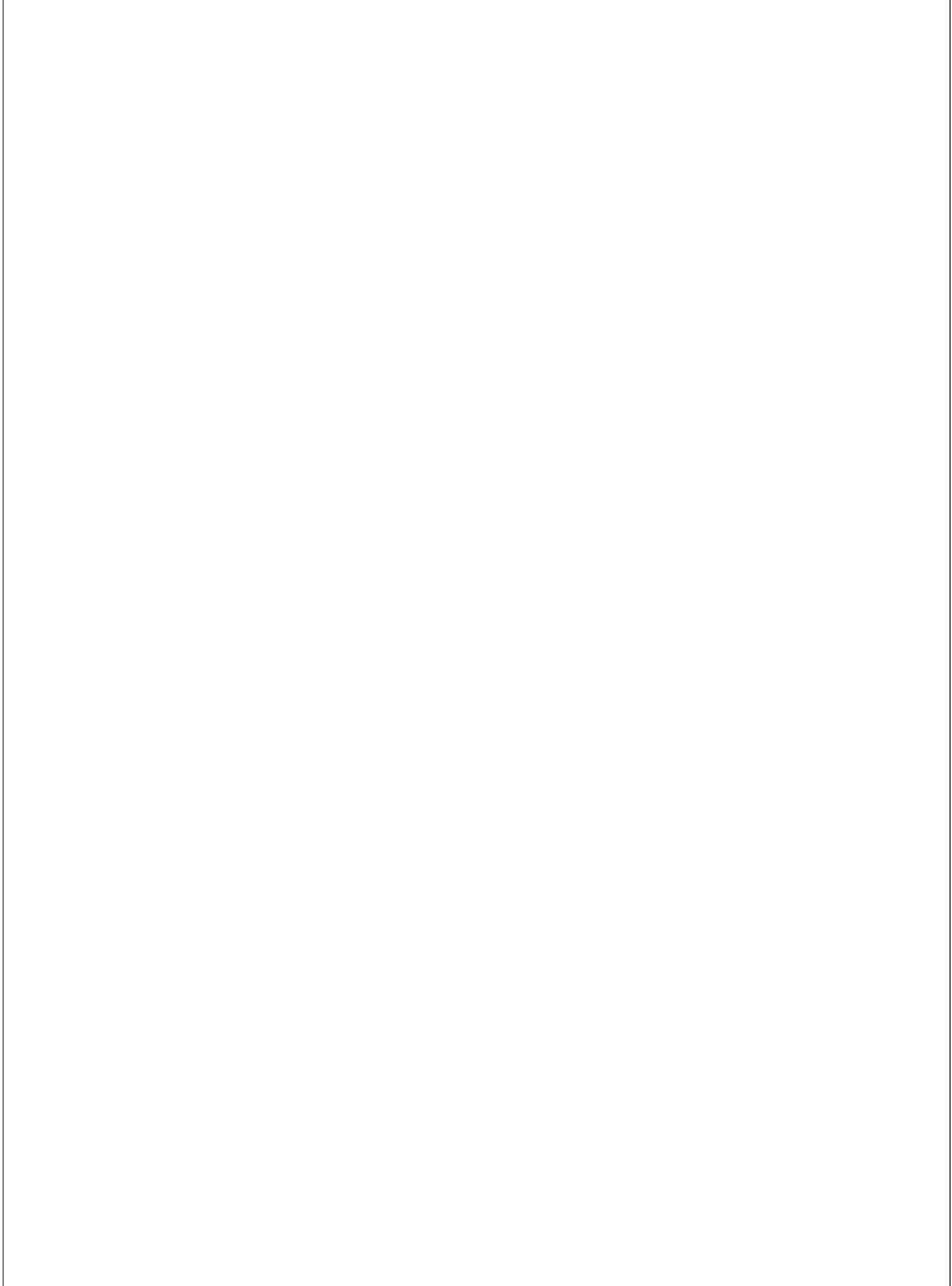
COUNTRY STUDY REPORT
BANGLADESH

Theme - II
 Value Added Tax



Tax Policy and Enterprise
 Development in South Asia





COUNTRY STUDY REPORT

BANGLADESH

Theme 2: The Impact of Value-Added-Tax (VAT)
on Enterprise Development

TAX POLICY AND ENTERPRISE DEVELOPMENT IN SOUTH ASIA

Mustafizur Rahman | Towfiqul Islam Khan | Md. Zafar Sadique



Centre for Policy Dialogue (CPD)

A Civil Society Think Tank

House 40C, Road 32, Dhanmondi R/A, Dhaka-1209, Bangladesh

www.cpd.org.bd

Copyright © 2014
by the Governance Institutes Network International (GINI)
9, Street 1, Sector F-6/3, Islamabad 44000, Pakistan

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior permission from GINI, Pakistan or IDRC, Canada

ISBN 978-969-7514-02-1

“This work was carried out with the aid of a grant from the
International Development Research Centre (IDRC), Ottawa, Canada.”

For a list of any errors or omissions found subsequent to printing, please visit our website at <http://giniweb.net>

About the Research

This research examines the impacts of property tax, value-added taxes, and tax exemptions and concessions on small enterprise development in South Asia. The goal is to provide decision-makers with data and insights to support more informed policy formulation and implementation for inclusive growth, productive employment, and enterprise development. The research also aims to examine the issues as they affect women entrepreneurs, to promote positive learning experiences among the countries, build fruitful exchanges, and foster effective policy discussions in a regional context.

The targeted outcomes include 5 Country Study Reports as well as a regional report based on Meta analysis. The reports are published and widely disseminated at the policy engagement workshops. Other project outcomes are policy workshops in all five countries and workshop reports, as well as an interactive website to support research and advocacy.

About CPD

The Centre for Policy Dialogue (CPD), established in 1993 by Professor Rehman Sobhan with support from leading civil society institutions in Bangladesh, is mandated by its Deed of Trust to service the growing demand that originates from the emerging civil society of Bangladesh for a more participatory and accountable development process. CPD seeks to address this felt need by way of organizing multi stakeholder consultations, by conducting research on issues of critical national and regional interests, through dissemination of knowledge and information on key developmental issues, and by influencing the policy making process in the country.

CPD has emerged as Bangladesh's premier think-tank and has established its credibility as one of the very few places in Bangladesh where the government and opposition political parties agree to sit around the dialogue table and conduct an informed discussion with the civil society.

About the Authors

Mustafizur Rahman

An economist by training, Dr. Rahman is currently the Executive Director of the Centre for Policy Dialogue (CPD). He has been a member of various national committees set up by the Government of Bangladesh including Regulatory Reforms Commission, National Coal Policy Review Committee, WTO Advisory Committee and National Consumer Rights Protection Committee. He did his Ph.D. in Development Economics from Moscow State University, and was a Visiting Post-doctoral Fellow at Oxford, and a Senior Fulbright Fellow at Yale.

Towfiqul Islam Khan

An economist by training, Khan is a Research Fellow at CPD. He obtained his academic education in the area of Economics from the University of Melbourne, Australia and Jahangirnagar University, Bangladesh. His areas of research interest include economic growth and development, international trade, macroeconomic management, fiscal policy, and poverty analysis. Khan has published a number of articles, book chapters and research reports both in Bangladesh and abroad.

Md. Zafar Sadique

A senior research associate, who has been affiliated with CPD since May 2010. He did his B.Sc. (Honors), and then MS, both in Applied Statistics, from University of Dhaka. Mr. Sadique has worked on diversified fields of economics, including public policies and fiscal framework, sustainable growth, taxation and mobilization of domestic resources, monetary sector and inflation, trade and investment, and mobilization of external resources, providing able research support at several joint projects of CPD with ILO, UNICEF, UNDP and other core development partners.

Table of Contents

List of Abbreviations and Acronyms	IX
List of Tables	X
List of Figures	XI
Executive Summary	1
Section I: Literature Review	3
1.1 <i>Definition of SME</i>	3
1.2 <i>Profiles of SMEs in Bangladesh</i>	4
1.3 <i>VAT and SMEs</i>	5
1.4 <i>Progressivity of VAT</i>	7
1.5 <i>Evolution of VAT in Bangladesh</i>	7
1.6 <i>Institutional Reforms</i>	8
1.7 <i>Key Knowledge Gaps</i>	8
1.8 <i>Data Sources</i>	9
Section II: Conceptual And Theoretical Framework	11
2.1 <i>Definitions of Key Concepts and Constructing Parameters</i>	13
2.2 <i>Research Questions</i>	14
Section III: Analytical Framework And Methodology	17
3.1 <i>Level of Analysis</i>	17
3.2 <i>Analytical Approach and Assumptions</i>	17
3.3 <i>Survey Design</i>	18
3.4 <i>FGDs and KIIs</i>	19
3.5 <i>Policy Analysis Framework</i>	19
Section-IV: Study Findings	21
4.1 <i>Results of the Survey</i>	21

4.2	<i>Results of Key Informant Interviews</i>	41
4.3	<i>Results of Focus Group Discussions</i>	46
Section V:	Policy Implications and Recommendations	54
References		53

List of Abbreviations & Acronyms

ATV	Advance Trade VAT
BDT	Bangladeshi Taka
BRTF	Better Regulation Task Force
BSCIC	Bangladesh Small and Cottage Industries Corporation
CPD	Centre for Policy Dialogue
Crore	South Asian equivalent of 10 million
DEDO	Duty Exemption and Drawback Office
FGDs	Focus Group Discussions
ILO	International Labor Organization
IMF	International Monetary Fund
KIIs	Key Informant Interviews
Lakh	South Asian equivalent of 0.1 million
LTU	Large Taxpayers' Unit
METR	Marginal Effective Tax Rate
MoF	Ministry of Finance
NBR	National Board Revenue
NID	National Identification
SFYP	Sixth Five-Year Plan
SME	Small and Medium Enterprise
UIPT	Urban Immovable Property Tax
USD	USDollar
VAT	Value Added Tax
VAT	Value Added Tax

List of Tables

Table 1: Number Of Enterprises Surveyed By Location
Table 2: Experience Of Entrepreneurs
Table 3: Capital Investment By Enterprise
Table 4: Capital Investment By BSCIC Zone
Table 5: Annual Sales In 2012
Table 6: Descriptive Statistics Of Employment By Enterprise
Table 7: Status Of Tax Payment By Sample Firms
Table 8: Responses As Regards Payment Of Different Kind Of Taxes
Table 9: Reasons For Not Paying Taxes
Table 10: Perception On Tax Structure (% Of Total Surveyed Firms)
Table 11: Problems Caused By Multiplicity Of Taxes
Table 12: Challenges Created By Prevailing Taxes
Table 13: Registered Firms With The Tax Authority
Table 14: Tax Related Expenses
Table 15: Annual Tax Related Cost
Table 16: Annual Costs On Tax Related Matters
Table 17: Tax Related Hassles
Table 18: Share Of Enterprises Initiated And Become Compliant By Period
Table 19: Descriptive Statistics: Vat Compliance Cost
Table 20: Impact Of Vat Cost On Enterprise Development
Table 21: Awareness Regarding New Vat Law
Table 22: Stakeholder Views On Vat Regulations And The Performance Of Officials
Table 23: A Glimpse Of Primary Survey For Theme 2
Table 24: Chronological Changes In Thresholds And Rates Of Turnover Tax

List of Figures

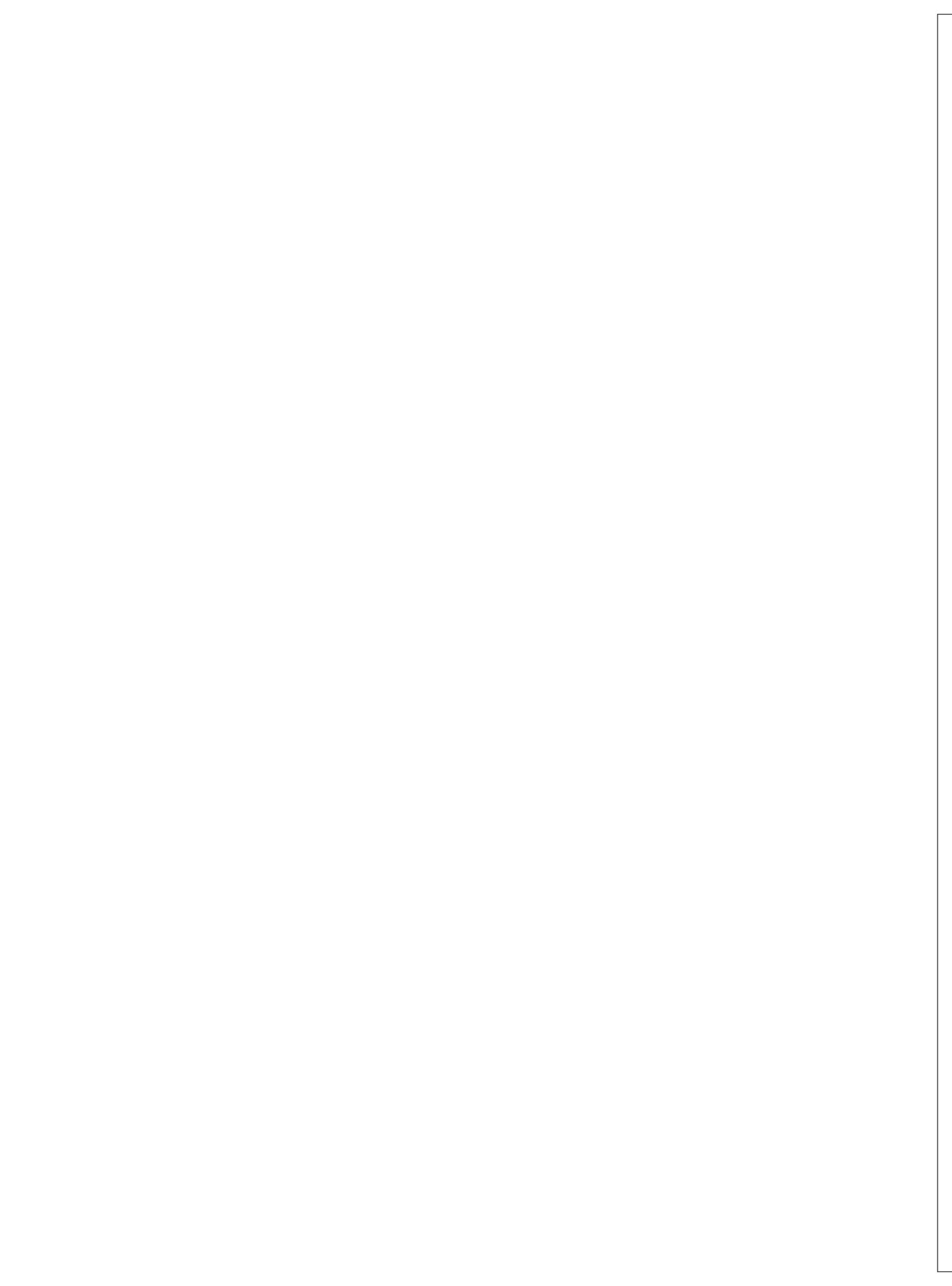
Figure 1: Educational Background Of Proprietors

Figure 2: Perception Of Entrepreneurs Of Various Sized Enterprises On The Existing Tax Structure

Figure 3: VAT Compliance By Enterprise

Figure 4: Benefits And Burdens Of VAT Cost

Figure 5: Reasons Behind Not Being Compliant



Executive Summary

Poverty alleviation at a faster pace is one of the priority developmental agenda for Bangladesh. It needs inclusive and accelerated economic growth to attain the goal. Meaningful employment generation and job creation is considered to play key role in this regard. Keeping in mind the number of small and medium enterprises (SMEs) operating in the economy and their countrywide spread, SMEs could potentially contribute to use the growing labour force for significant employment generation besides the large firms. In this context, research indicates that SME growth and employment generation are strongly linked to tax policy. It ought to be taken into consideration that development of SMEs in Bangladesh can be affected by policies with regard to VAT.

The study theme titled 'The Impact of Value-Added-Tax (VAT) on Enterprise Development' has essentially taken into account the impact of VAT particularly on SMEs, as 99 per cent of the enterprises operating in the Bangladesh economy are same of a kind. SMEs in Bangladesh can be characterised as a group of enterprises with limited access to formal credit, low capitalisation, incomplete record keeping, high intensity of cash transactions and poor compliance with regard to tax issues (Chowdhury, 2007). A large number of SMEs are operating in the undocumented economy and not registered to operational VAT regime. Indeed, there is no clear definition suggested for SMEs in the VAT policy. Therefore the research questions under the VAT theme seeks to answer whether the special provision of VAT (turnover tax) for SMEs have any significant discretionary impact on SMEs compared to their larger counter part; and also on its compliance/non-compliance nature.

A dedicated research team at the Centre for Policy Dialogue (CPD) was deployed for the Bangladesh country study. The study team conducted an enterprise level primary survey with 262 enterprises comprised from 4 different locations in Bangladesh. A number of the samples were drawn from large enterprises and also from enterprises located at special economic zones to provide dimensions for comparison. As per the requirements of the study, the survey accepted purposive sampling methods and remained limited to small sample size. To validate the primary survey results, the study team consulted with key informants from different sectors relevant to SMEs and organised a focus group discussion (FGD) with experts to discuss the issues in a common platform.

From the above mentioned discussions and survey results, emergence of SMEs in recent past was evident. It was found that large firms are more compliant with regard to VAT payments than SMEs. In parallel, larger firms faced VAT related complexity relatively

more than SMEs because of their compliance state. The SMEs took more time to become compliant than large firms. The VAT compliant firms believed they have better access to formal commercial loans and enjoyed the legal status because of their compliance.

- Median VAT compliance cost for SMEs is Tk. 3,000 annually. Some capital intensive SMEs maintain Tk. 20,000 monthly VAT compliance costs.
- Perception of major respondents is that VAT cost decreases their profitability and made them market uncompetitive.
- Main reason for non-compliance is procedural complexity. Lack of awareness of enterprises was the second cause that sets them off from VAT compliance.
- Perception towards VAT regulations was found somewhat low while many of the stakeholders are indifferent over the performance of the administration.

The sensitivity of the present VAT regime in Bangladesh does not adequately address the issues concerned by the SMEs. In connection to this a number of following policy recommendations may be considered to establish a SME friendly VAT regime in the Bangladesh context. First, the forthcoming new VAT regime needs to recognise SMEs with an explicit definition in the VAT law. The definition needs to commensurate with the definition placed by the other concerned policies (e.g. industrial policy, BSCIC). Second, the VAT related act and rules needs to incorporate SME related special provisions in a clear and well-articulated manner. In connection to this the special VAT provisions (including in the forms of turnover tax and package VAT) may use the measure of a firm's capital instead of using the sales or turnover value. At the same time, it is also important to streamline the loopholes in the VAT law as regards benefits for SMEs. Third, the VAT laws and procedures are often found to be complex. A more committed effort will be required to identify and simplify these laws and procedures. Fourth, for SMEs in Bangladesh costs as regards VAT compliance is found to be higher. The tax administration needs to ensure a better service delivery to SMEs, which will require enormous efforts to improve institutional capacity of tax administration through training and providing better work environment to the employees. Towards this end, decentralisation of tax administration should be a priority. Fifth, the tax administration will be required to ensure fair enforcement to establish a level playing field for the compliant SMEs.

SECTION-I

Literature Review

Agricultural sector related activities account for about half of the employment in Bangladesh. However, the sector also suffers from severe underemployment and seasonal unemployment. The developmental experience of Bangladesh over the past two decades evinces recognition of SMEs as one of the key drivers of poverty reduction in the country (Bhattacharya and Khan, 2008 and Murgai and Zaidi, 2005). Non-farm SMEs played an important role in accommodating the rising demand for employment opportunities which also helped Bangladesh to achieve notable structural changes during the 2000s (Rahman, Mondal and Iqbal, 2011). To alleviate poverty at a faster pace, Bangladesh needs to attain an accelerated, broad-based and sustained economic growth. Indeed, the attainment of this target will largely hinge on the ability of SMEs in Bangladesh to provide meaningful income generating employment opportunities for the growing labour force of the country. The importance of SMEs in fostering employment and growth is indeed validated by global experience. For example, the number of private SMEs in China has increased by approximately 40 million since early 1980s (Hall, 2007). SMEs are found to play diverse role including as supporting concerns to large industries and also act as a catalyst in delivering the goods and services to the final consumers. Moreover, competitive edges of these enterprises are found in their ability to produce goods and services at a relatively lower cost by using labour-intensive local technology. Rikta (2007) noted that capital-labour ratio in large scale enterprises in Bangladesh are significantly higher than that of SMEs. In view of the surplus labour and lower capital endowment of the country, SMEs thus could play an important role in the industrialisation of Bangladesh.

1.1 Definition of SME

There is no universally accepted definition of SME. Definitions of SMEs tend to be diversified and heterogeneous among countries. Countries are prone to define an SME according to their own policy perspectives. Gibson and Vaart (2008), however, proposed a more generalised definition of SME for developing countries - "An SME is a formal enterprise with annual turnover, in U.S. dollar terms, of between 10 and 1000 times the mean per capita gross national income, at purchasing power parity, of the country in which it operates" [Gibson and Vaart, 2008; p. 18]. This definition can be very useful considering its single ruler approach, particularly for the purpose of cross-country analyses. However, a review of the wide-ranging literature and relevant policy documents

shows that the threshold of the “number of employees” is the most oft-used criterion for the purpose of defining SMEs by national governments and statistical agencies. Existence of multiple definitions of SMEs within a country is also not uncommon, Bangladesh being one such example. Different policymaking bodies and policy documents in Bangladesh define SMEs according to their respective objectives and conveniences. These definitions have also varied over time. In Bangladesh, SMEs are generally defined according to the criteria of the size of the fixed assets and the number of workers employed. Among other countries, Cambodia also uses both fixed assets and number of workers employed criteria to define an SME. In Cambodia, firms that employ less than 200 employees and have fixed assets of below USD 500,000 are considered as SMEs. On the other hand, in Indonesia, any firm with less than 100 employees is an SME. The definitions of SME in Malaysia depend on both the number of employees and annual turnover criteria but these can vary from sector to sector.

In Bangladesh, Bangladesh Bank redefined SME in 2011 in conjunction with SME credit policies and programmes. It has proposed separate definitions of SMEs for manufacturing and services sectors according to their fixed assets and number of employees. According to this definition, a manufacturing enterprise with fixed assets (including replacement cost and excluding land and building) of up to Tk. 300 million and number of employees up to 250 will be considered as an SME. For services and business related enterprises, the ceilings are Tk. 150 million and 100 persons respectively (Bangladesh Bank, 2012). To be identified as an SME, an enterprise will have to satisfy both of the aforementioned criteria. These definitions are in line with the Industrial Policy 2010. According to the definition, SMEs are classified into Medium, Small, Micro and Cottage industries. If women own 51 per cent or more stock in a partnership enterprise or in an enterprise which is registered with Registrar of Joint Stock Companies and Firms, the SME will be considered as a woman-owned SME. However, VAT law in Bangladesh uses the criteria of annual turnover of an enterprise to define an SME. At present, an SME avails special benefits under VAT rule if its annual turnover remains less than Tk. 8 million.

1.2 Profiles of SMEs in Bangladesh

At present, there are about 0.9 million SME establishments in Bangladesh including about 0.8 million cottage industries. Indeed, about 99 per cent of the enterprises can be considered as SMEs in Bangladesh. Islam, Zohir and Hossain (2011) estimated that about 85 per cent industrial employment are provided by SMEs. However, most of the SMEs are service related. According to Economic Census 2001 and 2003, 64.5 per cent of all SMEs (10-

99 persons employed) and 87.4 per cent of all cottage industries are engaged in services-oriented activities. SMEs in Bangladesh can be characterised as a group of enterprises with limited access to formal credit, low capitalisation, incomplete record keeping, high intensity of cash transactions and poor compliance with regard to tax issues (Chowdhury, 2007). Moreover, a large number of SMEs belong to the undocumented economy (Bhattacharya, Faiz and Zohir, 2000). Uddin (2008) argued that the economic efficiency and overall performance of the SMEs, especially in the developing countries, significantly depend on macroeconomic situation and targeted policies pursued for the SMEs. Bakht (2008) also found strong linkages between overall private investment climate and SME performance in Bangladesh. As evidence would suggest, development of SMEs in Bangladesh faces several constraints. Miah (2006) provided a long list of such constraints which includes lack of adequate investment, lack of modern technology, high rate of interest on bank loans, irregular/inadequate supply of power, poor physical infrastructure and high transportation cost, poor information about market opportunities and requirements, inadequate availability of raw materials, lack of skilled technicians and workers, lack of research and development facilities, fierce competition, absence of effective and transparent legal system, difficulties in accessing technology, credit constraints, low access to business services, constraint of quality of human resources, lack of awareness, low lobbying capacity, rapid changes in policy environment. These constraints also create barriers to SMEs being tax-compliant.

1.3 VAT and SMEs

Bangladesh has one of the lowest revenue-GDP ratios (only 12.3 per cent in FY2013) in South Asia. In recent years significant efforts have been made by the government to raise the revenue-GDP ratio. Direct tax contributes only about 30 per cent to the tax-revenue portfolio (MoF, 2012). In contrast, tax revenue is highly dependent on indirect taxes, particularly on VAT collection. VAT at import and local level together contributes about 37.9 per cent of total tax collected by the NBR in FY2013. However, compared to its potential, VAT collection is lower in Bangladesh. As has been estimated, the NBR is able to actually collect only about 61.0 per cent of the potential VAT in FY2009 (Faridy and Sarker, 2011). In this context, in addition to the issue of raising income tax mobilisation, VAT will continue to attract significant attention.

VAT perhaps is not an optimal source for raising tax revenue (Hossain, 1995). The theory of optimal commodity taxation (Ramsey's Rules for Optimal Commodity Taxation) suggests that commodity tax rates should be such that the proportional reduction in compensated

demand should be equalised across goods; this generally implies non-uniformity in tax rates. This rule, however, presupposes complete information relating to own and cross-price elasticities for all goods which may not be available in real practice. As a result, VAT will continue to receive its fair share of importance in accumulating domestic resources. Bangladesh has put SME development as one of the core policy objectives in her ongoing Sixth Five Year Plan (SFYP). In view of this, the impact of VAT on SME development needs to be reviewed with caution.

Taxation authorities have to keep in mind the potential contribution of SME to the development of the developing economies. However, VAT is seen by policymakers around the world as a tool to collect at least some taxes from the SMEs (IFC, 2007). However, it ought to be taken into consideration that development of SMEs in Bangladesh can be affected by policies with regard to VAT. Thus far, however, SMEs have contributed insignificantly to the overall VAT yield in Bangladesh. Administrative burden to collect VAT from a large number of SMEs is rather high. International experience suggests that SMEs consider VAT as the most problematic tax from a compliance point of view; followed by the corporate income tax and the payroll tax (IFC, 2002). Generally, SMEs in developing countries are found to be sceptical to register for VAT. Lack of willingness to register voluntarily for VAT may increase the marginal effective tax rates (METR) for SMEs which pay turnover taxes but acquire goods and services from VAT-registered enterprises (IFC, 2007). It is often argued that a more simplified VAT procedure, perhaps in the form of turnover tax, is a better approach in developing countries (ITD, 2007). However, it is also important to make sure that the threshold for compulsory VAT registration is set at reasonably high level to promote SME development (IFC, 2007).

Analysing survey data of 11 African countries, Stern and Loeprick (2007) argued that, METR on SMEs (those outside of the VAT net) was higher compared to other enterprises. Moreover, they identified four issues which influenced SMEs to be non-compliant: (i) firms' perceptions on advantages/disadvantages of formalising their operations; (ii) information asymmetry; (iii) burdensome procedures; and (iv) inadequate reform measures. In addition to these issues, cost of compliance is also a determining factor in this context. For Swedish economy, Skatteverket (2006) estimated that cost of VAT compliance per employee for a business can be 35 times higher for enterprises with 1 to 4 workers than those with 50 to 499 workers. It is also important to understand SMEs as a heterogeneous group, particularly in terms of their size. Indeed, the ease to collect a larger amount of taxes from a small number of large firms against taxing a large number of SMEs to collect relatively a smaller proportion of tax makes SMEs a weaker stakeholder in policymaking. In this context they also face unfavourable treatments from the tax-men through various non-tax measures (Auriol and Warlters, 2005).

1.4 Progressivity of VAT

Ideally tax policy in developing countries should focus on a strategic objective - to ensure an environment which provides some support to the low income group of the society so that their position may not be further aggravated (Bird, 1974). It is often suggested that the adverse impact on the low-earning group of the society arising from regressive taxation can be countered with the dedicated public expenditure mechanism. However, there is scepticism with regard to the ability of traditional public expenditure policies to reach the low income group (Tanzi, 1974 and Meerman, 1979). The distributional impact of fiscal policy is often not taken into consideration in Bangladesh (CPD, 2012). Indeed, the overall tax structure in Bangladesh is found to be rather regressive (Khatun, Khan and Nabi, 2012). It has been argued that the VAT system in Bangladesh is regressive and the incidence of tax burden falls disproportionately on the poor compared to their rich counterparts (Mansur, Yunus and Nandi, 2011). From the perspective of SMEs, it is thus of key importance to assess the progressivity impacts of VAT burden on the small enterprises.

1.5 Evolution of VAT in Bangladesh

The regeneration of the old Sales Tax Act 1951 had initially been done through injunction of Sales Tax Ordinance 1982. 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 for the Bangladesh government. About one-third of the total government revenue has now been collected in the form of VAT in Bangladesh. At present, VAT is collected on manufacturing goods and services, both at import and local stages. It also needs to be mentioned that a number of items enjoy exemption from VAT. Furthermore VAT is zero-rated on exported goods. At present cottage industries are exempted from VAT. Small industries could avail full or partial exemption from VAT by fulfilling required terms and conditions. All other enterprises (with turnover above Tk. 8 million) will need to pay VAT according to the respective provisions.

It may be noted here that, the VAT Act 1991 is going to be replaced by the new VAT Act 2012. Indeed, introduction of the new VAT law was one of the conditions that the IMF credit facility extended to Bangladesh in 2011. The new law envisages major reforms which addresses some of the weaknesses in the old VAT regulations. The new VAT Act has been

drafted with a view to generalise the rules and laws in a more comprehensive and user-friendly manner which is expected to make it easier to understand, simple, and reliable for end users. The new VAT Act has already received approval from the Cabinet and placed before the parliament. The parliament passed the new VAT Act as a bill and is expected to come into effect from 1 July 2015. However, during the last three years a number of adjustments have been made in the present VAT law as part of preparing the relevant stakeholders for the proposed new one.

Under the new VAT Act, the existing price declaration provision has been discarded. Instead the taxpayers will need to notify the current price and input-output coefficient. The procedural complexities of advance trade VAT (ATV) and VAT deducted at source for services have been eased in the draft. The draft VAT Act also includes a provision of single registration for the businesses which have several branches, and restricts the provision of tariff value and truncated base value. It is argued that the existing provision of tariff value and truncated base create distortions (Mansur, Yunus and Nandi, 2011).

1.6 Institutional Reforms

The key authority to collect the taxes in Bangladesh, including the VAT, is the National Board of Revenue (NBR). The NBR generates almost 75 per cent of the total government revenue. The NBR is currently implementing a 5-year strategic plan starting from 2011 to implement the goal of modernising the NBR. The plan includes digital NBR agenda, reform in business processes, various tax policy reforms, improvement in tax compliance and tax services and, overall capacity building and institutional development of the NBR (NBR, 2011). The operation and location of tax offices are rather centralised in Bangladesh. Under the modernisation plan, the operations of tax authorities are expected to be taken to the grassroots level. This would imply that, the SMEs located in the periphery areas may also face VAT compliance issues. On the positive side, implementation of these reforms may reduce compliance cost for the SMEs. No doubt, the SMEs in Bangladesh will need to adapt to these reforms and these will have important implications for their functioning.

1.7 Key Knowledge Gaps

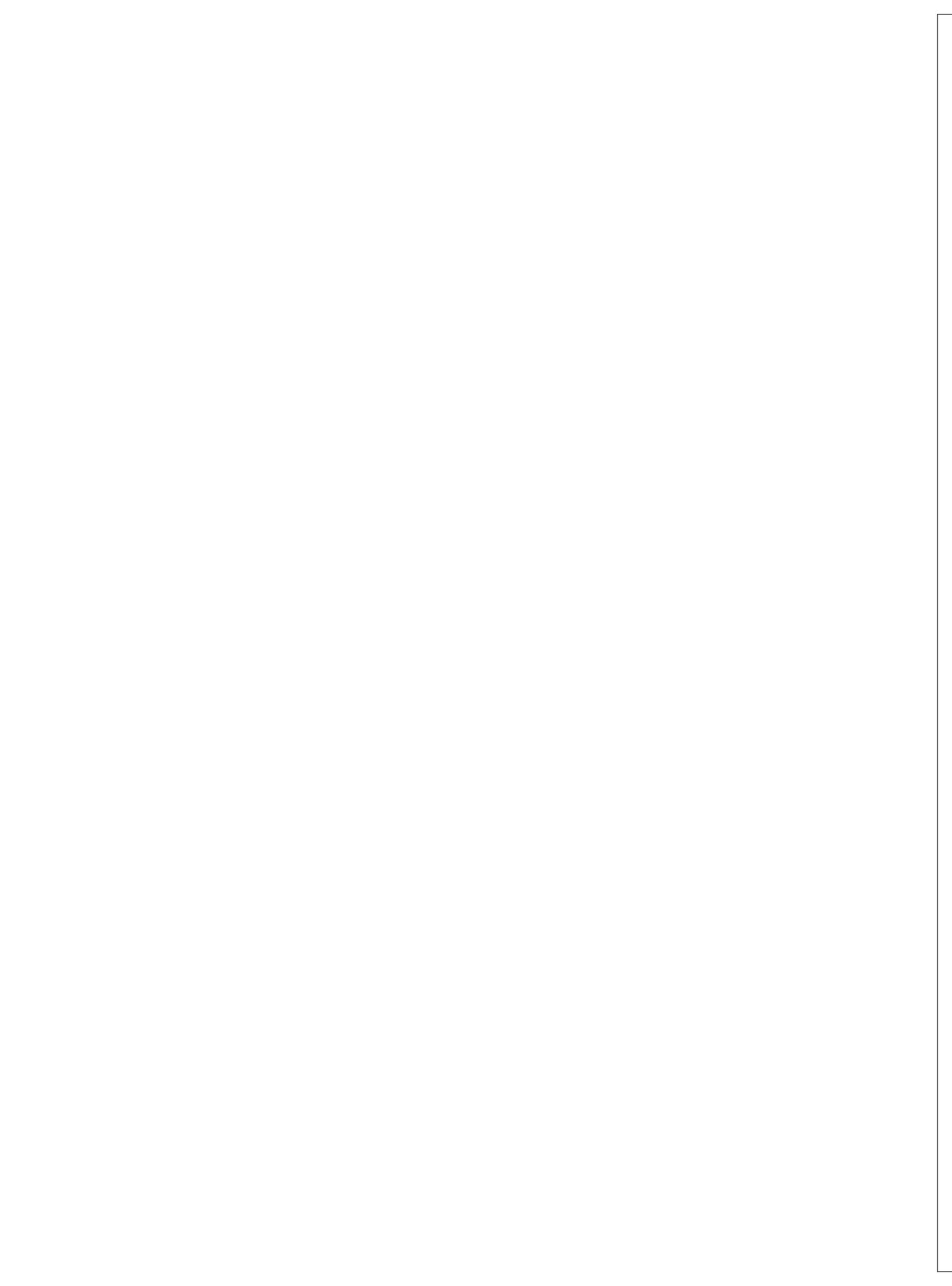
Preparations of putting in place new VAT provisions in Bangladesh tend to not give adequate attention to their possible implications for the SME development. Thus a

progressivity analysis is needed to be undertaken to assess the impacts of the VAT burden on SMEs' performance and productivity. It has been seen that, compliance cost and institutional bottlenecks often constraint compliance on the part of the SMEs. 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 (Spiro, 1993). This also creates barrier for SMEs to access various policy support provided by the government including targeted credit at relatively lower interest rate. Indeed, the fiscal policy framework often creates barriers that deter mainstreaming of the SMEs' economic activities and their potential contribution to the national economy. While crafting policies these aspects would require careful consideration. Since there is a dearth of evidence-based research in this area, policymakers in Bangladesh also face difficulties in accommodating special attention needed by the SMEs.

The aforementioned institutional and legal reforms will likely have a significant impact on tax compliance of SMEs and their overall performance. Thus assessing the impact of the new VAT provisions on SME development has long-term policy relevance for Bangladesh. At the same time, it is also important to understand the readiness and perception of the SMEs with regard to the likely impact and implications of the proposed reforms.

1.8 Data Sources

The NBR being the VAT collection authority in Bangladesh will be a key source of relevant information and data for this section. NBR consults relevant stakeholders and fixes annual tax collection targets. NBR is also the official source of revenue related data. NBR's annual report is also one of the published sources of data related to revenue collection including VAT. SME Foundation established through a gazette notification in 2007 as a non-profit organisation under the Companies Act (Act XXVIII), 1994 and registered with both the Ministry of Industries and the Registrar of Joint Stock Companies and Firms. The Foundation's vision is to promote SMEs with a view to alleviating poverty, generating employment and thereby accelerating economic growth. SME Foundation publishes periodical reports on SMEs.



SECTION-II

Conceptual And Theoretical Framework

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 also accepted that, a large proportion of SMEs operate in undocumented or underground economy in developing countries such as Bangladesh which are essentially non-compliant with regard to tax. But it is argued that the prevalence of underground economy may stimulate economic development in transition countries. Indeed, this undocumented economy can turn out to be an incentive to develop the entrepreneurial spirit (Enste 2003).

Sometimes it has been noted that the SMEs play a vital role in employment generation which provide arguments in favour of the idea to providing preferential treatment to the SMEs when VAT regulation is concerned. But some econometric evidences have challenged this argument. Davis, Haltiwanger and Schuh (1993) found no significant association between firm size and employment growth. In Sub-Saharan African manufacturing sector, large firms were the dominating job creators (Biggs and Shah, 1998). Conversely, OECD (2005) and World Bank studies opined that, in some developing countries, SMEs created practical employment opportunities in rural areas.

It is often argued that SME development is affected by taxes including VAT. VAT could become a subsidy incentive for a non-compliant firm if the firm is able to sell its final products at a price that a VAT compliant firm sells. At such case, the non-compliant SME could earn an extra profit that a VAT compliant firm used to pay as VAT. Overemphasis on VAT regulations on large taxpayers unit (LTU) perhaps hampers the growth of compliant SMEs. The phenomenon may induce SMEs to avoid taxation and restrict their growth to a limit. Relevant studies also found that given the presence of a large undocumented economy, VAT reform can reduce both welfare and revenue (Emran & Stiglitz, 2005). However, assuming complementarities between the undocumented economy and the official GDP, it was claimed 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 by Eilat and Zinnes (2000).

Empirical evidence suggests that women's SMEs tend to grow slowly compared to those owned by men. For example, Mead and Liedholm (1998) found that employment in male-headed SMEs grows by 11 per cent a year (on an average), which is 7 per cent for female-headed SMEs. It is argued that women typically face asymmetrical rights and obligations, particularly in developing countries. This constraint limits their labour mobility and burdens them with disproportionate household responsibilities (Downing & Daniels, 1992). Based on Guatemalan data, Kevane & Wydick, (2001) showed 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.

The literatures on the key determinants of the growth of existing SMEs are also inadequate. The growth of employment as a choice of dependent variable can be used for enterprise's ability to grow. At the same time, inflation adjusted annual turnover of the enterprise can be another estimate 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 volatile nature of employment creation by SMEs, which appears to increase with a lag after a sizeable growth in real sales. It also indicates that the employment growth measure may provide an underestimation of an enterprise's growth. At the same time, it is argued that female entrepreneurs keep their enterprises small in terms of employees due to administrative and social constraints.

On the other hand, some factors affecting the dependent variables relating to SME growth were described in relevant literatures. Some of the independent variables of SME growth were mentioned below:

- a) *Enterprise Size and Age*: Two key determinants SME growth can be the age and initial size of the enterprise in terms of employed persons or capital. An inverse relationship between these two variables and enterprise growth can be expected as suggested by "Learning models" of enterprise growth and empirical evidence from the United States and the developing world (Jovanovic 1982).
- b) *Sector*: Growth of an enterprise can vary among the various sectors. Firms in different sectors face different demands and encounter different cost structures which depend on the economic structure of a country. Liedholm and Mead (1999) suggested that

differences in SME growth among various sector 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 compared to their more isolated counterparts. For example, empirical evidence from Africa indicated more rapid growth in urban enterprises compared to their rural counterparts (Liedholm and Mead 1999).
- d) *Other Socioeconomic Variables:* Various socioeconomic variables relating to the entrepreneur may also be expected to influence SME growth. It is suggested that increases in “human capital”, including experience or education of the entrepreneur, is more likely to support enterprise growth process. The empirical evidence of this relationship, however, has been mixed (Liedholm and Mead 1999). In addition to “human capital,” gender of the proprietor may also be an important determinant of enterprise growth. Downing and Daniels (1992), for example, found that female entrepreneurs in Africa are more risk averse and thus less like to grow in comparison with their male counterparts.
- e) *Compliance:* Research indicates that SMEs suffer from a disproportionate compliance costs. Work conducted by the Better Regulation Task Force (BRTF) found that smaller companies often face a competitive disadvantage compared to the larger firms because of the cost and time involved in regulatory compliance being relatively higher (BRTF, 2000).

2.1 Definitions of Key Concepts and Constructing Parameters

2.1.1 Enterprise:

An enterprise is the administrative and financial decision making unit of an establishment. For an enterprise with a single establishment, the enterprise and establishment is the same. But there may be more than one establishment under a single enterprise. The enterprise can be a legal entity of corporate and quasi-corporate bodies. Under the present study, an enterprise produces only manufactured goods.

2.1.2 SME:

As is known, the definition of SME varies widely across countries or within a country; moreover it can be time variant. In Bangladesh definition of SME varies among the relevant institutions. To meet the survey purpose of the present study, an enterprise with less than 100 employees were considered as SMEs.

2.1.3 VAT:

The present VAT law in Bangladesh covers three types of taxes – turnover tax (particularly relevant for SMEs), VAT and supplementary duties. Cottage industries are kept outside the VAT net. Some special sectors within the SMEs enjoy VAT exemptions and differential rates (truncated rates) while exported commodities are also zero-rated to VAT. All these dimensions have significant implications in terms of progressivity of VAT.

2.1.4 Employment:

The study will define employment as the services provided by employed person(s) in full time basis. Employment generation capacity of an SME could be one of the key parameters determining its growth. Any unpaid household labour or any sort of unpaid apprenticeship will not be considered as employment.

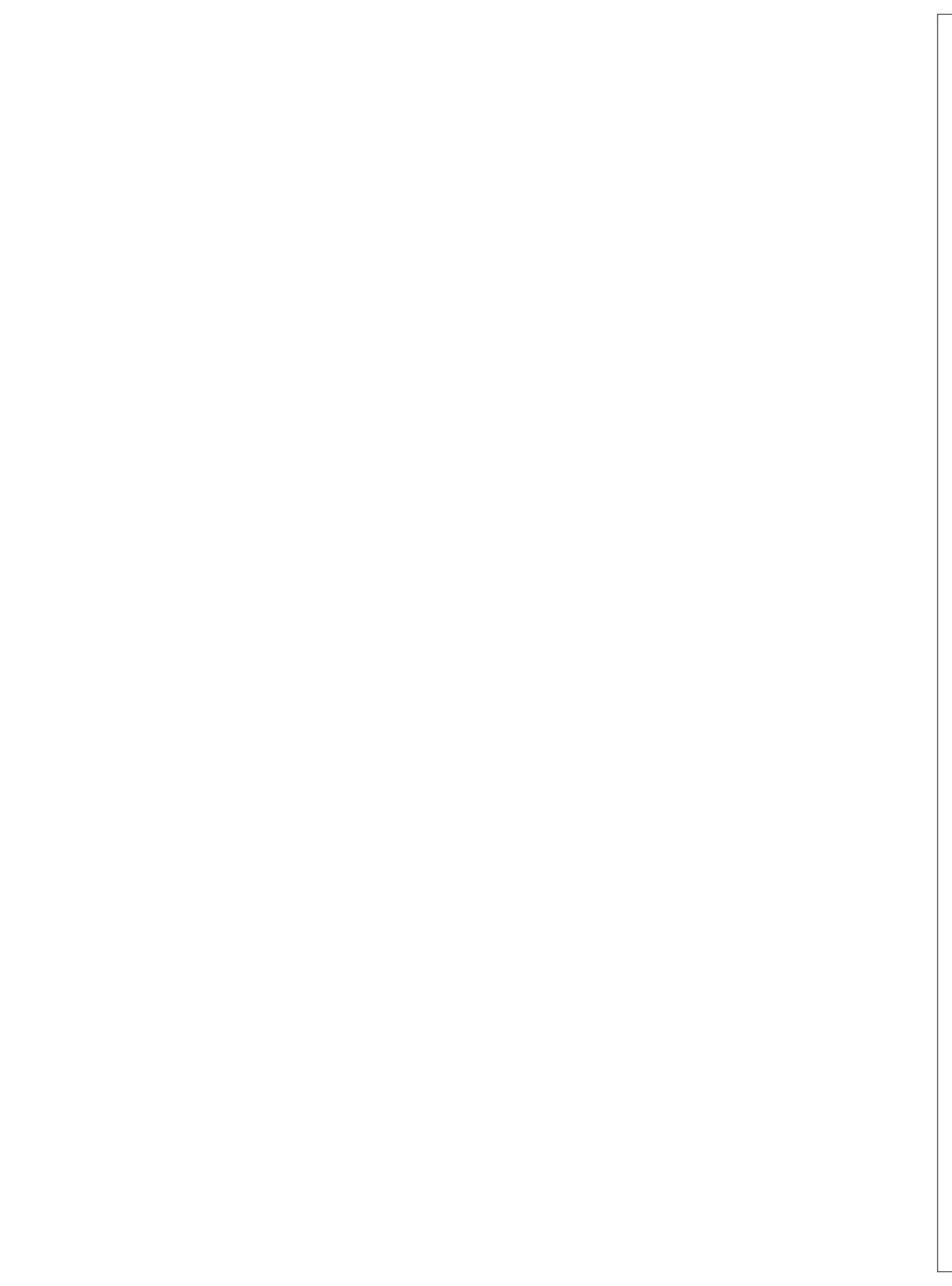
2.2 Research questions

The study will essentially concentrate to explore the impacts of VAT regulations and compliance on SME developments. In this connection distributional impact of indirect taxation (VAT) on SME will be envisaged. One of the main objectives of the study is to conduct a progressivity analysis of existing VAT law on SMEs under compared to large enterprises. Thus the inherent research question would be whether the existing VAT regulations are instrumental or detrimental towards the desired growth of SMEs - in terms of creating job opportunity and income generation.

The study will examine how the VAT compliance issue is linked with the growth of an SME. The study will also seek the behavioural response of the VAT administration system towards small businesses. Impact of discrimination (if any) by the system regarding the growth of small firms will be a matter of policy interest. The study may also like to explore the state of readiness of SMEs with regard to forthcoming VAT law in Bangladesh.

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

- i. Does the special provision (turnover tax) under Bangladesh's VAT law reduce the tax burden for SMEs compared to large enterprises?
- ii. Does VAT compliance/non-compliance have a significant impact on growth of SMEs?



SECTION-III

Analytical Framework and Methodology

3.1 Level of Analysis

Bangladesh is a small country and ruled under a uniform jurisdiction. Due to resource constraints as well as limited accessibility, it was not possible to conduct analyses beyond national level. The service sector in Bangladesh is very diverse and difficult to cover adequately given the study limitation. Hence, the analysis was limited to the manufacturing sector.

3.2 Analytical Approach and Assumptions

The available literatures on tax progressivity largely focused on the impact of tax on consumption. Tax incidence can provide a measure of progressivity of VAT. Atkinson and Stiglitz (1980) noted that economists analyse the incidence following different approaches. First, the impact of taxes on consumers as opposed to producers can be measured by a partial equilibrium model. Second, focus can be narrowed down to relative demands for different factors and the returns to those factors (such as capital, labour, land). For example, following a general equilibrium approach, Harberger (1962) concluded that capital is likely to bear approximately the full burden of corporate income tax. Third, individuals are grouped by some measure of economic well-being to analyze the progressivity of a tax system. Pechman and Okner (1974) analysed by grouping the taxpayers according to their annual income while Fullerton and Rogers (1993) replicated the Pechman analysis using taxpayers' lifetime income.

Hossain (1994) examined impact of VAT reform on consumers in Bangladesh. He argued that Computable General Equilibrium (CGE) approach may not be suitable for this purpose. He therefore followed equivalent variation technique, as proposed by Stern (1987), on consumer groups of heterogeneous population and concluded that revenue neutral uniform VAT system in Bangladesh is regressive in nature. However, it is still ambiguous whether the mentioned approaches are suitable for analysis on enterprises. As mentioned earlier, the SMEs under the VAT law are subject to turnover tax while the large

enterprises are subject to VAT and supplementary duty.

3.3 Survey Design

A sample survey was required to collect primary level enterprise data. The target respondent group for this analysis was comprised with all the manufacturing SMEs, both compliant and non-compliant with regard to VAT. Given the limited resources, the survey followed purposive sampling method and kept sample size limited.

The key objective of the survey was to learn about the impact of taxation on the state of growth of SMEs in Bangladesh. It would be worthwhile to note that, the survey covered only manufacturing enterprises. A total of 262 enterprises were surveyed in four districts of Bangladesh and 258 enterprises had their formal registrations. Among those surveyed, 223 enterprises were SMEs with less than 100 employees. The other 39 enterprises were considered large in terms of number of employees (100 and above) which represented the 'comparison' group (Table 1).

A set of 37 enterprises (from the surveyed 262 enterprises) came from BSCIC specialised industrial park which represented yet another comparison group. The BSCIC industrial parks were established in a number of districts with a view to facilitate growth of small firms and generate employment. These special economic zones are equipped with basic infrastructure facilities; industrial plot is leased at a subsidised rate. 100 per cent export-oriented firms have also been set up in these parks. Narshingdi BSCIC (20 samples) was targeted to cover the SMEs belonging to this category. However, a few BSCIC samples were also drawn from Bogra (11 samples) and Dhaka (6 samples) BSCIC. A total of 26 SMEs and 11 large firms were interviewed from the BSCIC zones.

The survey covered four districts (Bogra, Dhaka, Chittagong and Narshingdi) in Bangladesh. Dhaka (101 enterprises or 39 per cent of total) and Chittagong (60 enterprises; 23 per cent) was considered to represent core business activity places while Bogra (70 enterprises; 27 per cent) is chosen for its peripheral location. Narshingdi (31 enterprises; 12 per cent) was chosen to cover SMEs located in the BSCIC industrial park. However, 30 per cent of the firms located in the BSCIC zone were found to be of large-scale nature.

Table 1: Number of Enterprises Surveyed by Location

Division	SMEs	Total
Bogra	56	70
Chittagong	59	60
Dhaka	81	101
Narshingdi	27	31
Total	223	262

The samples were chosen through purposive sampling, as per the requirements of the study. The target respondent group comprised of manufacturing industries of all size categories available in Bangladesh spread over varied locations. Both compliant and non-compliant firms were visited. Given the limited resources, the survey accepted to follow purposive sampling method and kept the sample size limited.

3.4 FGDs and KIIs

For complementing the quantitative analysis the study also envisages conducting a number of focus group discussions (FGDs) and key informant interviews (KIIs). Interviews were conducted with a number of key informant stakeholders including relevant government officials, both current and retired, particularly from NBR and Ministry of Finance (MoF). Consultation with academics, civil society organisation representatives and tax practitioners were also conducted. Other autonomous actors such as officials at SME foundation, representative from international development partners and various business chambers have contributed to develop knowledge base. A number of instruments were used to conduct the KIIs including telephone, email, face to face interviews.

3.5 Policy Analysis Framework

The key focus of the policy analysis was the VAT policy and institutional framework which support SME development in Bangladesh. The results of the primary survey analysis were translated into policy recommendations. Information obtained from the results of key informants' interviews and FGD were also a basis of the policy analysis. While preparing

policy suggestions to the policymakers, the analysis considered the impacts these policies on other aspects of economy including revenue mobilisation. The policy analysis was prepared for short term and medium term separately.

SECTION-IV

Study Findings

This section compiled information derived from primary survey, key informant interviews and focus group discussions.

4.1 Results of the Survey

As was mentioned earlier, 262 enterprises were surveyed in purposive basis from 4 districts areas. The sample covered large firms and firms from special economic zones. These groups will enable comparative analysis with regards SME development.

Survey results sub-section is divided into three major parts. First, it addressed comparative characteristics of sampled firms. Second, it analysed general tax behaviour of the firms. Third, it took into cognisance the impact of VAT on SMEs, its associated costs, policy perspectives regarding their growth and other VAT administered issues.

4.1.1 Firm Characteristics

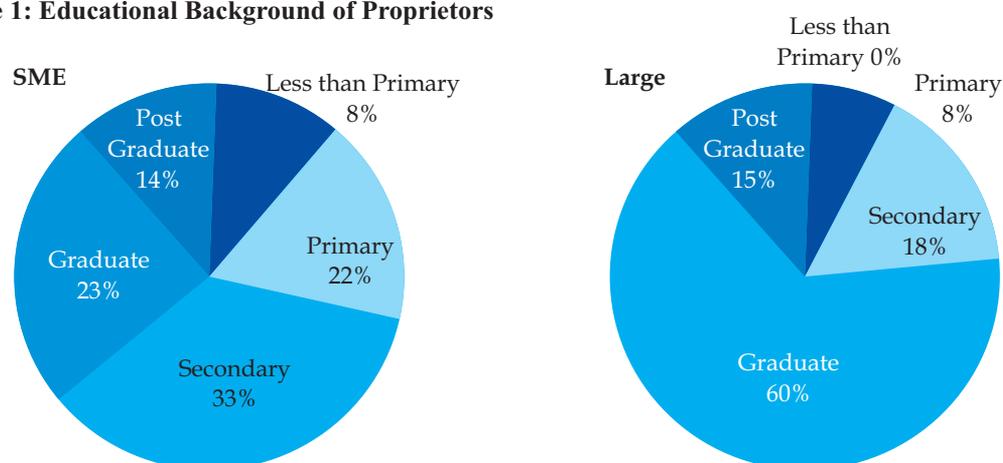
4.1.1.1 Registration Status

Out of 262 firms surveyed only 4 firms are found to be non-registered. These firms belonged to the SME category. About 50 per cent of the firms are found to be registered with City Corporations which issue trade license. The other authorities which are entitled to give registration are Upazilla Parishad, Union Parishad, and Pourashabha etc. More than 80 per cent of the SMEs were sole proprietorship-based enterprise. However, partnership-based firms were found to be more frequent in case of large enterprises. A number of enterprises were drawn from special economic zones.

The survey questionnaire also has a section on educational background and experience of the proprietor or key decision maker (as the case may be) of an enterprise. Three out of every four entrepreneurs of large firms have at least a graduation degree. In case of SMEs, one-third of the entrepreneurs have completed secondary education; 37 per cent obtained even a higher degree (Figure 1). Notwithstanding, entrepreneurs with only primary level

education or entrepreneurs with no institutional educational background also constituted a significant proportion (about 30 per cent of the total).

Figure 1: Educational Background of Proprietors



Source: CPD Primary Survey, 2013

It was found that entrepreneurs generally had some experience as regards their profession (Table 2). Many of the entrepreneurs are operating inherited business. Average years of experience were found to be 13.6 years with highest experience of an individual entrepreneur to be 45 years. Both high experience and higher level of education were the case for a number of entrepreneurs. About 58 per cent of the entrepreneurs with more than 5 years of experience were found to have a degree equivalent to secondary or higher than that. Some 50 SME entrepreneurs were with less than 5 years' experience which is indicative of growth of the SME sector in recent years.

Table 2: Experience of Entrepreneurs

Experience with present enterprise	Firm Size		
	SME	Large	Total
Up to 1 Year	13	0	13
Up to 5 Years	37	8	45
More than 5 Years	173	31	204
Total	223	39	262

Source: CPD Primary Survey, 2013

4.1.1.2 Assets and Turnover

According to primary survey results, more than 50 per cent of the SMEs have capital investment of up to Tk. 0.5 million (Table 3). Investment portfolio of most of the large firms start from Tk. 1 million, at least 25 per cent firms have capital investment equivalent to Tk. 10 million or more. Statistically capital investment portfolio of SMEs and large firms were found to be different at 1 per cent significance level (chi2 p-value=0.000).

Table 3: Capital Investment by Enterprise

Investment range (in Taka)	Firm Size		
	SME	Large	Total
Up to 500,000	119	6	125
500,001-1,000,000	37	5	42
1,000,001-5,000,000	54	11	65
5,000,001-10,000,000	5	7	12
10,000,000 above	8	10	18
Total	223	39	262

Source: CPD Primary Survey, 2013

Average capital investment of SMEs was found to be Tk. 2 million (with median value of Tk. 0.5 million), according to the survey data. For large firms, the corresponding figure is about Tk. 36.5 million. A single firm having investment of Tk. 750 million was an outlier, leading to overestimation of the data for large firms. However, half of the large firms have less or equal to Tk. 5 million of investment (median value). Hence, large firms could invest, on an average, 10 times more capital than SMEs, if median value is considered.

In case of enterprises in BSCIC zone, the capital investment opportunity is significantly different than that of the other enterprises which are operating outside BSCIC (chi2 (4) test statistic=31.3; p-value=0.000) (Table 4). While firms outside BSCIC (225 reported) have a capital investment amounting Tk. 0.5 million (median value), similar figure is Tk. 2.8 million (median value) for enterprises in BSCIC park (37 reported).

Table 4: Capital Investment by BSCIC Zone

Investment range (in Taka)	BSCIC zone		
	BSCIC	Not in BSCIC	Total
Up to 500,000	4	121	125
500,001-1,000,000	5	37	42
1,000,001-5,000,000	19	46	65
5,000,001-10,000,000	3	9	12
10,000,000 above	6	12	18
Total	37	225	262

Source: CPD Primary Survey, 2013

Table 5 shows, annual turnover of the surveyed SMEs were found to be Tk. 4.5 million (median value). Turnovers are significantly higher for large firms (Tk. 28.8 million).

Table 5: Annual Sales in 2012

Firm	N	Mean	Median	Std. dev.	Skewness	Kurtosis
SME	223	9,811,182	4,500,000	18,700,000	6	41
Large	39	176,000,000	28,800,000	289,000,000	2	7
Total	262	34,600,000	6,000,000	126,000,000	6	51

Source: CPD Primary Survey, 2013

4.1.1.3 Number of Staff

According to survey results, sample SMEs employed staff in a range between 8 and 85. On an average, 22 staff worked in each of the 222 SMEs in the sample (Table 6). On the other hand, dispersion of employment in large firms was found wide. One of the large firms employed 2,500 employees.

Table 6: Descriptive Statistics of Employment by Enterprise

Firm size	N	Mean	p50	Sd	Skewness	Kurtosis
SME	222	22	16	16	2	6
Large	39	335	155	444	3	16
Total	261	69	18	204	8	84

Source: CPD Primary Survey, 2013

Employment generation capacity of SMEs differed significantly as survey data suggests. 10 SMEs were running with less number of employees than the number of employees they had during their inception time into operation. Seasonal nature of employment, skill development, technological drawback, and financial considerations of staff, are some of the concerns which were mentioned by the SMEs with regard to sustainable job creation. The survey data analysis found that roughly 5 to 8 per cent employment generation is feasible from their current structure of operation. It is pertinent to assume that amount of job creation could be large if SMEs could receive increased support and priority from the government. Typically SMEs have limited access to formal loan for capital accumulation and struggle to develop their own infrastructure.

4.1.1.4 Access to Credit

Registration with local government (availing a trade license) is a mandatory compliance requirement for an enterprise in order to apply for formal loan. 121 SMEs (66.5 per cent) got access to formal commercial loan (out of 182 SMEs that received some kind of loan). A significant number of SMEs received credit from cooperatives and money lenders (7.7 per cent and 16.5 per cent respectively). However, in case of large firms, most of the credit was availed through the formal lines (about 80.6 per cent).

Large firms showed significantly different pattern with regard to outstanding credit. 53 per cent SME entrepreneurs have outstanding personal loan for business development, while for large firms the matched figure was 77 per cent.

4.1.2 General Tax Behaviour

This section attempts to examine existing tax structure, tax collection process and tax related compliances prevailing in Bangladesh. Questions included in this section were mainly targeted to gather information on status of firms as regards tax regulations, types of taxes, tax related compliance cost and entrepreneurs' perception about existing tax structure.

4.1.2.1 Overall Tax Compliance

Tax related compliance of firms was examined in the context of various types of direct and indirect taxes. According to the primary survey data, about 96 per cent enterprises reported themselves to be either direct or indirect tax payers whereas only 10 out of 262 enterprises (3.8 per cent) were found as non-tax payers (Table 7). Tax payers pay taxes at two levels – central and local. Taxes at the central level include corporate tax/Income tax, general sales tax, withholding tax, excise duty, import duty, turnover tax, supplementary

duty and others. Three types of taxes are paid by a significant share of surveyed tax-paying units which include corporate tax or income tax (91.7 per cent) and general sales tax (56.0 per cent) and excise duty (28.2 per cent) (Table 8). An overwhelming share of firms reported to be tax payers mainly due to biasness of the sample to cover only manufacturing units¹ which are largely operating under formal arrangements. A large number of industrial units informally operating in the service sector is largely out of the tax net (Walther, 2011) and have not been taken into consideration under this study.

On the other hand, taxes imposed on firms at local levels include property tax, land revenue, capital value tax on immovable property, fees for purchasing motor vehicles, stamps duty, electricity duty, fees for registration of real estate agencies, tolls on roads and bridges, fees on food and agriculture, fee for fairs, agricultural shows, cattle fairs, and tariffs for industrial water supply and drainage. Taxes and user fees paid by a large share of firms include electricity tariffs (51.2 per cent), property taxes (36.1 per cent), land revenue (21.0 per cent), fees for motor vehicles registration (19.4 per cent), tolls at roads and bridges (18.7 per cent) and fees for water (17.9 per cent) and drainages (about 19.4 per cent) (Table 8). Payment of local level taxes by relatively small share of firms indicates firms' limited access to different types of assets, utilities and services at the local levels. Low level of responses in case of payment of property taxes and land revenue indicate poor asset base of firms which is the most likely scenario for the SMEs in Bangladesh.

Table 7: Status of Tax Payment by Sample Firms

Responses about payment of taxes	Frequency	% Share
Yes	252	96.2
No	10	3.8
Total	262	100

Source: CPD Primary Survey, 2013

¹ The manufacturing sector has been chosen due to the feasible size of the respective sector in terms of conducting survey operation. Additional factor affecting the decision is the formal structure of such establishment and the availability of information from the sector.

Table 8: Responses as Regards Payment of Different Kind of Taxes

	Response	Percent (out of total 252 tax payers) Responses
Central Level Taxes		
Corporate Tax/Income Tax	231	91.7
General Sales Tax	141	56.0
Withholding Tax	26	10.3
Excise Duty	71	28.2
Import Duty	13	5.2
Turnover tax	1	0.4
Supplementary Duty	3	1.2
Others	1	0.4
Local Level Taxes		
Property Tax	91	36.1
Land Revenue	53	21.0
Capital Value Tax on Immoveable Property	2	0.8
Transfer of Sales Tax on Services	1	0.4
Motor Vehicles	49	19.4
Stamps Duty	26	10.3
Electricity Duty	129	51.2
Tolls on Roads and Bridges	47	18.7
Fees on Food & Agriculture	3	1.2
Fee for fairs, agricultural shows, cattle fairs,	2	0.8
Water Supply	45	17.9
Drainage	49	19.4

Source: CPD Primary Survey, 2013

A spatial distribution of firms in terms of payment of taxes reveals variation in payment of different kinds of taxes both at central and local levels. It has been observed during the survey that the share of firms paying income tax is varied between 80 per cent (in case of Dhaka) to 100 per cent (in case of Narshingdi). On the other hand, share of firms paying sales taxes widely varied between 28 per cent (Chittagong) to 77 per cent (in case of Dhaka). Similar cases are also revealed in case of payment of excise duty by firms located in different regions. In general, firms located in Dhaka are better tax compliant compared to that in other districts perhaps due to better operation of the tax administration in the capital city compared to that in other districts. Tax offices are conveniently located in the Dhaka city contribute to reduce hassles in paying taxes (discussed in later part of the report). Similar to the central level taxes, pattern in the payment of local taxes is widely

varied between firms located in different regions. Better compliance is observed in Bogra and Dhaka districts. Given the legal obligations for paying taxes and user fees, spatial variation could be explained by differences in extent of coverage in tax collection by local tax authorities and variation in the sample distribution where large firms are relatively high in Dhaka and Bogra which are supposed to be more tax complaint etc.

There are cases also among the survey samples which do not pay any kinds of taxes. As mentioned before, only 3.8 percent firms are not paying any taxes of the total 262 surveyed firms (Table 9). Most of these firms have turnover or sales below the taxable level (92.3 per cent of the non-tax paying units). One respondent has reported that he did not face any problem for not paying taxes implying that sales of the unit is above the minimum threshold level for the exemption of taxes but nonetheless he did not face any difficulty.

Table 9: Reasons for not Paying Taxes

Responses	Frequency	Percent
Turnover/Sales are below Exemption Level	12	92.3
No problem if tax is not paid	1	7.7
Total	13	100.0

Source: CPD Primary Survey, 2013

4.1.2.2 Overall Tax Perception and Experience

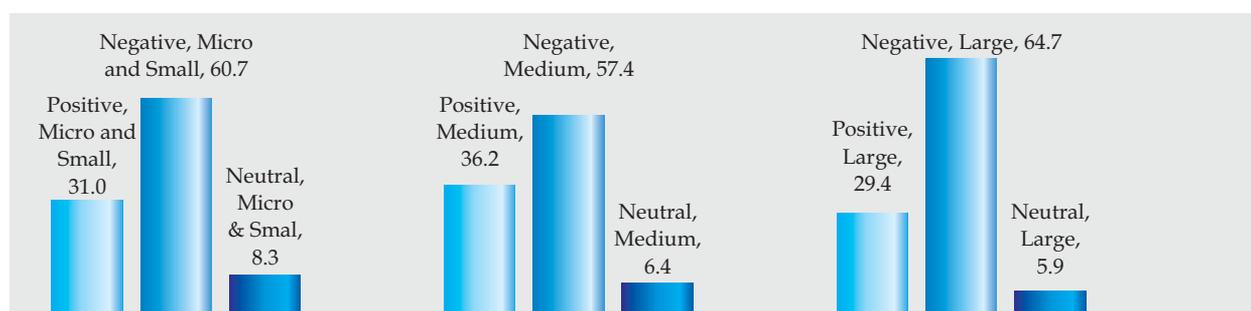
The structure of taxes, tax collection processes and processes in tax administration in Bangladesh, as in many developing countries, could be criticised on many grounds. About 80 per cent of survey-respondents either strongly or moderately agreed that structure of tax was not favourable for businesses. According to their opinion, this is because of the large number of taxes accompanying with procedural complexities. However, another 20 per cent respondents have different views regarding this issue. The competency of tax administration was in general found to be acceptable to the surveyed firms. About 60 per cent firms agreed that tax collection agencies have competent officers, and that locations of tax offices are convenient for them. However another 30 per cent respondents have opposite views regarding this issue. There are contrasting views regarding the experience of harassment by tax officials – about 40 per cent firms found tax staffs fair and respectful in their dealings with SMEs while about 54 per cent firms found tax staffs not dealing properly (Table 10). A large division in responses indicates issues and concerns from both sides with regard to determination of tax payable income/sales, amount of taxes, settlement of taxes etc.

Table 10: Perception on Tax Structure (% of Total Surveyed Firms)

Perception on different issues	Too many taxes?	Tax laws and procedures too complex	Tax collecting Agencies have competent officers and the location of tax office is convenient	Tax staff is fair and respectful in its dealing with SMEs	Harassed by the tax official
Strongly agree	43.5	48.1	16.0	6.9	26.3
Agree	35.1	33.6	44.3	34.7	27.9
Disagree	13.0	11.1	24.8	42.0	28.2
Strongly disagree	1.5	1.5	5.7	6.5	6.5
Indifferent	6.1	5.0	9.2	9.9	11.1
Total	99.2	99.2	100.0	100.0	100.0
Missing	0.8	0.8			
Total	100.0	100.0			

Source: CPD Primary Survey, 2013

Existing tax structure in terms of their number and procedural complexities was considered to be less benefit for the firms. About 60 per cent of firms found it negative for their firms – there is not much difference in the perception as regards to the nature and extent of implications of tax structure for different categories of firms (Figure 2). Multiplicity of taxes, on the other hand, has multi-dimensional adverse impacts on the enterprises including harassment, rise in expenses and waste of time (Table 11). Because of weaknesses and in efficiencies of various types, firms face multiple challenges in marketing the products. This is because of increase in tax compliance cost as also production cost which has adverse impact on the price of the marketed products (Table 12). Overall, there is scope for improving the existing tax structure, tax administration and tax collection processes in order to make them business friendly.

Figure 2: Perception of Entrepreneurs of Various Sized Enterprises on the Existing Tax Structure

Source: CPD Primary Survey, 2013

Table 11: Problems Caused by Multiplicity Of Taxes

Impact of Multiplicity of Tax	Responses	Percent	Percent of cases
Tax officers demand extra money	25	10.6%	16.4%
Multiple taxes is difficult to recognize	23	9.70%	10.1%
Multiplicity of taxes is more harassing	75	31.80%	49.3%
Increase in expenses	65	27.50%	42.8%
Waste of time	48	20.30%	31.6%
Total	236	100.00%	155.3%

Source: CPD Primary Survey, 2013

Table 12: Challenges Created by Prevailing Taxes

Challenges	Responses		
	Number	Percent	Percent of cases
Increase in expenses	90	36.10%	53.6%
Prices of goods increases	74	29.70%	44.0%
Harassment / misbehavior of tax office	24	9.60%	14.3%
Increase in production cost	27	10.80%	16.1%
Waste of time	34	13.70%	20.2%
Total	249	100.00%	148.2%

Source: CPD Primary Survey, 2013

4.1.2.3 Compliance Cost

Firms have to spend a considerable amount of money at different stages of operations starting from entering into the business towards the regular operation of firms. Table 13 provides a picture of the number of registered firms with the tax authority which shows that 84.70 percent of SMEs are registered with the tax authority.

Table 13: Registered Firms with the Tax Authority

		Yes	No	Total
Small & micro	N	144	26	170
	Percent	84.70	15.30	100.0
Medium	N	51	1	52
	Percent	98.10	1.90	100.0
Large	N	39	0	39
	Percent	100.00	0.00	100.0
Total	N	234	27	261
	Percent	89.70	10.30	100.0

Source: CPD Primary Survey, 2013

Registration of SMEs which is the first step of formalization of SMEs is supposed to be free of charge with a view to promote operation of SMEs in Bangladesh. According to the survey respondents, registering the firms is considered to be one of the major expenses incurred by the firms. Tax officials in the name of cost for processing registration collected money from the firms which are most likely various kinds of authorized and unauthorized payments for getting the formal registration from the authority. According to Table 14, sample firms on average have to spend about Tk.13500 for completing the process of registration. Registration fee is the only 'authorized' expense, which incurs about 20 per cent of total expenses while most of the rest are different kinds of 'unauthorized' payments including bribes to officials and other employees and processing charges for paper/documents etc. Different kinds of expenses vary widely between firms perhaps because of differences in the size of operation, location of firms and informal understanding of 'unauthorised' payments (Table 14). A large share of unauthorized payment by firms to tax authorities refutes their claim for experiencing better dealings from the latter. Part of this difference could be explained by variation in dealings at initial level when both parties are unknown to each other and dealings latter when both parties are familiar with each other.

Table 14: Tax Related Expenses

Items of Expenses	Number	In Taka		
		Minimum	Maximum	Mean
What was the registration cost?	235	0	15800	2760
How much you have to pay in addition to the regular amount for 'travel expense'?	46	100	3000	938
How much you have to pay in addition to the regular amount for 'Bribe'?	21	50	10000	2126
How much you have to pay in addition to the regular amount for 'Dalal/Peon'?	20	400	9000	2845
How much you have to pay in addition to the regular amount for 'Office'?	17	500	20000	3682
How much you have to pay in addition to the regular amount for 'Papers/ Documents'?	2	1000	1000	1000
How much you have to pay in addition to the regular amount for "others"?	1	200	200	200
Total				13551

Source: CPD Primary Survey, 2013

Firms have to bear tax related expenses for maintaining office staffs and/or for hiring tax lawyers. Most of the firms (about 74 per cent) did not have any employee specifically dealing with tax related issues (Table 15). Given the limited scope of work involved for processing tax related documents firms in most instances do not hire employees specifically to deal with these issues- either an employee is in charge of finance or the entrepreneurs themselves did the job. Expenses for hiring employees for dealing with taxes may become an issue for firms as average cost ranges between Tk. 20,000 to as high as Tk. 240,000 (Table 16). Other tax related costs are more burdensome which can be as high as 40 per cent of the total tax related costs in 2012. Tax related costs did not increase much in 2012 compared to that in 2011 after a jump in 2011 from 2010. Tax related costs are much higher for large firms though not much change of these costs took place particularly the limited period in consideration.

Table 15: Annual Tax Related Cost

	Annual cost associated with the salary and other payment to specialized tax employees (Tk.)	Annual cost on tax related matters (Tk.)		
		2010	2011	2012
Small & Micro				
N	37	127	131	141
Mean	4608	7761	8656	9137
Minimum	0	500	600	700
Maximum	20000	140000	140000	140000
Medium				
N	14	46	47	50
Mean	7364	13704	14657	16748
Minimum	0	1000	1000	200
Maximum	20000	100000	110000	120000
Large				
N	13	37	39	39
Mean	77692	93919	129749	140054
Minimum	1000	2000	2000	2000
Maximum	240000	1120000	1125000	1200000

Source: CPD Primary Survey, 2013

Table 16: Annual Costs On Tax Related Matters

Issues	Number	Minimum	Maximum	Mean
What is the annual cost associated with the salary and other payment to these specialized tax employees?	64	0	240000	20056
What has been your annual cost on tax related matters in 2010?	211	500	1120000	24171
What has been your annual cost on tax related matters in 2011?	218	600	1125000	31615
What has been your annual cost on tax related matters in 2012?	231	200	1200000	32895

Source: CPD Primary Survey, 2013

4.1.2.4 Willingness to Formalise

One of the prerequisites for firms to enjoy tax related benefits is to operate as a formal entity by registering with appropriate authorities. About 90 per cent of surveyed firms are registered with at least one authority. Interestingly, majority of these firms (about 70 per cent) are not interested to get tax benefits may be to avoid hassles and high costs related to compliance requirements. Among the firms which are not registered, the factors that instigated them not to become formalized include excess cost (88 per cent), complex rules and regulations (12 per cent) and offering bribe to tax officials (87.50 per cent) (Table 17). Because of overwhelming burden of financial and non-financial costs tax related benefits might be considered insignificant to firms. Hence firms' willingness or unwillingness to formalise does not seem to be associated with enjoying tax benefits.

Table 17: Tax Related Hassles

Tax related hassles	Registered		Unregistered		Total	
	Frequency	Per cent of total respondents	Frequency	Per cent of total respondents	Frequency	Per cent of total respondents
Cost	102	64.60%	22	88.00%	124	67.80%
Complex rules and regulations	55	34.80%	3	12.00%	58	31.70%
Documentation procedure	1	0.60%	0	0.00%	1	0.50%
Total	158	100.00%	25	100.00%	183	100.00%
Others						
Harassment	3	5.30%	1	12.50%	4	6.20%
Bribe	35	61.40%	7	87.50%	42	64.60%
Long distance from tax office	19	33.30%	0	0.00%	19	29.20%
	57	100.00%	8	100.00%	65	100.00%

Source: CPD Primary Survey, 2013

4.1.3 Impact of Value-Added-Tax (VAT) on Enterprise Development

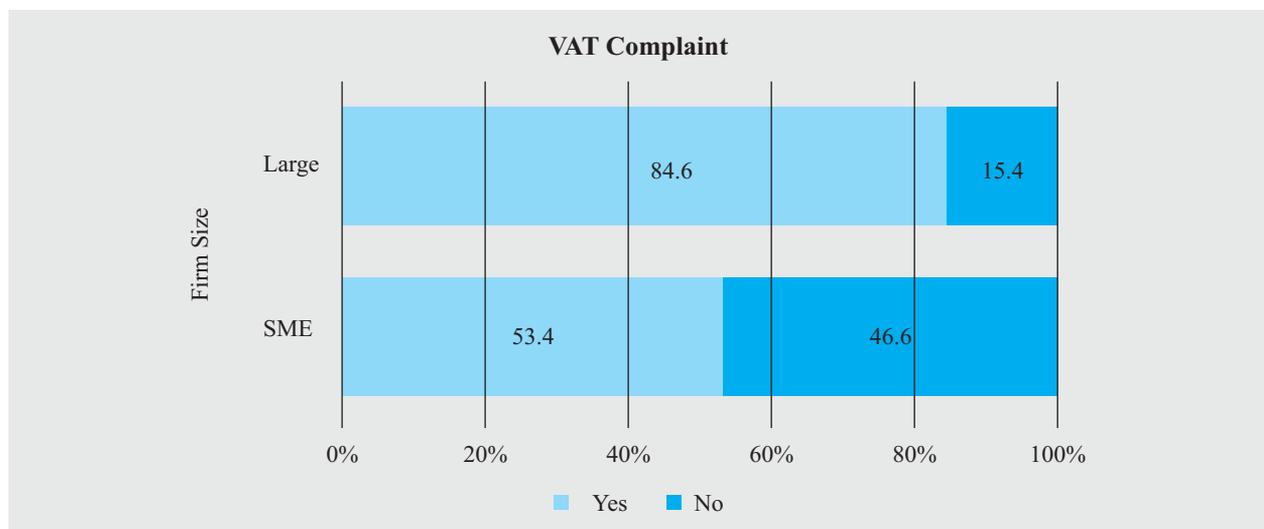
4.1.3.1 VAT Compliance

The respondents were asked whether they are VAT compliant² or not. All 262 enterprises responded to the question. It has been observed that large firms are more compliant to VAT than that of SMEs. About 84.6 per cent (33 firms) of the large firms reported that they are compliant to VAT whereas only 54 per cent SMEs (119 firms) are registered to VAT

² A firm is considered VAT compliant if it fulfils the necessary requirements to register with the VAT authority. Payment of VAT is not a necessary condition for VAT registration.

(Figure 3). The responses from large firms and SMEs are statistically different (chi2 p-value=0.002) at 1 per cent significance level. The result was expected as many of the SMEs are taking either turnover or package benefit of VAT law.³

Figure 3: VAT Compliance by Enterprise



According to the survey data analysis, the SMEs took, on an average, five and half years to become registered with VAT authority after their inception. The similar figure for large firms is almost four years. It may be considered that a number of large firms started their operation as SMEs. Interestingly, a good growth of SME activity is seen since 2005. Out of 202 SMEs (which have reported their business starting year), about 62 per cent came into operation over the period of last 8 years (Table 18). Although, rate of compliance is very poor, three out of every four SMEs surveyed have reported to become VAT registered during the mentioned period. Even a 65-year old SME registered with the VAT authority only in last year (2012). Efforts to broaden the tax net have also intensified during the mentioned period.

³ According to the existing law, compliant firms could avail turnover or 'package VAT' benefits without registering to VAT.

Table 18: Share of Enterprises Initiated and Become Compliant by Period

Year	Start of Business (%)		Become VAT Compliant (%)	
	SME	Large	SME	Large
Before 2000	16.3	21.2	0.8	18.2
2001-2005	21.8	15.2	14.4	15.2
2006-2010	47.5	54.5	46.6	39.4
2011-2013	14.4	9.1	38.1	27.3
Total	100.0	100.0	100.0	100.0
<i>Reported</i>	202	33	118	33

Source: CPD Primary Survey, 2013

4.1.3.2 VAT Compliance Cost

During the survey, the entrepreneurs were asked whether they incur any VAT compliance cost. 83 per cent (217 responses) of the entrepreneurs have shared their perception. The perceptions from SME owners and large firm owners were significantly different (chi2 p-value=0.014). About 21 per cent of SME entrepreneurs feel that they do bear the compliance cost for VAT, while about 40 per cent of large firm owners express the same perception.

Table 19: Descriptive Statistics: VAT Compliance Cost

Firm	Indicators					
	NaObservations	Mean	Median	Std. dev.	Skewness	Kurtosis
SME	36	24,903	3,000	62,506	3	8
Large	15	31,000	10,000	75,032	3	13
Total	51	26,696	5,000	65,720	3	11

Source: CPD Primary Survey, 2013

However, only 51 enterprises have revealed their VAT compliance cost. About 50 per cent of the SMEs bear as low as Tk. 3,000 VAT compliance cost annually on an average (Table 19). One can recall that a large number of SMEs avail the package VAT system, compliance cost of which can be very negligible. Conversely, some capital intensive SMEs⁴ maintain Tk. 20,000 monthly VAT compliance costs. In some cases, they operate separate section in the enterprise to comply with VAT regulations. On the other hand, as data reported, the cost of VAT compliance for large firms is even sparse (rightly skewed) compared to that of SMEs. The data could have been affected by small sample bias.

⁴ That includes plastic industries, textile industries etc.

An SME paid about Tk. 67,638 on an average, as VAT in 2012. It includes all forms of VAT⁵ they paid during the period. Like compliance cost data, VAT payment data is also rightly skewed. Hence, the median value of VAT paid is found only Tk. 19,000.

4.1.3.3 VAT Policy Perceptions

The entrepreneurs were also asked to share their views on the VAT policy of Bangladesh. The hunch is to figure out any problem existing in the policy that may hinder SME growth. Regarding VAT policy, the SMEs were actually not much aware of. They need to hire some experts to comply with the policy. Hence, VAT related costs were found to be burdensome to 75 per cent of SME respondents. The large firms possibly face VAT related complexity relatively more being compliant and therefore more large firms (than SMEs) opined the cost to be burdensome (about 83.3 per cent).

Table 20: Impact of VAT Cost on Enterprise Development

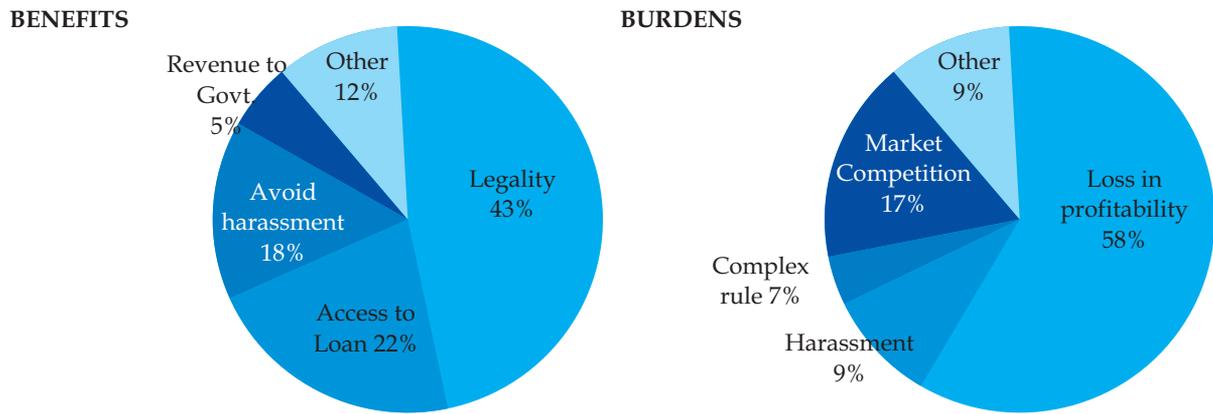
Response	Firm Size		
	SME	Large	Total
Beneficial	25.1	16.7	23.7
Burdensome	74.9	83.3	76.3
Share of response	100.0	100.0	100.0
Total responses	171	36	207
Missing responses	50 (22.6%)	5 (12.2%)	55 (21.2%)

Source: CPD Primary Survey, 2013

Table 20 shows expected results with regard to impact of VAT cost. To analyse the impact in-depth, the respondents were asked to share their experience, why they found VAT related expenses to be either helpful or taxing toward growth of their enterprise. 47 respondents described benefits and 144 respondents described burdens related to VAT cost. The respondents came up with a list of observations. According to the respondents, favourable tax gains of VAT cost include legality of business, access of their firms to formal commercial loans and more importantly it's a mental relief being a tax payer (Figure 4). On the other hand, a large share of respondent thought that VAT cost decreases their profitability and made them market uncompetitive. Among other reasons, complex procedures and fear of harassments by the VAT officials were also mentioned.

⁵ Firm specific rate of VAT is different. Most of the SMEs are covered under turnover tax or Package VAT provision.

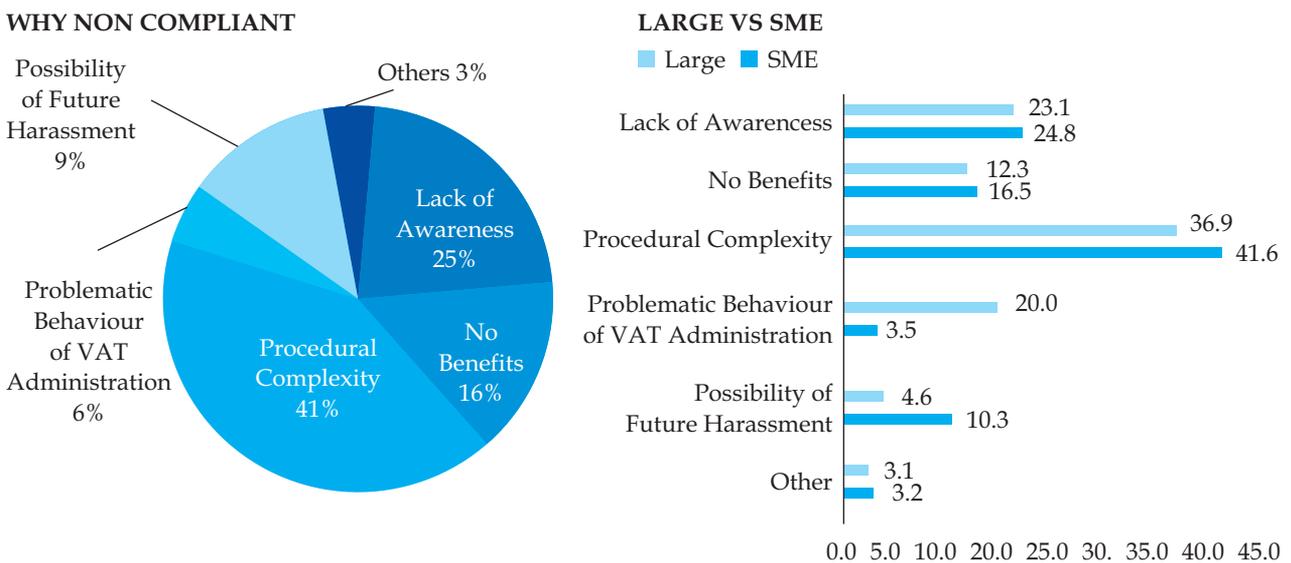
Figure 4: Benefits And Burdens Of VAT Cost



Source: CPD Primary Survey, 2013

Among the underlying reasons behind a firm’s not being compliant procedural complexity of VAT and lack of awareness about VAT regulations among the enterprises are the top two issues mentioned by the respondents (41 per cent and 25 per cent respectively). Except these two, the large firms mentioned about not-so-friendly VAT administration as the other important reason, while the SMEs mentioned about possibility of future harassment from the VAT authority (Figure 5).

Figure 5: Reasons Behind not being Compliant



Bangladesh is now in a transition to implement a new VAT law. The new law is designed to overcome the earlier flaws. It is expected that the new law will also meet end-user expectations along with the objective of revenue mobilisation. Awareness building promotion also needs adequate attention. Survey data shows, awareness about the new VAT law is not common among the entrepreneurs. About 85 per cent entrepreneurs do not know anything about the new VAT law (Table 21).

Table 21: Awareness Regarding New VAT Law

Response	Firm Size		
	SME	Large	Total
Yes	5	1	6
No	23	12	35
Do not know about the new law	195	26	221
Total	223	41	262

Source: CPD Primary Survey, 2013

4.1.3.4 VAT Administration Perceptions and Experiences

A sub-section of the survey questionnaire listed a set of questions to collect the views of entrepreneurs about the friendliness of VAT regulations and behaviour of the VAT administrators. Perception towards VAT regulations was found 'somewhat low' while many of the stakeholders did not complain over the performance of the administration. The scenario perhaps reflects the low compliance status of enterprises and their minimal impact on their business development (Table 22).

Table 22: Stakeholder Views on VAT Regulations and the Performance of Officials

Performance of VAT Officials	Friendliness of VAT Regulations					Total
	Very Low	Low	Indifferent	High	Very High	
Very Low	1	3	0	0	0	6
Low	3	24	5	5	0	41
Indifferent	14	30	13	13	0	116
High	12	29	36	36	2	90
Very High	1	1	3	3	2	9
Total	31	87	57	57	4	262

Source: CPD Primary Survey, 2013

Many of the entrepreneurs informed that they did not face any difficulty to collect VAT credit, and they do not think that VAT administration is less friendly to the women entrepreneurs and a few entrepreneurs received capacity building training on VAT promotion, regulations from the VAT administration. Even the visit of VAT officials is not frequent to stakeholder's end point. The survey data reveals that, VAT officials used to visit many large firms quarterly (44 per cent of the firms) while they visit most of the SMEs at annual basis (visits 35 per cent of the SMEs annually). All these indicators state the situation that, neither stakeholders thoroughly aware of VAT regulations nor are the officials interested to broaden their net. Therefore, many of the SMEs remain undocumented to VAT regulations and could not avail the mainstream opportunities and access. And they fail to streamline their business due to lack of mainstream opportunities and access.

Summary of Key Findings from Primary Survey

- Large firms are more compliant with regard to VAT payments than SMEs. In parallel, larger firms faced VAT related complexity relatively more than SMEs because of their compliance state.
- Median VAT compliance cost for SMEs is Tk. 3,000 annually. Some capital intensive SMEs maintain Tk. 20,000 monthly VAT compliance costs.
- Perception of major respondents is that VAT cost decreases their profitability and made them market uncompetitive.
- Main reason for non-compliance is procedural complexity. Lack of awareness of enterprises was the second cause that sets them off from VAT compliant.
- Perception towards VAT regulations was found somewhat low while many of the stakeholders are indifferent over the performance of the administration.
- Neither stakeholders were thoroughly aware of VAT regulations nor were the officials interested to broaden their net when specifically SMEs are concerned. Of course, low revenue intake from SMEs compared to large taxpayers would be a factor here when limited manpower of VAT administration is considered.

Table 23: A Glimpse of Primary Survey for Theme 2

Indicators	Responses
Target respondents	SMEs and Large Enterprises
Number of responding enterprises	262 (SME: 223)
Methodology of survey	Perception based
Coverage	Bogra, Dhaka, Chittagong, Narshingdi
Number of registered firms	258 (SME: 219)
VAT compliant	152 (SME: 119)
Reported VAT paid	137 (SME: 107)
Average VAT paid (Median)	Tk. 30,000 (SME: Tk. 19,000)
Average VAT compliance cost (Median)	Tk. 5,000
Knowledge on new VAT law	Unsatisfactorily low

Source: CPD Primary Survey, 2013

4.2 Results of Key Informant Interviews

Under the present study a set of key informant interviews (KIIs) were conducted to supplement the results originated from primary survey. Under the research theme of the impact of VAT on enterprise development, a number of interviews were executed. The target group of individuals who were interviewed include present and retired tax officials, tax experts, academics, non-state actors, entrepreneurs, representatives from international financial institutions and other key stakeholders related to SMEs.

The key questions asked to the informants were related to the state of VAT regime in Bangladesh and its implications to the SME development; special and differential provisions under the VAT law for SMEs; and treatments of tax administration towards SMEs. Moreover, the informants were expected to provide expert opinion on the adjustments made in the new VAT law, to be mainstreamed in full swing from FY2016, towards the development of SMEs.

4.2.1 VAT Law and Special Provisions for SMEs

Bangladesh implemented VAT law for the first time in 1991. The Value Added Tax Act 1991 has replaced the then existing Sales Tax Ordinance 1982. According to the VAT Act 1991, VAT is collected on manufacturing goods and services, both at import and local stages. Under the VAT Act 1991, a number of items enjoy exemption from VAT e.g. exported products, essential commodities etc. However, the present VAT regime does not

explicitly recognise SME, which is readily defined in the Industrial Policy 2010. However, two special provisions are in place for the small entrepreneurs. First, the cottage industries are fully exempted from VAT. Second, turnover tax gives preferential provision to the small enterprises, which has annual turnover below Tk. 80 lakhs, to pay turnover tax at a lower rate of 3 per cent. There is also provision for 'Package VAT' for small scale trading enterprises which usually do not maintain any formal ledger accounting. All other enterprises need to pay VAT according to the respective provisions articulated in the Act. In general, tax culture in Bangladesh does not give much emphasis on SME. According to the tax officials, contribution from SMEs within the total VAT intake is rather low and the growth of revenue generation from this particular sector has not been very significant over the years.

4.2.2 Ideal Tax Culture and Significance to SMEs

It has been observed that the first VAT law in Bangladesh did not respond adequately to the fact that its regressive nature could further aggravate the ability to develop of small enterprises. An ideal VAT policy should have focused to create a favourable policy environment that will ensure the progressivity of tax. In this respect, the key informants were first asked to answer whether the SMEs were given sufficient priority or faced any disproportionate behaviour by the VAT law. One of the tax policy makers termed the prevailing VAT policy to be SME friendly. He pronounced special provisions of cottage benefits and turnover tax scheme available for the small firms. Under turnover tax provision, an entrepreneur has to keep minimum ledger accounting that could reduce his administrative cost. He added that, being compliant to VAT, an entrepreneur could become respectful to law and avoid administrative harassment as tax evader. Notwithstanding, a field level tax administrator admitted discretionary treatments of VAT law against the SMEs. He briefed, the treatments of turnover tax are different by sector, by firm or even by products. This differential treatment could raise the tax level for a sick industry while giving benefits to a better off firm. Some association members informed that, some small producers manufacture a vast variety of intermediate goods and categorisation of those products is not an easy task and it is difficult to provide VAT exemption on those products. This feature regarded as a major hurdle for being SMEs compliant to VAT. However, the tax administrators believed that putting emphasis on good governance and awareness building would benefit both tax intake and SME growth.

A major portion of the stakeholders believe that, SMEs are not properly addressed by the law. Eventually most of the small firms are not aware of their tax benefits. Implementation bottlenecks force a big portion of firms to remain informal. To avoid complexity to become formal and harassments of the tax officials, many of the entrepreneurs turned into package VAT and other informal measures.

The non-state actors highlighted two major distortions of the law that goes against the SME development effort. One is double taxation and other is the turnover tax provision. Without taking input from a 'registered' supplier, one cannot claim VAT refund benefit against its input VAT. According to the law, the enterprises can enjoy the turnover tax provision without being registered under the VAT administration. One can however voluntarily be registered to VAT administration, even though the enterprise is eligible for turnover tax. In that case, the enterprise will be treated under the general scheme of VAT provisions. Hence, the firm will no longer remain within the turnover regime following VAT registration. However, the entrepreneurs, who are enjoying turnover tax facility (without VAT registration), cannot not participate in government tenders. Indeed, in recent times to be eligible, participation for a large private sector tendering process also requires VAT registration. Under this circumstance, the SMEs are in a dilemma.

At the specialised industrial park for SME, known as the Bangladesh Small & Cottage Industries Corporation (BSCIC) zones, the SMEs enjoy tax related technical support in addition to the ample infrastructure benefits, according to a BSCIC administrative officer. VAT registration is not mandatory to establish an enterprise there, but the facilities provided by the zone authority influence them to become VAT compliant. They also enjoys tax holiday for first three years. For some specific products, enterprises get VAT exemption benefits. And the authority could also arrange a common employee for record keeping collectively. These facilities ease their VAT regulation rules and reduce compliance cost significantly. VAT officials also get natural incentive visiting the park frequently.

4.2.3 Compliance Cost

VAT registered SMEs incur more compliance cost than those which operate informally due to lack of enforcement. In this connection, the tax officials admitted that there are limitations with regard to policy 'enforcement' which also resulted in low intake of VAT registration by the SMEs. Hence, non-compliant SMEs are getting disproportionate sales benefits. SMEs also incur disproportionate compliance cost compared to large enterprises. It is also mentioned that even though a number of SMEs do not incur formal compliance cost they may have to incur informal payments to the tax officials. Furthermore, low level awareness among the SMEs leads to higher cost of compliance by the SMEs.

4.2.4 Bargaining Capacity of SMEs in Formulating Fiscal Policy

The tax officials emphasised the political economy of the state of the bargaining power of SMEs in formulating fiscal policy. Although there is a large number of SMEs operating in the economy, they are not a united entity. Hence, SMEs in Bangladesh have limited voice

and lobbying capacity and cannot take collective actions for their wellbeing. They termed VAT liability of SMEs as a burden that restricts their utility maximisation. An ex-NBR member mentioned complex registration rules, high cost of accounting and discouraging perceptions from tax administration restricts the expansion of turnover tax net. Thus many SMEs have to either opt for being compliant under the general VAT provisions or remain outside the tax net. The latter group will miss out the benefits of being tax compliant SMEs as a result.

4.2.5 Administrative Friendliness

It is argued that the tax authorities are not accommodative to the SMEs. The unhelpful mindset of tax administration creates bias towards the development of SMEs. Tax experts opined that VAT administration needs more manpower to cover a populous cluster of SMEs. However, VAT intake from SMEs is considerably lower than VAT paid by the large firms. This creates a disincentive to the mindset of tax officials. The stakeholders also argued that limited bargaining capacity of SMEs put them into difficult situation and especially women entrepreneurs are often harassed legally and mentally by the tax officials. The informants are of the opinion that the women entrepreneurs have a lower level of knowledge and awareness about the law.

4.2.6 Policy History of VAT Reform and New VAT Law

The regeneration of the old Sales Tax Act 1951 had initially been done through injunction of Sales Tax Ordinance 1982. 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 for the Bangladesh government. At the present time, about one-third of the total government revenue is collected in the form of VAT in Bangladesh.

Table 24: Chronological Changes in Thresholds and Rates of Turnover Tax

Year	Changes
Fy1991	Turnover tax @2%
FY1997	Turnover tax @4%
FY2007	Turnover ceiling raised to Tk. 20 lakhs
FY2009	Turnover ceiling raised to Tk. 40 lakhs
FY2010	Turnover ceiling raised to Tk. 60 lakhs
FY2011	Turnover tax @3%
FY2012	Turnover ceiling raised to Tk. 70 lakhs
FY2013	Turnover ceiling raised to Tk. 80 lakhs

Source: CPD Primary Survey, 2013

It may be noted here that, the VAT Act 1991 is going to be replaced by the new VAT Act 2012. The new law envisages major reforms which addresses some of the weaknesses in the old VAT regulations. The new VAT Act has been drafted with a view to generalise the rules and laws in a more comprehensive and user-friendly manner which is expected to make it easier to understand, simple, and reliable for end users. The new VAT Act is expected to come into effect from 1 July 2015. However, during the last three years a number of adjustments have been made in the present VAT law as part of preparing the relevant stakeholders for the proposed new one.

Under the proposed VAT Act, the existing price declaration provision has been discarded. Instead the taxpayers will need to notify the current price and input-output coefficient. The procedural complexities of advance trade VAT (ATV) and VAT deducted at source for services have been eased in the draft. The draft VAT Act also includes a provision of single registration for the businesses which have several branches, and restricts the provision of tariff value and truncated base value. From the revenue mobilisation perspectives, it is argued by the academics that the existing provision of tariff value and truncated base create distortions. NBR officials said that the new law will ensure justice to the SMEs. No value declaration provision will continue. It was expected, that will lead to compel NBR to increase its administrative capacity and decrease leakages. The lack of capacity often leads to distortional behaviour by the tax officials. Most importantly but unfortunately, the entrepreneurs have very little knowledge about the VAT law for preparing themselves to comply with it.

4.3 Results of Focus Group Discussions

While conducting the FGD with a multi-stakeholder group involving entrepreneurs, policymakers, tax administrators, non-state activists and academics, the discussion mainly floated around broad topics – implications of VAT for SMEs; compliance cost of VAT for SMEs, administrative friendliness towards SMEs and implications for new VAT law. The FGD discussion below is also summarized under these four broad headings.

4.3.1 Implications of VAT for SMEs

All the stakeholders agreed that there are some special provisions for SMEs in the present VAT regime in Bangladesh. However, they also recognized that the absence of a common SME definition in all regulations including tax related legal frameworks, industrial policies and credit incentives is a major impediment towards implementation of policies for SME growth and sometimes it can create confusion. Most of the stakeholders opined that there is a need for a common set of criteria and a single definition for SME.

On the issue of implications of VAT regulations on SME the stakeholders were found divided. The tax policymakers were of the opinion that there are already a number of benefits within the VAT system, including turnover tax and exemption from cottage industries, and SMEs should be able to avail these opportunities. They did not think that there is any need for additional benefits.

In contrast, non-state actors and entrepreneurs opined that these provisions are difficult to avail at the ground level. For example, they mentioned that it is not easy to get the registration as a cottage industry. The registration procedure is cumbersome and requires overcoming significant bureaucratic procedures. They also opined that the definition of cottage industry is very limited and requires an extension.

SMEs also cannot avail the VAT facilities due to their operation in the informal market. Most of the SMEs acquire raw materials or inputs from other SMEs. As a result, a VAT compliant SME may not be able to receive formal documents (challans) from its suppliers. Hence the SME will then have to incur the total VAT payment and cannot get tax credit. In contrast, when a SME supplies to the large firms, the VAT is deducted at source (withholding VAT) and thus even if the SME may be eligible for VAT exemption or turnover tax, it cannot avail the system. Many SMEs do not understand this tax accounting system and pay double tax.

The stakeholders also highlighted that to be benefitted from the turnover tax (which is 3

per cent of total turnover), the value addition of an SME needs to be more than 20 per cent. For a large section of SMEs, particularly those who operate trading activities this can be lower. Thus if they comply, the turnover provision is not a benefit for them.

The SME owners also mentioned during the FGD that most of their SME competitors are not VAT compliant. Hence, when they are fixing the price including VAT or turnover tax, they are facing price competition. They think that if the rate of VAT can be reduced more SME owners will be willing to pay taxes and there will be a level playing field.

It is also mentioned by the participants of FGD that many SMEs do not have a depth in knowledge about the tax system which can mislead SMEs. The stakeholders recalled a number of experiences where an SME was exempted from VAT but included the VAT in their offered price. As a result they faced price competition.

The stakeholders also acknowledged that most of the SMEs in Bangladesh are not registered for VAT. Even the registered SMEs do not fully comply with the VAT. They may declare lower level of production at the time of reporting to the tax administrators. Sometimes they have to pay bribe to the tax administration. They also opined that since the threshold of turnover tax may not be raised regularly, the SMEs report lower level of turnover since it may fall outside the threshold during the following year.

The entrepreneurs acknowledged that in order to grow in the market, an SME will have to register with the VAT administration. Thus it is important to raise awareness among the SMEs about the VAT regulations. But they opined that VAT for SMEs should be lower. They opined that large firms enjoy the 'economies of scale'. To compete with them the SME will need this benefit. Indeed, the entrepreneurs consider as a cost of production.

4.3.2 Compliance Cost

The tax administrators did not put forward comments on the compliance cost. They have a very little idea about it. They think that for many SMEs (particularly for medium enterprises) this cost is not burdensome.

The entrepreneurs however think that the compliance cost for an SME is disproportionately higher than a large enterprise. They recommended that tax administration needs to be more decentralized. They find it difficult to travel to district headquarters of tax offices. They also informed that they may have to go to the divisional headquarters for some official reasons. They recommended that introduction of mobile tax payment system can help. For the tax related activities, the SMEs have to rely heavily on the tax lawyers. Thus the compliance cost is much higher for SMEs.

4.3.3 Administrative Friendliness

The tax officials acknowledged that it may be difficult for SMEs to deal with the tax officials. But they also opined that the administration put little emphasis on compliance of SMEs, particularly on small enterprises. They think that it is very important to raise the number of tax officials at the field level to serve the SMEs. However, they also recognized that it is important to enhance the tax net in Bangladesh given the low revenue mobilization. VAT collection from SMEs thus needs to be emphasized.

The entrepreneurs and other non-state actors on the other hand expressed that the behaviour of tax administration is biased towards large firms. They also opined that the formulation of fiscal policy puts little emphasis on the SMEs. Thus their voices remain unheard.

The entrepreneurs and other non-state stakeholders also opined that the present administrative procedures are quite difficult for SMEs to follow. The SME related stakeholders acknowledged that a number of recent initiatives including introduction of online TIN application, tax payment, greater dissemination of information through NBR website and introduction of a new website for VAT by a tax administrator (<http://vatbd.com/>) are commendable and are helpful for SMEs. However they also mentioned that such efforts are not enough. They think if the tax administration can be decentralized and local level tax offices can be established, then it will be easier for SMEs to maintain relationship with the tax officials and influencing them to become more SME friendly.

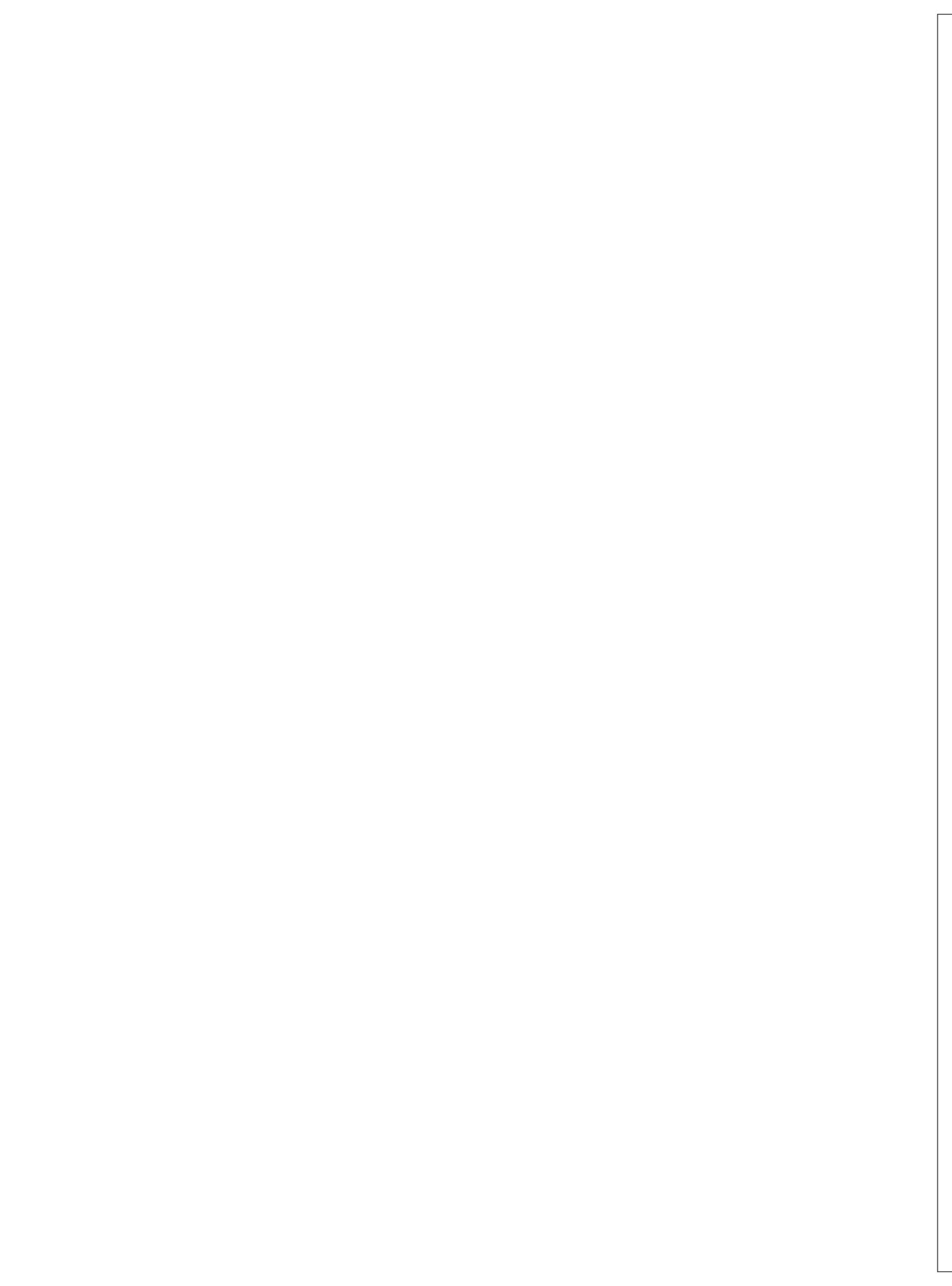
The entrepreneurs also find it difficult to face the tax administration. One of the entrepreneurs highlighted that most of the tax officials are either corrupt or exceptionally honest. According to him, both of these two groups are not SME-friendly. He also recognized the fact that the entrepreneurs are also not totally honest.

4.3.4 New VAT Law

The NBR officials mentioned that the Board is taking necessary preparations in order to implement the new VAT law. They recognized that there will be a major shift in the area of VAT regime. They also acknowledged that some of the SMEs may have to adjust considerably during the new regime. However, they also reported that considering these facts, the Board provided a period of three years (2012-2015) to adapt. The NBR officials also highlighted that they have prepared an implementation plan in collaboration with IMF.

Other stakeholders along with the entrepreneurs however, acknowledged that there is little knowledge about the new VAT regime among the SMEs. However, they recalled that during the preparation of VAT law the issues put forward by the SME lobbying groups were not addressed adequately. Usually the lobbying groups place their sectoral demands with minimum linkage serving the greater national interest. This could be one of the underlying reasons, their demands were not entertained properly. They could not mention any dedicated preparation towards adaptation to the new VAT law. The entrepreneurs also hoped that the implementation deadline may be extended. This perception of the stakeholders came from their past experience. They also think that there may be a change in the government regime as the national election is nearby. They may be able to lobby the new government for a change or extension of the timeline.

The non-state stakeholders also opined that the new VAT framework is formulated from the perspective of higher revenue mobilization. The non-entrepreneur section among the non-state stakeholders recognized that it is important for SMEs to mainstream themselves and formalise their transaction in order to grow as enterprises. However, they highlighted that there is a very mention in the NBR implementation plan about the awareness raising and capacity building of SMEs towards this end.



SECTION-V

Policy Implications and Recommendations

The sensitivity of the present VAT regime in Bangladesh does not adequately address the issues concerned by the SMEs. In connection to this a number of following policy recommendations may be considered to establish a SME friendly VAT regime in the Bangladesh context.

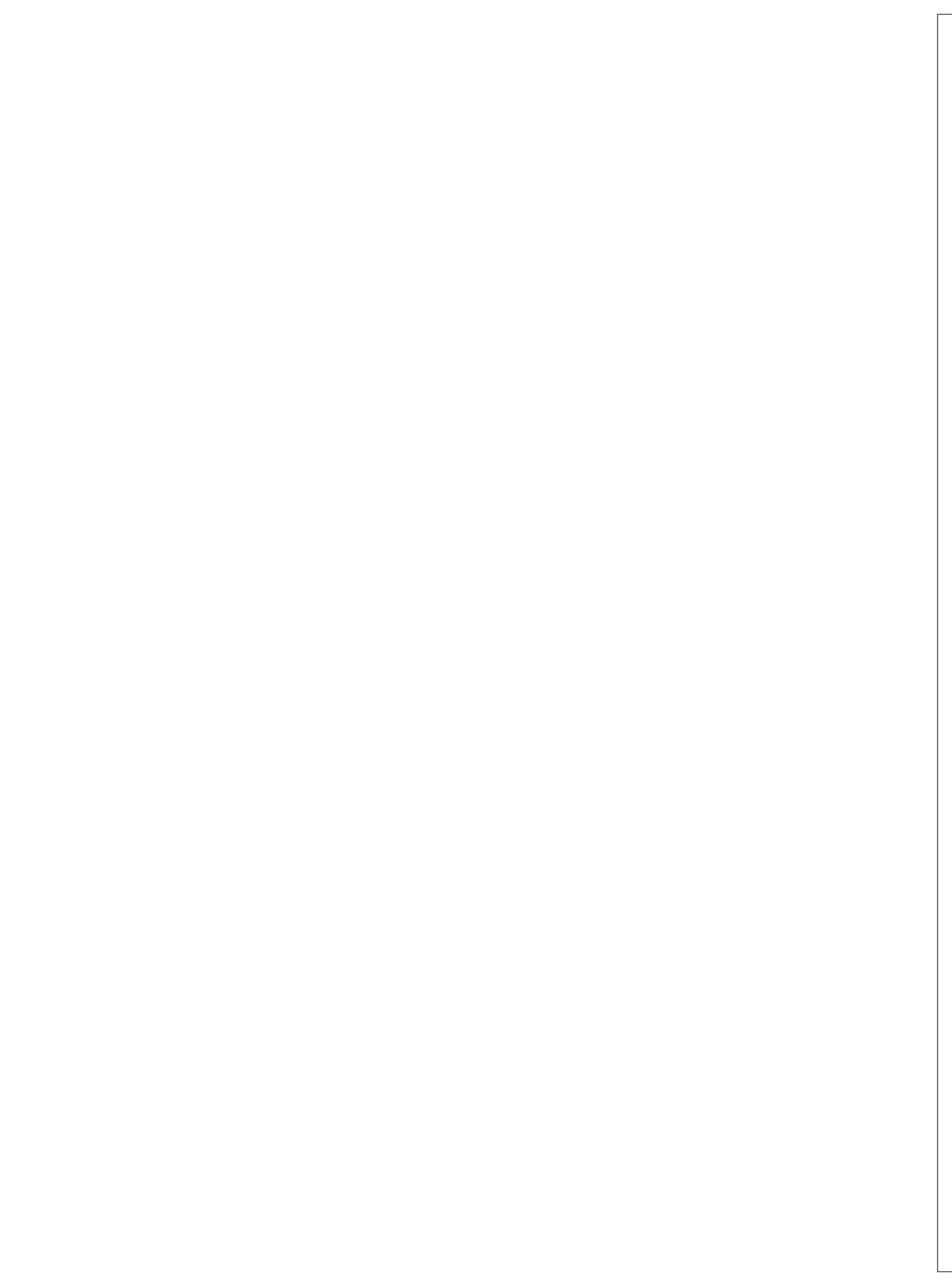
First, the forthcoming new VAT regime needs to recognise SMEs with an explicit definition in the VAT law. The definition needs to commensurate with the definition placed by the other concerned polices (e.g. industrial policy, BSCIC).

Second, the VAT related act and rules need to incorporate SME related special provisions in a clear and well-articulated manner. In connection to this the special VAT provisions (including the forms of turnover tax and package VAT) may use the measure of a firm's capital instead of using the sales or turnover value. At the same time, it is also important to streamline the loopholes in the VAT law as regards benefits for SMEs.

Third, the VAT laws and procedures are often found to be complex. A more committed effort will be required to identify and simplify these laws and procedures.

Fourth, for SMEs in Bangladesh costs as regards VAT compliance is found to be higher. The tax administration needs to ensure a better service delivery to SMEs. Indeed, to ensure that the tax administration is strengthened, its institutional capacity and the services to SMEs must be enhanced. Towards this end, decentralisation of tax administration should be a priority.

Fifth, the tax administration will be required to ensure fair enforcement to establish a level playing field for the compliant SMEs.



References:

- Auriol, E. and Warlters, M. 2005. "Taxation Base in Developing Countries." *Journal of Public Economics*. Vol.89 Issue.4: 625-646. Available at: <http://www.sciencedirect.com/science/article/pii/S0047272704000945>
- Bakht, Z. 2008. "Development of the SME Sector in Bangladesh." In Osmani, S.R. (ed.) *Emerging Issues in Bangladesh Economy*. Dhaka: Centre for Policy Dialogue and The University Press Limited.
- Bird, R.M. 1974. "Public Finance and Inequality." *Finance and Development* 11 (March): 2-4.
- Bangladesh Bank. 2012. *Annual Report 2010-11*. Dhaka: Bangladesh Bank.
- Bhattacharya, D. and Khan, T.I. 2008. "Pro-poor Economic Growth in Bangladesh: Exploring Growth and Inequality Linkages in Poverty Reduction." In Osmani, S.R. (ed.) *Emerging Issues in Bangladesh Economy: A Review of Bangladesh's Development 2005-06*. Dhaka: Centre for Policy Dialogue (CPD) and The University Press Limited (UPL).
- Bhattacharya, D., Faiz, N., and Zohir, S. 2000. *Policy for Employment Generation in the Informal Sector of Bangladesh. A Study prepared for the International Labor Office, Centre for Policy Dialogue, Dhaka.*
- Chowdhury, F. 2007. *Customized Form of Finance for SMEs. Seminar Proceedings, National SME Development Program for OIC Member Countries, FBCCI, Dhaka.*
- CPD. 2012. *Bangladesh Economy in FY2011-12: Third Interim Review of Macroeconomic Performance*. Dhaka: Centre for Policy Dialogue (CPD).
- Faridy N. and Sarker, T. 2011. "Incidence of Value Added Tax (VAT) in Developing Countries: A Case in Bangladesh." *International Journal of Trade Economic and Finance*, Vol.2, No.5: 437-442.
- Gibson, T. and Vaart, H. J. 2008. *Defining SMEs: A Less Imperfect Way of Defining Small and Medium Enterprises in Developing Countries* <http://www.brookings.edu/research/papers/2008/09/development-gibson>

- Hall, C. 2007. When the Dragon Awakes: Internationalization of SMEs in China and Implications for Europe. CESifo Forum, Vol. 8, No. 2: 29-34.
- Hossain, S.M. 1995. "The equity impact of Value Added Tax in Bangladesh." IMF Staff Papers, vol.42, No.2: 411-430.
- IFC. 2007. Designing a Tax System for Micro and Small Businesses: Guide for Practitioners. Washington: International Finance Corporation.
- IFC. 2002. Ukraine: An Assessment of the Business Enabling Environment. Washington: International Finance Corporation.
- Islam, K.M., Zohir, S.C. and Hossain, M. 2011. "SME Development in Bangladesh." In Mujeri, M. K. and Alam, S. (eds.) Sixth Five Year Plan of Bangladesh 2011-2015 Background Papers Volume 2. Dhaka: Bangladesh Institute of Development Studies and General Economics Division, Planning Commission, Government of The People's Republic of Bangladesh.
- ITD. 2007. Taxation of Small and Medium Enterprises, Background paper prepared for the International Tax Dialogue (ITD) conference, Buenos Aires, October 2007. Available at: <http://www.itdweb.org/SMEconference/ConferencePapers.aspx>
- Khatun, F., Khan, T. I. and Nabi, A. 2012. National Budget for the Ultra Poor: An Analysis of Allocation and Effectiveness. Dhaka: Centre for Policy Dialogue and BRAC.
- Khondker, B. H. and Raihan, S. 2011. "Technical Framework Papers: Volume 2." In Mujeri, M. K. and Alam, S. (eds.) Sixth Five Year Plan of Bangladesh 2011-2015: Technical Framework Papers. Dhaka: Bangladesh Institute of Development Studies and General Economics Division, Planning Commission, Government of The People's Republic of Bangladesh.
- Mansur, A. H., Yunus, M. and Nandi, B. K. 2011. An Evaluation of the Tax System in Bangladesh. Paper presented in Conference titled "Linking Research to Policy: Growth and Development Issues in Bangladesh," organised by International Growth Centre (IGC) Bangladesh, held on 20 December 2011.
- Meerman, J. 1979. Public Expenditure in Malaysia: Who Benefits and Why. New York: Oxford University Press.
- Miah, M.A. 2006. Key Success Factors for National SME Development Program; Lessons

- for OIC Member Countries from Bangladesh Experience. Dhaka: SME Foundation.
- MoF. 2012. Monthly Report on Fiscal Position (July FY2012-13). vol.1, FY2013. Report prepared by Macroeconomic Wing, Finance Division, Ministry of Finance, Government of The People's Republic of Bangladesh.
- Murgai, R. and Zaidi, S. 2005. "Poverty Trends during Nineties." In Ahmed, S. (ed.) Transforming Bangladesh into a Middle Income Economy. New Delhi: Macmillan India Limited.
- NBR. 2011. Outline of Modernization Plan (2011-2016). Dhaka: National Board of Revenue (NBR).
- Rahman, R.I., Mondal, A. H. and Iqbal, Z. 2011. "Employment and the Labour Market: Recent Changes and Policy Options for Bangladesh." In Mujeri, M. K. and Alam, S. (eds.) Sixth Five Year Plan of Bangladesh 2011-2015 Background Papers: Volume 3. Dhaka: Bangladesh Institute of Development Studies and General Economics Division, Planning Commission, Government of The People's Republic of Bangladesh.
- Rikta, N.N. 2007. Intuitional Lending and Financing Policy for SMEs in Bangladesh. Bangladesh Bank Policy Note Series: PN 0804. Dhaka: Bangladesh Bank.
- Skatteverket. 2006. Compliance costs of value-added tax in Sweden. Report no 2006:3B. Solna, Stockholm: Skatteverket.
- Spiro, P.S. 1993. Evidence of a Post-GST Increase in the Underground Economy. Canadian Tax Journal, vol. 41, no. 2: 247-258.
- Stern, R. and Loeprick, J. 2007. Small Business Taxation: Is this the Key to Formalization? Evidence from Africa and Possible Solutions. Washington: FIAS Tax Team, World Bank Group.
- Tanzi, V. 1974. "Redistributing Income through the Budget in Latin America." Banca Nazionale di Lavoro Quarterly Review 17: 65-87.
- Uddin, S.M.N. 2008. SME Development and Regional Economic Integration, Seminar Proceedings, Joint Regional Workshop held in Tokyo, Japan.



International Development Research Centre
150 Kent Street, Ottawa, ON, Canada K1P 0B2
Phone: (+1) 613 236 6163,
Fax: (+1) 613 238 7230
Email: info@idrc.ca



Governance Institutes Network International
9, Street 1, Sector F-6/3, Islamabad 44000,
Pakistan- Phone: (+92 51) 2307831-33
Fax: (+92 51) 2307835
E-mail: mail@giniweb.net or info@giniweb.net



National Institute of Public Finance and Policy
18/2, Satsang Vihar Marg, Special Institutional
Area (Near JNU), New Delhi 110067, India
Phone: (+91 11) 26569303, 26569780
Fax: (+91 11) 26852548
E-mail: support@nipfp.org.in



Institute for Integrated Development Studies
P.O. Box No. 2254, Mandikhatar, Kathmandu
Nepal - Phone: (+977 1) 4371006, 4378831
Fax: (+977 1) 4378809
E-mail: info@iids.org.np



Institute of Public Policy, BNU
126-B Ahmed Block, New Garden Town,
Lahore, Pakistan
Phone: (+92 42) 35913304, 35913306
Fax: (+92 42) 35913303
E-mail: ipp@bnu.edu.pk



Institute of Policy Studies of Sri Lanka
100/20, Independence Avenue,
Colombo 07, Sri Lanka.
Phone: (+94 11) 2143100, 2665068
Fax: (+94 11) 2665065
E-mail: ips@ips.lk



Centre for Policy Dialogue
House 40C, Road 32, Dhanmondi R/A, Dhaka-1209, Bangladesh
Phone: (+88 02) 8124770, 9141734, Fax: (+880 2) 8130951, E-mail: info@cpd.org.bd