THE REDUCTION OF PRESUMPTIVE ELEMENTS IN VAT – A COMPARATIVE ANALYSIS OF THE VALUE ADDED TAX (VAT) AND SUPPLEMENTARY DUTY ACT, 2012, AND THE VALUE ADDED TAX (VAT) ACT, 1991, OF BANGLADESH

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Abstract

The Value Added Tax (VAT) and Supplementary Duty Act, 2012 of Bangladesh, which, having already been deferred a number of times following its enactment, was scheduled to be implemented from July 01, 2017, has been postponed again, amid concerns among, and opposition from, the business community and members of the public. However, the tax authority of Bangladesh claims that the 2012 Act is superior to the existing Value Added Tax (VAT) Act, 1991, in terms of revenue mobilisation and the reduction of tax evasion. While the 1991 Act is fraught with the presumptive elements that are the major sources of tax evasion and causes of departure from the standard VAT system, the proposed Act is free of presumptive elements, so it will be closer to the standard VAT system. This paper demonstrates that the implementation of the proposed VAT Act would dramatically reduce the incentives for tax evasion as the presumptive elements have been eliminated.

Keywords: Value Added Tax (VAT), Tariff Value (TV), Truncated Base (TB), Input Tax.

1. INTRODUCTION

Value Added Tax (VAT) was introduced in Bangladesh through the enactment of the Value Added Tax (VAT) Act, 1991, which took effect on July 1, 1991. Prior to the introduction of VAT, sales tax had been imposed at the import stage, while domestically produced goods and services were taxed under the excise duty regime. VAT was implemented against the backdrop of these systems' detrimental features, i.e. multiple rates, excessive exemptions, the cascading effect in the absence of credit mechanism, and the two systems' narrow tax bases. It was designed to replace them with a view to expanding the tax base, simplifying the tax collection procedure and curbing tax evasion, as well as achieving the most desired goal of mobilising an increased amount of revenue (Government of Bangladesh, 1991). Additional objectives when introducing VAT included bringing transparency and consistency to the taxation system and removing the cascading effect which was present in the existing system, i.e. taxes on taxes (National Board of Revenue, 1994). However, two and a half decades after the government of Bangladesh implemented VAT, efforts to evaluate the extent to which it has achieved its objectives and goals have had gloomy outcomes. Smith, Islam and Zaman (2011) conclude that VAT in Bangladesh has failed to achieve the desired objectives and hence they suggest reforming VAT administration by creating intensive awareness of VAT among the people,

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revisiting the list of VAT-exempted items and increasing the efficiency of the monitoring system. The existing VAT legislation has also been reported to be fraught with excessive exemptions (National Board of Revenue, 2005). However, the most striking feature of the VAT Act, 1991, and, for that matter, of the existing VAT system of Bangladesh as a whole, is that it is dominated by presumptive elements. The existence and dominance of presumptive elements is the reason for the existing VAT system's departure from the standard VAT system. The input tax credit mechanism – the bedrock of the standard VAT system – does not work when presumptive elements are present in the VAT system. In essence, the absence of the input tax credit mechanism due to the presence of presumptive elements provides incentives for tax evasion and introduces distortion into the system, as well as causing it to deviate from the standard VAT system. Saleheen (2012) thus suggested that such presumptive elements should be eliminated from the VAT system of Bangladesh. Therefore, as part of an ongoing process to reform the tax system, the government of Bangladesh enacted the Value Added Tax (VAT) and Supplementary Duty Act, 2012, (hereinafter termed "the proposed Act"), with a view to removing the presumptive elements that result in distortions of, and deviations from, the existing VAT system, thereby bringing efficiency to the system and mobilising more revenue. As and when the proposed Act comes into force, it will supplant the VAT Act, 1991. Thanks to the fact that it will implement an overarching uniform VAT rate of 15%, the proposed Act is also expected to augment revenue mobilisation for the exchequer. Although the proposed Act was, as its name suggests, passed by the parliament of Bangladesh in 2012, it was subject to a series of deferments and wasn't scheduled to take effect until July 01, 2017. However, its implementation was further delayed, amid concerns among, and opposition from, the business community and members of the public.

2. PRESUMPTIVE ELEMENTS IN THE VAT ACT, 1991

The VAT legislation currently in force in Bangladesh, the VAT Act, 1991, contains a number of presumptive elements. These are:

- Turnover tax (TT)
- The rate and amount of value added by traders
- The truncated base (TB) for services
- The tariff value (TV) of goods and services.

These presumptive elements are, in essence, the sources of departure for the current VAT system of Bangladesh from the standard VAT system. This is because they do not allow the input tax credit mechanism, which is a basic attribute of the standard VAT system, to operate. When the input tax credit mechanism operates, input tax, i.e. the VAT paid for purchasing the inputs, is deducted from the output tax, i.e. the VAT collected for selling the outputs. Hence, in the standard VAT system, a VAT entity is, in effect, the collector and not the payer of VAT, in the sense that it collects VAT from the consumers for selling outputs to them, retains the VAT it paid for purchasing the inputs from the collected VAT and deposits the remaining amount, i.e. output tax net of input tax, to the government exchequer. However, in order for the input tax credit mechanism to operate and, for that matter, the standard VAT system to operate, the VAT entities must maintain proper books of accounts that can be relied on in order to measure tax liability. However, some VAT entities in the Bangladesh business community reason that they are not in a position to maintain proper books of accounts as doing so will increase their compliance costs, something which they cannot afford. It may be noted here that, in Bangladesh, VAT is imposed on imported as well as domestically produced goods and services which are not exempted from VAT as per VAT legislation. In other words, VAT is

imposable on the relevant goods and services at the import, the production and the sales (wholesale as well as retail) stages. Therefore, from the perspective of coverage, a wide spectrum of entities comes within the purview of VAT, ranging from petty retailers to the giant producers who vary conspicuously in terms of education, skill and income levels, and, hence revenue-generating capacity and potentiality. Consequently, since a large number of VAT entities are not capable of maintaining proper books of account, it is hard to measure tax liability based on actual transaction values due to a lack of reliable records. In tax literature, such transactions are termed 'hard-to-tax transactions'. The problem of the lack of availability of actual transaction values and, hence, the desired tax base, for the want of reliable accounts and records in cases of hard-to-tax transactions is intended to be addressed by inferring notional values based on simple indicators. Such notional values serve as the base for taxing hard-to-tax transactions and introduce presumptive elements into the VAT system. The presumptive elements, as mentioned before, which prevail in the VAT system of Bangladesh are discussed in the subsequent sections.

2.1 Turnover Tax (TT)

Turnover tax is applicable to domestically produced goods and services at the production stage and at subsequent stages of business activities, such as the wholesale and retail sales stage – which we will term as trading – if the annual turnover at the respective stage does not exceed BDT 8 million (USD 100,000/- approximately). Under such conditions, the entity concerned has to collect and remit VAT at the rate of 3% on its annual turnover and no input tax – VAT paid for purchasing inputs – credit is allowed. It may be noted here that the standard VAT rate in Bangladesh is 15%. Hence, it is argued that the standard VAT rate of 15% is still being applied to the TT entities. However, the base upon which the 15% rate is applied is presumed to be 20% of the annual turnover. Consequently, the effective rate on the total turnover applies at (20% * 15%) = 3%. More specifically, the value added at the respective stage is presumed to be 20% of annual turnover. The phenomenon that VAT is collected on the basis of some notional value of the transactions for which no input tax credit is allowed, rather than on the basis of the actual value of the transactions, introduces a presumptive element, hence distortion in the VAT system, ultimately resulting in deviation from the standard VAT system. Despite such distortion and deviation, the presumptive element, in the form of TT, has continued to form part of the VAT system of Bangladesh. This is primarily because taxpayers prefer it, because it results in low compliance costs, as they can avoid the rigorous compliance demands of maintaining proper books of accounts and relevant records, which they argue that they cannot afford to do given their education, skill and income levels, and hence their revenue-generating capacities and potentiality. The tax authority also accepts it because they find that TT allows them to tax hard-to-tax transactions and collect at least some revenue which would otherwise remain uncollected. However, the most damaging side of presumptive element is that it provides an incentive for tax evasion, something which we will discuss later on.

2.2 The Rate and Amount of Value Added by Traders

The rate and amount of value added by traders implies the base or notional value of transactions upon which the traders may collect VAT and remit it to the exchequer. Here, traders are VAT entities engaged in business activities involving goods, without changing their form at the import stages and thereafter, or at the stages subsequent to the production of locally produced goods. The rate of VAT for the traders is 4% as opposed to the standard rate of 15%. The 4% rate essentially implies that the amount of value added or the notional value of the transactions carried out by the traders is (4%/15%) = 26.67% of the actual value of the transactions, for

which no input tax credit is allowed. However, a trader may also opt for the 15% rate to be applied, in which case s/he is entitled to input tax credit. This option is, in effect, free of any presumptive element and hence falls within the ambit of the standard VAT system. In Bangladesh, at present, traders may collect and remit VAT under the following presumptive taxation regime:

- VAT at the rate of 4% on the transactions at the stages subsequent to the production stage of locally produced goods without the VAT entity being entitled to input tax credit. VAT entities, i.e. traders, who may adopt this method include wholesalers, retailers, commission agents, distributors and dealers etc.

- VAT at the rate of 4% – commonly termed Advance Trade VAT (ATV) – collected from importers at the import stage for the transactions without changing the form of the imported goods at the first stage subsequent to the import. The importers concerned are not entitled to any input tax credit.

- Package VAT for small traders. When using this method, the notional value of yearly transactions upon which the VAT rate of 15% will be applied is fixed depending on the location of the traders' business premises. No input tax credit is allowed. The current schedule for package VAT is presented in the following table:

Location of business premises	*Notional value of yearly transactions*	*VAT rate*	*VAT amount*
Dhaka North and South City Corporation, Chittagong City Corporation	BDT 186,667/- (USD 2333 approximately)	15%	BDT 28,000/- (USD 350)
Other City Corporations	BDT 133,334/- (USD 1667 approximately)	15%	BDT 20,000/- (USD 250)
Municipality area of District Towns	BDT 93,334/- (USD 1167 approximately)	15%	BDT 14,000/- (USD 175)
Other areas of the country	BDT 46,667/- (USD 583 approximately)	15%	BDT 7,000/- (USD 87.5)

Obviously, the package VAT under the presumptive taxation regime is a preferential treatment or special benefit given to the small traders, as they only have to collect and remit a nominal amount of VAT, ranging from BDT 7,000/- to BDT 28,000/- per year, depending upon the location of their business premises, to the government exchequer. However, the most important issue, that of identifying the traders who will benefit from package VAT, is resolved through mutual dialogue between the local VAT authority and the local traders' association. Due to the current structure of Bangladesh's economy, a large number of people engaged in business activities fall within the category of small traders. Although they are not large traders in terms of the amount of capital, turnover and net income they generate, they nonetheless constitute an important segment of the whole VAT system – the final stage in the value added chain – and essentially consummate the VAT system, as the imported and locally produced VAT-chargeable goods predominantly make their way to the end consumers through them.

Nevertheless, they are hard to tax, as they claim that they lack the capability to maintain proper books of accounts and records of transactions. In such a context, the VAT authority of Bangladesh, with its limited human and other resources, is not in a position to make the large number of small and other traders who enjoy the presumptive taxation regime comply with the requirements of the standard VAT system. Therefore, package VAT is offered in order to encourage small traders to come within the VAT net voluntarily, as a first step towards collecting a fraction of the enormous amount of revenue that could be collected from these traders and ensuring that the VAT mechanism functions, to some extent, throughout the value added chain from the first to the final stages. However, package VAT and other methods of presumptive taxation offered to traders, as discussed here, result in distortion in the VAT system and deviation from the standard VAT system, since the input tax credit mechanism does not work in the presence of such presumptive elements and thus provides incentives for tax evasion.

2.3 The Truncated Base (TB) for Services

At present, the base for imposing VAT of 15% on services is truncated. More specifically, under the regime of presumptive taxation, notional values, instead of actual values, of transactions for these services are used as the base to which the VAT rate of 15% is applied. Such notional values are essentially certain percentages of the actual values of transactions. That the VAT rate of 15% is applied to certain percentages of actual values of transactions or actual bases implies that the actual bases are, in effect, reduced or truncated in order to apply VAT. The VAT legislation of Bangladesh currently contains 9 truncated bases (10%, 16.67%, 20%, 26.67%, 30%, 33.33%, 40%, 50% and 66.67% of the actual bases or actual values of transactions), which correspond to 9 effective rates of VAT (1.5%, 2.5%, 3%, 4%, 4.5%, 5%, 6%, 7.5% and 10% respectively). For example, when the 15% VAT rate is applied to the truncated base of 66.67% of the actual base or the actual value of transactions, it results in a (66.67% * 15%) = 10% effective rate of VAT on the whole actual base or actual value of transactions. As with the other methods of presumptive taxation, there is no entitlement to input tax credit when using presumptive taxation of services under the truncated base.

The truncated base for the service of providing electricity is 33.33% of the actual base or the actual value of transactions which, in turn, results in an effective VAT rate of 5% on the whole actual base or actual value of transactions when the 15% VAT rate is applied to the truncated base. Suppose an electricity provider purchases inputs for BDT 200/- and pays input tax of BDT 30/-. Since the service provider is not entitled to input tax credit, BDT 30/- will be added to the cost of inputs and the total input cost will be BDT 230/-. If the further value of BDT 70/-, which includes all costs along with profit, is added to the inputs cost of BDT 230/- in order to convert the inputs into the cost of the final service, which is provided to the consumer as electricity, the actual base or actual value of the transaction for providing this service is BDT 300/-. However, as per the present VAT legislation of Bangladesh, the truncated base of this transaction is (300/- * 33.33%) = BDT 100 and the amount of VAT collected from the consumer is (100 * 15%) = BDT 15/- or (300/- * 33.33% * 15%) = (300/- * 5%) = BDT 15/-. Finally, the consumer pays (300 + 15) = BDT 315/- in total for this service: BDT 300/- as the actual value of the transaction and BDT 15/- as VAT. However, rigorous scrutiny shows that the consumer pays (30 + 15) = BDT 45/- as VAT in total. This is because the actual value of the transaction, BDT 300/-, includes BDT 30/- in respect of input VAT, which the service provider paid when purchasing inputs but nonetheless passed to the consumer via the price of the service and finally recovered from the consumer, as the service provider is not entitled to input tax credit. The point to be noted here is that the total VAT throughout this value added

chain (BDT 45/-) is wholly paid by the end consumer. However, although the service provider collected VAT BDT 45/- from the end consumer, s/he would remit BDT 15/- to the exchequer and recognise the remaining amount of BDT 30/- as recovered input VAT paid for purchasing inputs. The seller of the inputs, however, collected VAT BDT 30/- from the service provider and would deposit the same to the government exchequer.

It is evident from this discussion that the end consumer is the ultimate payer of VAT. The intermediaries within the value addition chain are mere collectors, rather than payers, of VAT. The total VAT paid by the end consumer (BDT 45/-) ultimately ends up in the government's coffers but is deposited in two stages: BDT 15/- is deposited by the service provider and BDT 30/- is deposited by the seller of inputs. Like other methods of presumptive taxation, the truncated base of services method results in distortion, such as cascading effect (tax on tax), in the VAT system and deviation from the standard VAT system, as the input tax credit mechanism does not operate, which, in turn, acts as a potential incentive for tax evasion. As mentioned before, 9 different truncated bases are currently applicable to 15 different services within the VAT system of Bangladesh. However, the VAT legislation does not say anything about how, and on what basis, the truncated bases are determined. In contrast to the standard VAT system, whether the magnitude of total VAT revenue under truncated bases will increase or decrease critically depends on, as shown in Appendix A, the relative value of input tax to value addition and the percentage of truncated base to the standard VAT rate.

2.4 The Tariff Value (TV) of Goods and Services

Under the presumptive taxation regime, the basis for imposing VAT on locally produced goods and services is the tariff value (TV), which is essentially the notional value, rather than the actual value, of the transactions. The VAT rate of 15% is applied to the tariff value of the goods and services concerned and no input tax credit is allowed when determining VAT liability. Currently, the VAT legislation of Bangladesh stipulates the tariff values for the service of providing mobile phone SIM cards and for a wide variety of goods, such as powdered milk, tomato paste, fruit juice, corrugated iron (CI) sheets, different types of mild steel (MS) products and electric transformers.

For example, the TV per Metric Ton (MT) of MS product produced from billets or ingots is BDT 3,000/-. However, the market value of this type of MS product is BDT 60,000/- per MT. It thus implies that BDT 3,000/- is the notional value or presumptive base for imposing VAT. In other words, it is presumed that the net value addition per MT of MS product produced from billets or ingots is BDT 3,000/-. Therefore, under this regime, a producer will collect (3,000/- * 15%) = BDT 450/- as VAT per MT of MS product from its purchaser at the production stage and deposit the same amount to the government exchequer, whereas under the standard VAT system, input tax (i.e. VAT paid for purchasing inputs such as billets or ingots, and electricity and gas) is deducted from the VAT collected on the actual base or actual transaction value instead of the notional value of the transaction or tariff value, and the remaining amount is deposited to the government exchequer.

As with the TB, the criteria for fixing TV for services and various goods is not spelled out in the VAT legislation. Since input tax credit is not allowed when using the TV method, it becomes part of the cost of goods and services, and is recovered from the customers via the price of goods and services. This deviates from the standard VAT system and causes distortion, such as the cascading effect i.e. tax on tax, and can serve as an incentive for tax evasion. In comparison with standard VAT system, the revenue impact of TV depends on, as shown in

Appendix B, the relative values of TV and value added. The rationale given for their existence in Bangladesh's current VAT legislation, at the insistence of the VAT entities, is procedural simplification and reduced compliance costs, as these entities argue that it is expensive and cumbersome for them to maintain proper records and books of accounts, and to follow the stringent procedures that they are required to in order to claim input tax credit and, hence, to comply with the requirements of the standard VAT system.

The presumptive elements discussed so far are the most overt or explicit forms of notional bases prevailing in the VAT system of Bangladesh for which no input tax credit is allowed. Apart from these, the other transactions for which input tax credit is allowed, despite seeming to follow the features of the standard VAT system, in effect, implicitly contain elements of presumptive taxation from the standpoint that, even for these transactions, the tax base upon which the VAT rate of 15% is applied is not the actual value of the transaction as determined freely in the market mechanism. Rather, even for these transactions, as per the present VAT legislation, VAT entities have to declare prices to the VAT authority which, after examination and scrutiny, determines the price and, for that matter, the tax base upon which the VAT rate of 15% is applied. Such approved prices or tax bases invariably differ from the actual values of the transactions as determined freely in the market mechanism.

3. THE ABSENCE OF PRESUMPTIVE ELEMENTS IN THE VAT AND SUPPLEMENTARY DUTY ACT, 2012

The VAT and Supplementary Duty Act, 2012, i.e., 'the proposed Act', does not contain presumptive elements in any form – overt or covert. In 1991, Bangladesh entered the VAT era, replacing the sales tax and excise duty regime, which was, in essence, presumptive. Thus, the VAT Act, 1991, basically inherited its presumptive nature from its predecessor. At the outset, allowing this feature of the past regime to continue provisionally despite being an aberration from the standard system may have been to allow stakeholders some leeway when it came to being prepared for the switchover to the new regime. Additionally, the VAT authority realised that presumptive taxation was an effective tool, not only against the backdrop of a preponderance of cash transactions and unscrupulous business persons' duplicity in terms of maintaining double records of business transactions, but also due to its contribution to procedural simplification and maintaining low compliance costs, and the fact that it reflected the preferences of the VAT entities. However, such deviation cannot continue for an unlimited period. Along with causing distortions, inefficiency and incentives for tax evasion, the downsides of the inclusion of presumptive elements in the VAT system include the existence of victims who maintain true records of business transactions and who are willing to be taxed on the actual value of transactions. Now, more than two and a half decades since the introduction of VAT in Bangladesh, the government is attempting to put in place a standard VAT system by implementing the proposed Act, which would replace the existing VAT Act, 1991. In addition to eliminating of the requirement of price declaration, the essential features of the proposed Act are the entitlement to input tax credit and a single, uniform rate of VAT at 15% on the actual value of transactions at all stages along the value added chain. Such features will remove the existence of the multiplicity of effective VAT rates and the dysfunctional input tax credit mechanism arising from the presumptive elements in the existing VAT system. The fact that the proposed Act eliminates the presumptive elements will make the VAT system simple, uniform and more transparent, and will enable the input tax credit mechanism to operate effectively, reducing incentives for tax evasion. However, the business community opposes the implementation of the proposed Act, mainly because of members' fascination with

the effective rates of VAT of less than 15% which arise from the presumptive elements within the existing system.

4. AN ANALYSIS OF THE BUSINESS COMMUNITY'S REACTION

As discussed before, in the standard VAT system, the end consumers of goods and services are the ultimate payers of VAT. Entities other than the end consumers in the value added chain, i.e. intermediaries, are the collectors of VAT, not the payers. This is because, in the standard VAT system, an intermediary collects VAT – output tax – from the intermediary of the next stage or from the end consumer, receives credit for the VAT – input tax - paid to the intermediary in the previous stage and, finally, remits the balance – output tax less input tax – to the exchequer. However, certain conditions need to be fulfilled and proper documentation needs to be maintained in order for input tax credit to be claimed. Although onerous, this nonetheless ensures accountability and transparency in the tax system. Such a credit mechanism is the bedrock upon which the proposed Act and the VAT system stand and can operate properly, as well as without interruption, if – and only if – a uniform and single rate of VAT is applied at all applicable stages and in all cases. From this standpoint, the foundation of the proposed Act looks stronger and much more solid than that of the existing one, and hence the Act deserves to be accepted and implemented.

In the context of Bangladesh's present VAT system, however, which lacks accountability and transparency, the intermediaries and, for that matter, the business community mistakenly see themselves as being the payers rather than the collectors of VAT, which is one of the main reasons for their opposition to the proposed Act. They wrongly perceive that they will have to pay more VAT because a single and uniform rate of 15% would be applied at all stages and in all cases in the proposed system, rather than the rate of less than 15% rate which applies under the presumptive regime in the existing system. In fact, the intermediaries should not be worried about the rate because whatever the rate may be, they will not ultimately pay any VAT. Nevertheless, the implementation of the proposed Act has been deferred a number of times since its enactment in 2012. It was then scheduled for July 2017, but postponed again, amid concerns among, and opposition from, the business community. In my analysis, other possible reasons for the business community taking such a stance are as follows. First, intermediaries find the task of maintaining the proper documentation required in order to receive input tax credit to be cumbersome. Second, intermediaries are inordinately biased towards the rates below 15% which are associated with the truncated base, turnover tax, and tax on traders, and the apparently lower amount of VAT resulting from tariff value, while they are not aware of the fact that the net VAT resulting from the 15% rate on the usual sales value with input tax credit does not make a significant difference to the amount of VAT arising from the truncated base, turnover tax, tax on traders and tariff value methods. Third, intermediaries are not concerned about the cascading effect – VAT on VAT – which is an obvious concomitant of presumptive elements.

Some members of the business community also object as they believe that the implementation of the proposed Act will induce inflation in the economy because of the imposition of 15% VAT at all stages and in all cases. However, careful analysis reveals that this may not be the case. For example, in the current system, M.S. products and utilities, such as electricity and gases, are subject to VAT under the tariff value and truncated base methods respectively. If the market price of a ton of M.S. product is BDT 60,000/- and the tariff value of the same for imposing VAT is BDT 3,000/- , a ton of M.S. product will cost a consumer BDT (60,000/- + (3,000/- * 15%)) = 60,450/- in total under the current system. Some may come to the naive

conclusion that under the terms of the proposed Act, the total cost of a ton of M.S. product to the end consumer would be BDT (60,000/- + (60,000/- * 15%)) = BDT 69,000/- and hence it would induce inflation, as the price would rise from BDT 60,450/ to BDT 69,000/-. They may also argue that since these items, i.e. M.S. products and utilities such as electricity and gas, are the basic inputs for the production of myriad goods and services, VAT-induced rises in the prices of these inputs would result in a negative supply shock, leading to an increase in overall price levels and a decrease in the total output of the economy. However, such a conclusion and argument may not prove to be convincing when the matter has been subjected to deeper scrutiny. Under the proposed Act, the VAT exclusive price of a ton of M.S. product must fall below BDT 60,000/-, since the VAT paid for purchasing inputs and subsumed in the BDT 60,000/- must be subtracted from it. If it so happens that the amount of VAT paid for purchasing inputs and subsumed in the BDT 60,000/- is BDT 7,435/-, the VAT exclusive price of a ton of M.S. product will stand at BDT (60,000/- - 7,435/-) = 52,565/- and hence, under the terms of the proposed Act, a ton of M.S. product will cost a consumer BDT (52,565/- + (52,565/- * 15%)) = 60,450/- in total as well.

A similar exercise can be carried out for utilities, such as electricity and gas. It has been argued that the implementation of the proposed Act would increase the price of utilities and thus cause the common people untold misery. However, it can be shown, as above, that since the unit price of utilities under the current system includes VAT paid for purchasing inputs, the VAT-imposable unit price under the proposed Act will, as the input VAT will be subtracted from it, fall below the prevailing unit price to such extent that the imposition of the 15% VAT rate will make no significant difference to the total cost of electricity to a consumer.

In addition, the argument that the implementation of the proposed Act will cause VAT-induced inflation is untenable from the standpoint that more items are reported to be exempted from VAT under the proposed Act than are exempted within the current VAT regime.

The proposed Act has been heavily criticised with regard to the some of the issues relating to the transition from the current VAT regime to that laid out in the proposed Act. One such issue is the VAT Deduction at Source (VDS) on contracts made in the current regime, for which payment shall be made under the proposed Act. For example, if the VDS-excluded value of a contract for construction work made under the current VAT regime is Tk. 1,000,000/-, the VDS would be at 6%, so the total contract value would be Tk. 1,060,000/- and the contractor would expect to receive Tk.1,000,000/- after VDS. It can be argued that, had the proposed Act been implemented and the payment for this contract had been made under the proposed VAT regime, the contractor would have been adversely affected since, after the VDS at 15% of Tk. (1,000,000/- * 15%) = 150,000/-, the contractor would receive Tk. (1,060,000/- - 150,000/-) = 910,000/-, which is less than his/her expectation of Tk. 100,000/-. However, such argument is not tenable in view of the fact that the VDS-excluded value of the contract (Tk. 1,000,000/-) includes the VAT paid for purchasing all the inputs required for the execution of the contract. If the amount of such VAT is "T", the VDS-imposable value of the contract under the proposed VAT regime will be Tk. (1,000,000/- - T) and the contractor would be entitled to receive input tax credit of Tk. "T", subject to the maintenance of proper documentation. In such a case, it may be shown, in the following way, that for a certain amount of "T", the contractor will remain unaffected even though the VDS is applied at 15% instead of at 6%:

((1,000,000/- - T) * 15%) - T = (1,000,000/- * 6%)
Hence, T = 78,268/-

Here, T = 78,268/- is the critical value. If the contractor can produce the documents of "T" for more than Tk. 78,268/-, s/he will end up receiving more than TK. 1,000,000/- and thus will have benefited, rather than have been adversely affected, by switching from the current VAT regime to that laid out in the proposed Act.

5. THE PROPOSED ACT REDUCES THE INCENTIVES FOR TAX EVASION

The end consumers of goods and services are the ultimate payers of VAT. However, in most cases, VAT paid by the consumers is collected and remitted to the government's treasury by businesses, i.e. intermediaries operating in the value addition chain. In addition, even though intermediaries are not the ultimate payers of VAT, they nonetheless pay VAT to the intermediaries of the previous stages and collect VAT from the intermediaries of the next stages Therefore, tax will be evaded if the intermediaries:

- do not collect VAT from the end consumers and the intermediaries of the previous stages at all.
- collect VAT from the end consumers and the intermediaries of the previous stages but do not deposit it with the government's treasury.

In this paper, we argue that the proposed system essentially reduces the incentives for tax evasion that exist within the current system, mainly because the proposed system is free of presumptive elements. In any VAT system, be it the proposed or existing one, the main channel of tax evasion is through unrecorded purchases of inputs. If purchases of inputs are recorded, production according to output-input coefficients must be recorded, and sales made out of that as well as VAT imposed thereon has to be recorded and deposited to the government exchequer sooner or later. However, if the purchase of inputs is not recorded, there is no scope to record subsequent activities (production, sales and hence VAT), so VAT is evaded through the channel of unrecorded purchases of inputs. Since the proposed system is free of presumptive elements and features input tax credit, it provides entities with more incentive to record purchases of inputs than the existing system, in which input tax credit is not allowed for the sale of outputs under presumptive methods. Consequently, the proposed system provides fewer incentives for tax evasion than the existing system. Therefore, the crux of the issue with regard to mobilising VAT revenue is to ensure that purchases of inputs are recorded and, by construction, the proposed system is stronger in respect of this than the existing system.

The existing system, as highlighted by its distortion of, and departure from, the standard VAT system because the input tax credit mechanism does not work properly within it due to the dominance of presumptive elements, is more vulnerable to tax evasion, and hence the theoretical VAT revenue yield of the existing system is not sustainable. For example, inputs are bought at TV and TB at the first stage and, after value has been added at the second stage, are sold at TV at the third stage. Further value is added at the third stage and they are then sold at market price. In this process, since input tax credit is not allowed at the second stage, as the outputs are then sold at TV, there is no incentive for recording the inputs purchased from the first stage and, consequently, the theoretical VAT revenue yield of the total process is more likely to be evaded. In contrast, in the proposed system, since inputs are purchased from the previous stage at market price at every stage and outputs are sold from each stage to the next at market price, input tax credit is allowed at every stage, which provides entities with incentives for recording the purchase of inputs at every stage and thus reduces the susceptibility of the system to tax evasion.

Unrecorded purchases of inputs, be they in the proposed or existing system, are more favourable to the entities than recorded purchases of inputs. However, unrecorded purchases of inputs are more favourable to the entities in the existing system than in the proposed system. For example, inputs are purchased at TV and TB after the first stage and, after value had been added at the second stage, are then sold at market price. Hence, the input tax paid for purchasing the inputs from the first stage is allowable as credit against the output tax. However, if the purchase of inputs is not recorded, consequently, when the output has been produced and, sold, the VAT collected will not be recorded and deposited to the government exchequer. Hence, by adopting this scheme of unrecorded purchases of inputs, the entity is losing input tax credit but gaining the output tax collected from the customer issuing the fake VAT document. Therefore, the entity will make a net gain, as the amount of output tax collected will be more than the input tax credit lost. The entities will also gain when making unrecorded purchases in the proposed system. However, their net gain when doing so within the proposed system would be less than when doing so within the existing system, as shown in Appendix C. Therefore, there is more incentive for VAT entities to make unrecorded purchases of inputs in the existing system than in the proposed system. This, in turn, makes the existing system more vulnerable to tax evasion than the proposed system.

At the beginning of this section, we identified two tax evasion methods. The basic idea behind both methods is that purchases of inputs are not recorded in the books of accounts presented to the tax authority. Both methods involve unrecorded sales of unrecorded purchases but, when using the first method, the VAT is not collected from the customers while, when using the second method, the VAT is collected but is not remitted to the government's treasury. As we explained earlier, the presence of presumptive elements in the VAT system provides incentives for the adoption of such a scheme of tax evasion. It thus shows that these presumptive elements engender a lack of transparency in terms of keeping records of business transactions, leading to the maintenance of double sets of books of accounts. One of the arguments for incorporating presumptive elements in VAT legislation is the ease of taxing hard-to-tax entities whose operations lack transparency in terms of the records of business transactions kept. Presumptive elements, as is argued in this paper, on the other hand, act as a spur to a lack of transparency with regard to keeping records of business transactions. Presumptive elements and a lack of transparency with regard to keeping business records thus form a vicious circle – one reinforces other. Against such a backdrop, the fact that the proposed Act eliminates the elements of presumptive taxation would mean the introduction of transparency into businesses' record-keeping procedures and a reduction in the scope of tax evasion.

Under presumptive methods of taxation, particularly turnover tax, taxing of traders and package VAT, tax is collected on a lump sum basis. VAT entities collecting taxes under these methods find themselves the ultimate payers of VAT even though they often include the VAT element when pricing their products and therefore recover the VAT from the customers. Therefore, under presumptive taxation, which inherently lacks transparency when it comes to the keeping of business records, it is possible that the amount of VAT collected will be more than the amount of VAT remitted to the government exchequer, resulting in tax evasion. However, business entities argue that in extremely competitive market conditions, where consumers are inordinately price-sensitive, the VAT cannot be passed on to consumers within the price. They further claim that, under presumptive taxation, business entities, rather than consumers, are the ultimate payers of VAT and this reduces their profit margins. Whatever the arguments, the bottom line is that presumptive taxation, by construction, entails avenues for tax evasion. By eliminating the provisions of presumptive taxation, the proposed Act closes a window of opportunity for tax evasion.

In the existing system, the requirement to declare prices and have them approved by the VAT authority so that they can be used as bases for imposing VAT, which has been dubbed 'implicit presumptive taxation', also provides an incentive for tax evasion. Within the dynamics of a market economy in which the market conditions are continuously changing, it is hardly a reality that business transactions could always be made at fixed prices approved by the VAT authority. Nevertheless, the existing VAT legislation requires the VAT entities to collect and deposit VAT on the basis of approved prices. If the actual transaction price is higher than the approved price and VAT is collected, the opportunity exists for the entities not to deposit the VAT collected which is in excess of the amount that should be collected on the basis of the approved price. If this happens, it is clear evidence of tax evasion. On the other hand, it would go against the norms and fundamentals of business transactions to collect VAT on an approved price which is higher than the actual price of a transaction. However, under the existing VAT legislation, entities are liable to collect and remit VAT on the basis of approved prices. Therefore, in order to avoid the legal complexities and liabilities of paying VAT which is in excess of the amount they may credibly collect, entities underreport the volume of their business transactions, resulting in tax evasion. The proposed Act does not contain legal provisions for price declaration and approval – the implicit form of presumptive taxation. According to the terms of the proposed Act, VAT will be collected on the actual value of the transactions, i.e. the actual base instead of the presumptive base fixed by the VAT authority, therefore eliminating the incentives for tax evasion through the channel of presumptive taxation.

6. CONCLUSION

This paper argues that the VAT system currently in effect in Bangladesh, which is based on the VAT Act, 1991, is essentially presumptive, which provides VAT entities with incentives for tax evasion and results in distortions, inefficiency, lack of transparency in respect of keeping records of business transactions and deviation from the standard VAT system. In contrast, the proposed Act, i.e. the VAT and Supplementary Duty Act, 2012, is purged from all forms of presumptive element. The paper explains that the incentives for tax evasion will be reduced with the implementation of the proposed Act, as it does not contain any presumptive elements. The proposed Act and, for that matter, the proposed system reduce tax evasion through reducing the incentives to fail to record purchases of inputs. The proposed system thus enhances the recording of transactions, in particular, the recording of sales, by reducing the incentives to complete unrecorded purchases of inputs, as well as improving monitoring processes, ensuring transparency, and increasing accountability for both the taxpayers and the tax authority. Since reported sales are used as the bottom line for both VAT and income tax, the proposed system may yield more income tax revenue in tandem with a higher amount of VAT. Although implementation of the proposed Act was scheduled to begin in July 2017, it was postponed again amid concerns amongst, and opposition from, the business community. The paper argues that many of the business community's concerns are unfounded and hence the proposed Act deserves to be implemented. Along with removing distortions from the VAT system and bringing transparency and accountability into it, the proposed system, by construction, will yield more VAT revenue than the existing system. However, the effect of the proposed system on revenue will be more prominent because of its ability to reduce the incentives for tax evasion through eliminating presumptive elements.

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APPENDIX A: THE MAGNITUDE OF TOTAL VAT REVENUE UNDER TRUNCATED BASE (TB) AND THE STANDARD VAT SYSTEM

Cost of the input purchased at market price excluding VAT = A
Rate of VAT is a constant = C and C < 1
VAT paid for purchasing the input at market price i.e. input tax = A * C
Total cost of the input purchased at market price = A + (A * C)

Here, the final product produced from the input is sold at TB, so input tax credit will not be allowed. Under such circumstances, the input tax paid is part of the cost of the final product. Suppose, for example, further value is added to the input to produce the final product = F

Hence, the price of the final product = A + (A * C) + F
Let's assume the TB of the final product = G, where G < 1
Hence, output tax = {A + (A * C) + F} (G * C)
Therefore, the total amount of VAT that goes into the government's coffers under TB (RTB) is:

RTB = {A + (A * C) + F} (G * C) + (A * C)

The total amount of VAT that goes into the government's coffers under the standard VAT system (RSTD) is:

RSTD = (A + F) * C

For ease of comparison between RTB and RSTD, this can be simplified as follows:

RTB = [{A + (A * C) + F} (G * C) + (A * C) - (A * C)] / (F * C)
RTB = [{A + (A * C) + F} (G * C)] / (F * C)
RTB = {(A * C)/F} (G/C) + [{(A * C)/F} * G] + G

RSTD = [{(A + F) * C} - (A * C)]/ (F * C)
RSTD = 1

Therefore, the total revenue generated under TB (RTB) will be greater than the total revenue generated under the standard VAT system (RSTD) if RTB > 1.

Whether the RTB will be greater than 1 or not depends upon (A * C)/F and (G/C), i.e. the relative value of input tax to value addition and the percentage of truncated base to the standard VAT rate.

APPENDIX B: THE MAGNITUDE OF TOTAL VAT REVENUE UNDER TARIFF VALUE (TV) AND THE STANDARD VAT SYSTEM

Cost of the input purchased at market price excluding VAT = A
Rate of VAT is a constant = C and C < 1
VAT paid for purchasing the input at market price, i.e. input tax = A * C
Total cost of the input purchased at market price = A + (A * C)

Here, the final product produced from the input is sold at TV, so input tax credit will not be allowed. Under such circumstances, the input tax paid is part of the cost of the final product. Suppose, for example, further value is added to the input to produce the final product = F

Hence, the price of the final product = A + (A * C) + F
Let's assume the TV of the final product = H
Hence, output tax = (H * C)
Therefore, the total amount of VAT that goes into the government's coffers under TV (RTV) is:

RTV = (H * C) + (A * C)

The total amount of VAT that goes into the government's coffers under the standard VAT system is:

RSTD = (A + F) * C

For ease of comparison between RTB and RSTD, this can be simplified as follows:

RTV = [(H * C) + (A * C)) - (A * C)] / (F * C)
RTV = H/F

RSTD = [{(A + F) * C} - (A * C)]/ (F * C)
RSTD = 1

Therefore, the total revenue under TV (RTV) will be greater than the total revenue under the standard VAT system (RSTD) if RTV > 1.

Whether RTV will be greater than 1 or not depends upon H/F, i.e. the relative values of TV and value added.

APPENDIX C: THE NET GAIN TO ENTITIES IN RESPECT OF THE UNRECORDED PURCHASE OF INPUTS IS LOWER IN THE PROPOSED SYSTEM THAN IN THE EXISTING SYSTEM

Cost of input purchased at TV excluding VAT = A
TV of the input for imposing VAT = B
Rate of VAT is a constant = C and C < 1
VAT paid for purchasing the input at TV, i.e. input tax = B * C
Total cost of the input purchased at TV = A + (B * C)

In this case, the final product produced from the input is sold at market price. Therefore, input tax credit will be allowed. Under such circumstances, the input tax paid is not part of the cost of the final product. Further value added to the input to produce the final product = F

Hence, the price of the final product = A + F

Under the presumptive regime:
Output tax = (A + F) * C
Input tax credit = (B * C)

Under the standard VAT system:
Output tax = (A + F) * C
Input tax credit = (A * C)

When adopting the scheme of not recording purchases of inputs, the entity loses input tax credit but gains from the output tax collected from the customer who issues the fake VAT document.

The net gain to the entity under the presumptive regime (NGP) is:
NGP = (A + F) * C - (B * C)
NGP = F * C + (A - B) * C

The net gain to the entity under the standard VAT system (NGS) is:
NGS = (A + F) * C - (A * C)
NGS = F * C

Since, by construction, A is always greater than B:
NGS < NGP