



## Working Paper 14

# **The Political Economy of Tax Reform in Bangladesh:** Political Settlements, Informal Institutions and the Negotiation of Reform

Mirza Hassan and Wilson Prichard

November 2013



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# **The Political Economy of Tax Reform in Bangladesh: Political Settlements, Informal Institutions and the Negotiation of Reform**

Mirza Hassan and Wilson Prichard

## **Summary**

This paper explores the political economy of tax reform in Bangladesh over several decades, shedding light on the complex factors that account for unusually effective and sustained resistance to significant reform. We contend that it is necessary to understand both deep-seated formal and informal institutions and the micro-level incentives that shape the negotiation of short-term reform in order to comprehend tax outcomes. We describe a tax system that is highly informal, largely manual and characterised by high levels of discretion and corruption. However, despite appearing highly dysfunctional on the surface, this system serves the core interests of powerful political, economic and administrative actors. Underpinned by robust informal institutions, the current system delivers low and predictable tax rates to businesses, provides extensive discretion and opportunities for corruption to the tax administration, and acts as an important vehicle for political elites to raise funds and distribute patronage and economic rents. While the tax system has not been without reform, individual reform efforts have been constrained by the parameters of this broader settlement, leaving competing interest groups to pursue strategic gains at the margins while seeking to satisfy external reform demands. This tax bargain reflects Bangladesh's broader political economy, which is characterised by entrenched informal institutions underpinning the combination of generally weak governance and high levels of economic growth – the so-called 'paradox of Bangladesh'.

**Keywords:** political economy; tax reform; political settlements; Bangladesh.

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## Acronyms

AL	Awami League
BCS	Bangladesh Civil Service
BGMEA	Bangladesh Garments Manufacturers and Exporters Association
BKMEA	Bangladesh Knitwear Manufacturers and Exporters Association
BNP	Bangladesh Nationalist Party
CAM	Customs Administration Modernization
DFID	Department for International Development
ECR	Electronic Cash Register
FBCCI	Federation of Bangladesh Chambers of Commerce and Industry
IMF	International Monetary Fund
LTU	Large Taxpayer Units
MAP	Modernization and Automation Program
MIS	Management Information Systems
MOF	Ministry of Finance
NBR	National Board of Revenue
PMO	Prime Minister's Office
PRI	Policy Research Institute
PSI	Pre-Shipment Inspection
RAMP	Revenue Administration Modernization Project
RMG	Ready Made Garment
RIRA	Reforms in Revenue Administration
SME	Small and Medium Enterprises
SRO	Statutory Regulatory Order
TAMP	Tax Administration Modernization Project
TIN	Taxpayer Identification Number
VAT	Value Added Tax

# Introduction

Growing attention to questions of taxation and tax reform in the developing world in recent years has been accompanied by increasing recognition of the centrality of politics to understanding outcomes (IMF 2011). The centrality of politics should not be surprising: taxation lies at the very heart of the relationship between states and citizens, is central to shaping economic opportunities, and is fundamental to the redistributive and social policies of states. However, while the centrality of politics is increasingly recognised, detailed empirical research has remained both rare and fragmented.

A particular challenge lies in the fact that existing research in this area has been characterised by two very different intellectual approaches. One approach, growing out of the traditions of historical institutionalism and fiscal sociology, has focused on explaining long-term continuity in tax outcomes by focusing on the persistent influence of formal and informal institutions, and on the broader political bargains underpinning them (Lieberman 2003; Schneider 2012). The alternative approach has focused more narrowly on individual reform episodes, concentrating on the individual incentives of competing interest groups and the efforts of reformists to overcome entrenched opposition (Bates 1989; Fairfield 2010, 2013).

In this paper we explicitly link these two traditions in order to explore the political economy of tax reform in Bangladesh. By focusing initially on the formal and informal institutions underpinning tax outcomes, we place individual reform episodes within a broader historical context, highlighting the ways in which individual interests are interconnected and embedded in pre-existing informal norms and networks. Meanwhile, relative to accounts focused solely on historical institutions and political settlements, our approach injects important attention to questions of agency, incentives and the micro-political dynamics of change (Bates 2010).

To this end, the tax system in Bangladesh presents a particularly interesting case study owing to the coexistence of two seemingly contradictory realities. On one hand, the tax system in Bangladesh is, by conventional measures, among the least effective tax systems in the world, characterised by manual administration, low revenue and high levels of discretion and corruption. On the other hand, the tax system has witnessed the repeated failure of frequently high profile reform efforts, owing to significant resistance to change that cuts across political, economic and administrative elites. It is only by combining the two intellectual traditions noted above that we are able to make sense of this seemingly contradictory reality.

On the basis of extensive interviews carried out over the course of more than two years,<sup>1</sup> we conclude that the persistent weakness of reform efforts is rooted in durable informal institutions, norms and networks – sometimes referred to as a ‘political settlement’ – that have made the existing system attractive to powerful economic and political interests. Despite high levels of informality, discretion and corruption, the tax system has provided generally low and predictable tax rates to key economic actors, while serving as a valuable conduit for patronage politics. However, while key features of the tax system have been highly resilient to change, they have not been static. They have been consistently contested, and renegotiated, with the informal underpinnings of the system challenged by external and domestic developments. In order to capture these processes we provide a detailed account

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<sup>1</sup> These interviews have included leading politicians, tax officials, business leaders, donor officials and civil society actors. Some of these interviews have been one-off, but others have been on-going conversations in order to follow the evolution of recent reform. An initial part of this research was conducted with the support of the World Bank, which was seeking political economy insights to inform subsequent reform initiatives. This period of the research offered access to donor officials, as well as official meetings with a cross-section of senior officials within the National Board of Revenue (NBR). This included the presentation of preliminary elements of the analysis to a round table of senior officials in May 2011, which offered validation of some of the broad conclusions.

of repeated efforts to reform Value Added Tax (VAT). In doing so, we capture the ways in which periodic reform – frequently under pressure from external actors - has been negotiated, while being shaped by existing institutions, norms and networks. We thus inject important agency and dynamism into our historical account by highlighting the ways in which competing groups have sought both to defend existing privileges and exploit reform episodes to advance new interests, thus subtly shifting the character of the underlying bargain.

One of the merits of a historically grounded approach to understanding the evolution of taxation is that it offers a lens through which to comprehend broader governance dynamics. A significant body of literature has long been interested in the so-called paradox of Bangladesh – the coexistence of high levels of economic growth with seemingly very weak governance (World Bank 2007, 2010; Mahmud et al. 2008).<sup>2</sup> This literature has proposed that the explanation lies in the existence of a political settlement that is characterised by intense partisan competition, high levels of corruption and extensive patronage networks, but which is equally built on informal norms and networks that have ensured predictability and profitability for leading sectors, led by Ready Made Garments (Khan 2008a, 2010, 2011, 2013; Hassan 2012; Ahmed et al. forthcoming). Our account provides a detailed empirical account of precisely this type of dynamics at work within the realm of taxation.

The remainder of the paper proceeds in five parts. The next section reviews the existing literature. Section two presents an overview of key elements of the tax system in Bangladesh as it has evolved over the past two decades. Section three reflects on these broad features and describes the informal institutions, norms and networks that have underpinned the development of the tax system. Having painted this broader picture, section four then turns to a more detailed analysis of two critical, and closely related, instances of reform: the original introduction of VAT in 1991 and efforts initiated in 2009 to reform the original VAT. Finally, section five concludes.

# 1 Competing approaches to the politics of taxation

Existing research into the political economy of tax reform can be usefully divided into two broad approaches: literature focused on incentives, political contestation and the micro politics of tax reform, and literature that approaches tax reform through the lens of historical institutionalism and broader political settlements.

## 1.1 Incentives, political contestation and the micro politics of taxation

The most common approach to the study of the politics of taxation has been to view specific tax outcomes as the result of the interests of key actors and contestation between competing interest groups. This has, in turn, focused attention on understanding incentives, interests and power among key actors, and the ways in which these actors have interacted in shaping reform outcomes.

Within this tradition one strand of literature has focused on a set of broad domestic and international factors shaping incentives for political leaders to expand tax collection and pursue tax reform. This research has particularly highlighted five messages of relevance here. First, access to non-tax revenue tends, all else being equal, to discourage domestic tax

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<sup>2</sup> For example, in 2006 the World Bank's World Governance Indicators ranked Bangladesh 204<sup>th</sup> of 212 for 'control of corruption'. Bangladesh has risen to 177<sup>th</sup> of 212 countries since then, surrounded almost entirely by conflict-affected and resource-dependent countries.



effort (Bornhorst et al. 2008; Besley and Persson 2011).<sup>3</sup> Second, investments in improved tax collection are most likely when political elites have long time horizons, and thus expect to be able to benefit from costly investments in fiscal capacity (Besley and Persson 2011; Melo 2007; Levi 1988; Prichard 2009; North and Weingast 1989; Tilly 1992).<sup>4</sup> Third, fiscal crisis and moments of political transition have frequently played a role in opening new opportunities for reform, as they have served to strengthen support for reform while disrupting existing networks of resistance (Mahon 2004; Sanchez 2006; Keen and Lockwood 2010; Fjeldstad and Moore 2008). Fourth, international pressure and support – most often from the International Monetary Fund (IMF) – has often been a driver of reform, though reform undertaken in response to external pressure has sometimes been comparatively superficial (Mahon 2004; Sanchez 2006; Keen and Lockwood 2010; Moore and Fjeldstad 2008; Prichard et al. 2012). Finally, a large literature has documented the potential for tax competition as states seek to attract increasingly mobile foreign investment (Keen and Konrad 2012).

While these studies are useful in explaining broad cross-country differences in tax outcomes, a closely related strand of research has focused on understanding political actors, incentives and reform strategies as determinants of specific reform outcomes. This research has generally conceptualised the challenge of reform in terms of the need to mobilise political forces in favour of reform, while weakening political forces opposed to reform (Fairfield 2010; Bates 1989; Ascher 1984). At the root of this research tradition is a focus on the frequently significant political barriers to mobilising necessary support for reform. Those who are threatened by tax reform ('the losers') are generally more concentrated, organised and politically influential than the broad groups that stand to benefit from expanded public spending or a reduced burden of taxation (Olson 1965; Fairfield 2010, 2013; Bird and Zolt 2005; Bird 1974). Critically, this resistance not only serves to prevent the reform of tax policy, but may equally make it difficult to translate changes in tax policy into changes in de facto tax administration and outcomes (Casanegra de Jantscher 1990).

Research has focused in particular on resistance from two sources: business taxpayers and the tax administration itself. Among the former, most focus has been on the collective action potential of larger businesses, which may also enjoy personal ties to the political and administrative leadership (Fairfield 2013; Quinn and Shapiro 1991; Elizondo 1994; Bird 1992). More recently, a small body of work has noted the potential for well-organised small business and shop owners to become mobilised in response to certain types of reform (Prichard 2009, 2010b). Meanwhile, growing attention has been paid to the potential for tax administrations to emerge as important sites of resistance to reform, with vested interests in defending existing ways of doing business, patronage networks and areas of authority and autonomy (Varsano 2003; Prichard 2009; Joshi et al. 2012; Fjeldstad 2003, 2005; Devas et al. 2001).<sup>5</sup> As with other areas of civil service reform, administrators may be able to undermine reform through both overt resistance and through non-cooperation with implementation (Grindle and Thomas 1991).

Given the expected strength of resistance to tax reform, the core message from this literature is the paramount importance of high-level political leadership, alongside high-level leadership

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<sup>3</sup> Several studies have investigated whether access to foreign assistance may similarly reduce domestic tax effort, but existing evidence suggests that any such relationship is highly contingent on domestic factors and other features of the aid relationship (Clist and Morrissey 2011; Prichard et al. 2012; Benedek et al. 2012; Gupta et al. 2004).

<sup>4</sup> In this vein, stable parliamentary politics may facilitate tax reform by extending time horizons and facilitating bargaining (Levi 1988; Prichard 2009; North and Weingast 1989; Tilly 1992), though econometric evidence on the general connection between democracy and taxation has been somewhat inconclusive (Cheibub 1998; Gould and Baker 2002; Timmons 2010).

<sup>5</sup> On the question of simple inertia within tax administrations, and resistance to changing ways of doing business, several authors have recently explored the difficulty of shifting from rather centralised, coercive, styles of administration towards a more decentralised, customer oriented, approach (Bird and Vazquez-Caro 2011; Martinez-Vazquez and McNab 2000; Aberbach and Christensen 2007).

within the tax administration (IMF 2011; Fairfield 2010; Fjeldstad 2005; Durand and Thorp 1998; Elizondo 1994; Harberger 1989; Ascher 1989; Morrissey 1995; Bird 2008; Khalilzadeh-Shirazi and Shah 1991). While research has been able to say little about the origins of such political leadership, it has sought to capture strategies for weakening resistance and building sustainable support for reform. Fairfield (2013) has gone furthest in exploring strategies for overcoming business resistance, highlighting in particular the potential benefits of pushing impacts into the future, obfuscating the implications of reform and appealing to norms of horizontal equity in order to demobilise resistance and fragment business opposition (see also Ascher 1984, 1989; Elizondo 1994; Bird 1992; Prichard 2010a).

Less has been written about strategies for building proactive support for reform, in part because pervasive mistrust in government, coupled with uncertainty about reform outcomes, has historically made mobilising such support difficult (Ascher 1989; Lledo et al. 2004). That said, research has suggested that emphasising reciprocity and horizontal equity can be valuable strategies for building pro-reform coalitions (Ascher 1989; Fjeldstad 2004; Bergman 2002, 2003; Harberger 1989; Fairfield 2013; Prichard 2010a, 2010b). Beyond that general guidance, Bates (1989: 490) has offered the useful reminder that because of the diverse nature of relevant interests, 'no general formulas for success can be valid. Rather, what is needed is highly specific political knowledge, and of a rather specific kind: of the groups in society, their interests and the way in which they can - and cannot - combine'.

## 1.2 Historical institutions, tax bargains and political settlements

Whereas the works discussed so far have largely focused on understanding interests, incentives and political dynamics shaping specific reform efforts, an alternative tradition has emphasised the historical durability of key features of tax systems. It has sought to explain these long-term differences in tax systems as emerging from slow-changing institutions and durable political bargains, which are 'symptomatic' of broader state-society relations and relations among competing elite groups (Martin et al. 2009; Di John 2010). In this view tax systems can thus be seen as emerging from often implicit 'bargains' between competing groups, and most often between the state and large taxpayers (Tilly 1992; Lieberman 2003; Schneider 2012; Luong and Weinthal 2004).

The role of institutions in shaping tax systems has been emphasised most clearly by Sven Steinmo (1993), who studied the role of formal electoral and legislative institutions in shaping tax systems in OECD countries. Lledo et al. (2004:9) have applied a similar logic to studying developing countries, but cast the net more broadly, arguing that 'tax systems are understood to emerge from the pressures of social forces, but only after they have been filtered by formal and *informal institutions* of the state' [emphasis added]. This is consistent with growing attention in developing countries to the importance of informal institutions, which Helmke and Levitsky (2004: 727), define as 'socially shared, usually unwritten, and created, communicated and enforced outside of officially sanctioned channels'.

Recent scholarship has gone a step further in arguing that specific outcomes can be understood as the product of broader, often implicit, bargains and understanding among political and economic elites. This idea is most closely associated within the recent work of North et al. (2009) who introduce the concept of a 'social order' to capture the overarching rules and elite bargains governing the distribution of political and economic resources in a given society. They characterise low-income countries as 'limited access orders' in which the distribution of resources is hierarchically organised, and regulated by elite groups. As Khan explains, these overarching bargains ensure that 'the distribution of benefits is consistent with the distribution of power in society', and thus provide a framework for predictably sharing rents and maintaining stability (Khan 2010: 18).<sup>6</sup> While conceptually complex, the core

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<sup>6</sup> North et al. (2009) describe this equilibrium as a 'double balance'.

message is straightforward: specific tax outcomes are likely to be shaped not only by easily recognisable institutions, but by informal bargains among elite groups, and by the broader norms and networks governing elite interactions.

### 1.3 An integrated framework

Recent scholarship has increasingly adopted the concept of a 'social order' or political settlement to describe durable, and comparatively institutionalised, bargains and norms governing the distribution of rents among elite groups.<sup>7</sup> This language has usefully drawn attention to the frequent strength and persistence of informal 'rules of the game' shaping development outcomes. However, the concept of a political settlement or social order also risks implying a misleading degree of permanence and institutionalisation, while obfuscating the role of agency in continuously reshaping the existing rules of the game. As Bates has written of North et al.'s (2009) framework, 'This reader, at least, is surprised by the limited role that micro-level reasoning plays in their arguments' (Bates 2010: 755). With this in mind, the following analysis seeks to combine an analysis of long-lived informal institutions and political bargains with a focus on the micro-level politics surrounding specific tax outcomes.

The first part of the analysis correspondingly focuses on capturing key features of the political settlement, as reflected in the relatively durable political bargains, formal and informal institutions and informal networks that have underpinned key features of the tax system over several decades. This provides broad insights into the ways in which the existing system serves the interests of powerful constituencies, and into the frequently informal rules governing existing practices. The second part of the analysis then turns to providing a more micro-level view of the politics of specific episodes of tax reform. This allows us to move beyond a static analysis of the broad political forces shaping long-term tax outcomes, and towards an understanding of the strategies employed by competing groups in negotiating and renegotiating both specific reform and the broader rules governing the systems. By combining these two alternative approaches to understanding the politics of tax reform, we are thus able to capture the remarkable durability of the informal institutions, norms and networks governing the tax system, but are also able to capture the political dynamics underpinning this durability – and the consequent potential for unexpected political realignment and the creation of new opportunities for reform.<sup>8</sup>

## 2 Tax reform and the tax system in Bangladesh

Despite the obvious political barriers to reform, significant, if incomplete, policy and administrative reforms have taken root across much of the developing world, and particularly in Africa and Latin America (Keen 2013). By contrast, reform has been much more halting and incomplete across South Asia, while this has been particularly true of Bangladesh. Despite repeated reform initiatives revenue collection has remained stubbornly low, while the administrative system has continued to be largely manual and characterised by high levels of discretion and corruption.

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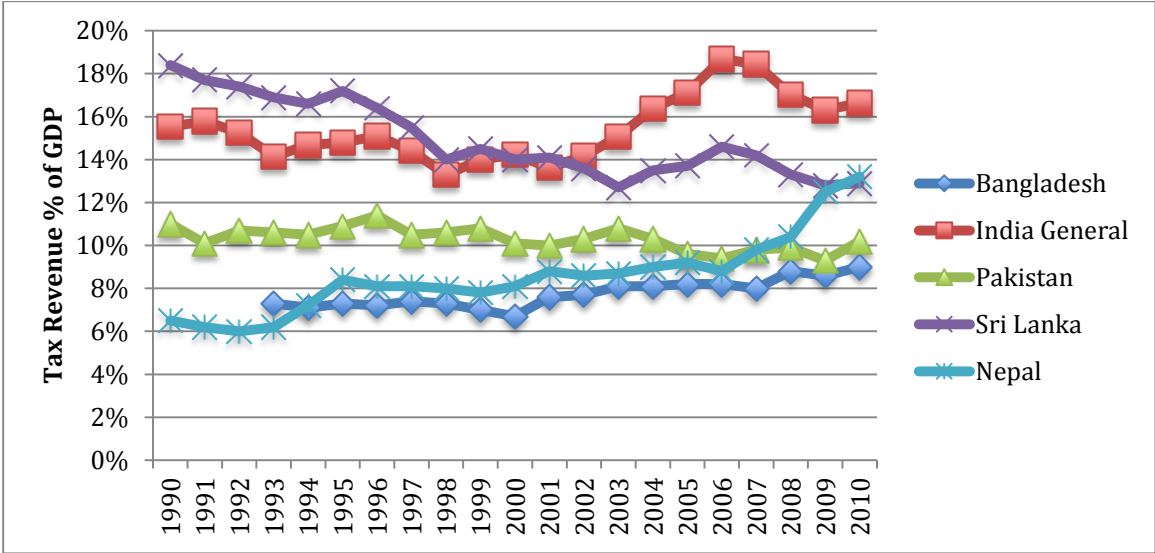
<sup>7</sup> This has been particularly common in writing about Bangladesh, where informal political norms and bargains have played an unusually consistent and important role in shaping governance and economic growth (Khan 2008a, 2010, 2011, 2013; Hassan 2012; Ahmed et al. forthcoming).

<sup>8</sup> One of the most notable weaknesses of analysis focused on political settlements is that it implies a permanence that is inconsistent with the history of unexpected economic reform in low-income countries. Economic reform has frequently appeared politically impossible beforehand owing to the alignment of political forces against it, only for political realignment to make seemingly impossible reform a reality. The framework here correspondingly seeks to capture the potential for both long-term continuity and sudden change (Bates 1989; Ascher 1989; Thirsk 1997; Roe 1994; Grindle and Thomas 1991; Haggard and Webb 1993).

### 2.1 Weaknesses of the tax system

While the share of tax collection in GDP is an imperfect indicator of the quality of tax systems, Table 1 highlights the relative weakness of the tax system in Bangladesh relative to other countries in the region. While a modest uptick in revenue is apparent in recent years, Bangladesh’s National Board of Revenue (NBR) continues to be characterised by a weak policy framework, very limited administrative modernisation, a high degree of administrative fragmentation, significant human resource constraints and weak enforcement mechanisms.

**Table 1 Tax revenue as % of GDP: comparing South Asian countries**



Note: Data for India is for general government, owing to its federal revenue system. All other countries based on central government data, as sub-national revenue data is incomplete and negligible.

Source: ICTD revenue database.

The most basic challenge has been the overall weakness of the policy framework, which is characterised by an enormous range of exemptions, incentives and special regimes. These range from the existence of simplified regimes associated with VAT, to significant scope within the law for tax officials and political elites to grant comparatively discretionary benefits. This directly undermines revenue collection, but equally complicates administration, undermines equity in the system and introduces significant scope for officials to exercise discretion in both policy and administration.

This space for discretion within the tax law is closely linked to the broader challenge of very limited administrative modernisation. Most tax systems in low-income countries have sought to progressively increase reliance on self-reported tax returns, voluntary compliance and risk based auditing, with at least some success (Bird and Vazquez-Caro 2011). By contrast, NBR has maintained an outdated ‘control’ based system, which relies on the physical monitoring of taxpayers in order to enforce compliance. This is reflected, among other things, in extremely low levels of automation, and has allowed NBR officials to retain enormous discretion and, in turn, opportunities for collusion with, or extraction from, taxpayers.

The discretion enjoyed by tax officials, as well as the overall inefficiency of data management within the NBR, has been exacerbated by a high degree of administrative fragmentation. Whereas there has been a trend across low-income countries towards greater integration

across administrative units,<sup>9</sup> the NBR remains divided into three highly autonomous divisions: direct tax, VAT and customs. The relative absence of data sharing across departments severely undermines administration, and opens space for collusion, arbitrariness and abuse, while fragmentation also creates additional costs for taxpayers.

These challenges have been consistently underpinned by significant human resource constraints within the NBR. Hiring is subject to the common constraints of civil service recruitment through the Public Service Commission, making timely hiring very difficult and the hiring of staff with the specialised skills necessary for modern tax administration extremely rare. This is in contrast to the trend elsewhere in the developing world towards semi-autonomous revenue authorities, with greater flexibility over hiring decisions (Kloeden 2011; Devas et al. 2001; Fjeldstad and Moore 2008). This has been exacerbated by a legal battle that sharply constrained hiring to the VAT and customs departments from the early 1980s until 2011. This resulted in only slightly more than half of nearly 5,000 allocated positions being filled as recently as 2008, while poorly qualified staff have been promoted to officer positions in the absence of new hiring.

Finally, even where tax assessment has been effective, enforcement mechanisms have been weak. This has in part reflected the ability of large taxpayers to use political influence to avoid enforcement efforts, but has also resulted from dysfunction within the judicial system. The lower levels of the appeals process are characterised by widespread corruption, while cases that escalate to the high court are subject to processing delays lasting several years or longer. The latter has offered an informal means to delay or avoid tax payments, as no taxes are collected while cases are pending – and no steps had been taken to reduce the backlog of cases as of the time of writing.

The end result of these weaknesses is a tax system characterised by an extremely high degree of informality and discretion, and by the corresponding prevalence of negotiated tax liabilities. While large businesses submit tax returns to the government, they are emphatic that these tax returns represent merely a starting point for subsequent negotiations with tax officials. Over time most firms accept this reality, and enter into implicit agreements with tax officials that involve regular informal payments and the informal negotiation of liabilities between tax officials, lawyers and auditors, sometimes collectively referred to as the ‘trinity’ or ‘tri-party syndicate’. These agreements are periodically destabilised, particularly when officials are re-assigned, thus initiating new rounds of negotiation around tax liabilities and informal payments. This basic pattern is repeated for smaller firms, though on a much more constant basis, owing to regular interaction between tax collectors and firms within the manual, control based, system of administration.<sup>10</sup> While accounting and audit firms nominally verify tax declarations, they are largely passive participants in these broader informal processes, merely affirming the outcomes of informal negotiations.<sup>11</sup> Put most simply, it is thus a system with an unusually expansive scope for politicisation, collusion and corruption.

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<sup>9</sup> This has been reflected in the push towards the creation of integrated revenue authorities, as well as a push towards reorganisation according to function rather than tax type. The latter push has advanced most rapidly in the creation of Large Taxpayer Units (LTUs), but improved data sharing and integration is equally a broader goal (Kloeden 2011; Baer et al. 2002).

<sup>10</sup> This description is based on repeated in-depth interviews with a broad cross-section of businesses focused on understanding taxpaying experiences. These interviews were carried out as part of research supported by the World Bank in April-June 2011.

<sup>11</sup> Multinational accounting firms are generally felt to be comparatively excluded from these informal processes. In part for this reason, the vast majority of firms rely on domestic audit firms, with many routinely paying small fees in order to have fake audit certification provided by less reputable firms.

## 2.2 Repeated failures of reform

While these limitations of the existing system are significant, they are not uncommon in low-income countries. The most notable feature of experiences in Bangladesh is thus not the nature of the challenges, but the near total absence of reform despite widespread acknowledgement of the problems. Whereas major tax reform has occurred across much of the developing world in recent decades, the same problems have persisted for decades in Bangladesh despite almost continuous reform efforts, often fuelled and funded by external donors.

The most striking examples lie in areas where reform is technically straightforward, and demands only political leadership to implement reform. This is most notably true of human resource policies, where dramatic shortfalls in the hiring of skilled staff have continued for more than two decades, thus critically undermining administration and reform. While hiring problems have been explained as the result of unresolvable legal battles, the astonishing scale and duration of the problem speaks to broader political barriers. In similar fashion, encouraging even the most basic cooperation and data sharing across the different tax departments is overwhelmingly a question of political leadership, but has gone unaddressed since the early 1990s.

More broadly, the past two decades are littered with unimplemented reform programmes, often with external financial backing. The first major policy reform measure came with the introduction of VAT in 1991 but, as discussed below, the new tax was never implemented in the form that was initially envisioned. Meanwhile, income tax legislation still dates to the Income Tax Ordinance 1984, promulgated under military rule. Over time it has become characterised by a huge range of exemptions introduced by way of difficult to monitor Statutory Regulatory Orders (SROs), while there has until recently been no sustained effort to reform the underlying law or rationalise relevant legislation.

On the administrative side, a procession of donor-supported projects have been initiated since the late 1990s, but these projects have been characterised by a repeated pattern of long delays and major financial outlays with few deliverable results. This is most clearly reflected in a series of projects beginning with the World Bank-supported Customs Administration Modernization (CAM) project, initiated in 1999. The CAM project was to be the first phase of a nine-year Revenue Administration Modernization Program (RAMP), and enjoyed some modest success early on despite the widely recognised absence of significant political leadership (Draper 2001). However, in the years to follow the programme was repeatedly delayed and scaled back. For example, new ASYCUDA++ software was never fully implemented or rolled out to all of the intended customs posts. Meanwhile the implementation of Pre-shipment Inspection (PSI) for imports was piecemeal and incomplete, and was periodically plagued by accusations of manipulation and ineffective implementation.<sup>12</sup>

Despite these problems, the second phase of the original reform programme – the Modernization and Automation Program (MAP) – was designed and initiated in 2005, with many of the same goals as the earlier CAM project (Mozumder 2012). The MAP was scheduled to run until 2009, eventually giving way to a further phase of the programme – the Tax Administration Modernization Project (TAMP) (World Bank 2006). However, this further phase of the project was dropped owing to the poor performance of the earlier programme. Meanwhile, the UK's Department for International Development (DFID) introduced a parallel

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<sup>12</sup> While the limited implementation of PSI was initially successful, over time efforts to extend the reach of PSI have faced increasing resistance and interference from local customs officials. They have, for example, frequently insisted on inspecting cargo that has already been through a PSI (TIB 2011), while there are also claims that certificates issued by PSI firms have been open to manipulation (Uzzaman and Yusuf 2011).

Reforms in Revenue Administration (RIRA) project, which was similarly not renewed after 2008 owing to poor performance.

Since 2008 Bangladesh has faced mounting concern about long-term fiscal management, which has motivated increased demands from donors for more aggressive tax reform efforts. These demands have focused on the implementation of a major VAT reform, with a secondary focus on reform of the Income Tax Act. Both reform measures have become formal conditions for new IMF lending. In response to this external pressure and the mounting need for additional resources, the government put in place plans to introduce new VAT and Income Tax legislation. However, as is discussed in greater detail later in the paper, these reform measures have again been repeatedly postponed and altered, as the government has sought to secure the release of much-needed IMF funds while minimising the extent of actual reform (*The Financial Express* 2011; *The Daily Star* 2012a). Meanwhile, donor support for administrative reform has continued in a piecemeal fashion, with gains continuing to be very limited.<sup>14</sup>

What is most striking about this picture is not simply the weakness of the tax system but the repeated failure of even relatively straightforward reform efforts, many of which have been successfully undertaken in other low-income countries. That this has occurred despite significant external pressure for reform speaks not merely to the limits of internal capacity, but to sustained resistance to reform from a broad range of stakeholders. The remainder of this analysis correspondingly seeks to account for the broad failure of reform, while shedding light on potential spaces for change.

### 3 Informal institutions and the political logic of the tax system

Up to a point the weakness of tax reform efforts is not surprising. Tax reform is almost never politically popular, and many taxpayers are likely to welcome weak revenue collection. However, the type of pervasive discretion and corruption observed in Bangladesh could reasonably be expected to generate incentives for at least moderate reform both to raise additional revenue and to increase predictability. This is the pattern that has been witnessed in a wide range of developing countries in recent years.

In order to understand why this has not been the case, we begin by describing the broad interests of the two most prominent sources of resistance to reform – the tax administration and the business community. However, we argue that the interests of these groups taken in isolation do not provide an adequate explanation for the absence of reform. Instead, the persistence of existing practices reflects the existence of long-standing informal institutions, norms and networks that have shaped de facto outcomes and made the existing systems mutually beneficial to powerful political, economic and administrative actors.

#### 3.1 Bureaucratic resistance, rigidity and politicisation

At a broad level, resistance to reform from within the NBR is not surprising. NBR officials enjoy a large degree of autonomy and substantial discretionary power under the status quo. This opens the door to systemic corruption that is organised and sanctioned at every level of

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<sup>14</sup> A notable example surrounds the introduction of online tax filing, which after two years had only been extended to two neighbourhoods in Dhaka and, more strikingly, saw only 24 users file taxes online during the most recent year.

the administration.<sup>15</sup> As such, many within the NBR are strongly resistant to any reform programme that would reduce their autonomy and discretionary power, including through increased transparency. The strength of bureaucratic resistance is consistent with patterns elsewhere in the civil service (Huque and Rahman 2003).

However, resistance to reform is not uniform. The senior leadership, made up of the appointed chairman and board members, has traditionally been comparatively reformist in their orientation. They are specifically chosen to be the public face of the agency, while they are generally near retirement and removed from day-to-day administration. This has given them a stronger incentive to adopt more reformist positions. However, despite occupying nominally powerful positions, in practice these senior officials have lacked sufficient authority to lead genuine reform.

By contrast, senior levels of the front line administration are widely viewed as being aligned against reform. The deputy commissioners in particular are consistently acknowledged in interviews as being at the centre of day-to-day networks of corruption, with the commissioners identified as overseeing these activities. They are able to exercise significant influence over administrative performance, and thus over de facto support for, or resistance to, reform.

The rank and file of the NBR are an entrenched source of resistance to reform, as is the case in much of the developing world (Fjeldstad 2005; Therkildsen 2004; Devas et al. 2001). These officials are at the front line of networks of corruption and informal bargaining, and those lacking the technical skills to adapt to automation view reform as a threat. Administrative resistance has correspondingly been aimed at preventing redundancy, limiting new hiring and new skill requirements, and blocking the implementation of effective performance monitoring systems.

### **3.2 Business resistance and reform**

The most important resistance to reform has come from the business community, which has at various times been explicitly cited by the government as the reason for altering or abandoning reform initiatives.<sup>16</sup> As described in more detail below, the business community has been extremely successful in lobbying for delayed implementation, special treatment and other loopholes even when confronted by formal policy reform.

Formally, business engagement occurs through business associations, with the Federation of Bangladesh Chambers of Commerce and Industry (FBCCI) at their apex. Lobbying is equally carried out bilaterally by powerful firms, as there are close links between political officials and business leaders, with the latter making generous political contributions and often represented directly in politics.<sup>17</sup> These large business associations have publicly expressed significant support for reform focused on simplifying procedures, establishing non-governmental dispute resolution processes and reducing some of the discretionary power exercised by tax officials. However, in private support has been much more limited. Business associations have jealously guarded the significant array of exemptions, special regimes and informal benefits that they currently enjoy, and this has created resistance to any major

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<sup>15</sup> This has been most systematically documented by Transparency International Bangladesh in a study that received significant attention among public officials (TIB 2011).

<sup>16</sup> As discussed at greater length below, the government explicitly pointed to business resistance as the justification for abandoning plans for a new VAT law in 2011 (*The Financial Express* 2011).

<sup>17</sup> By one estimate, 50 to 75 owners of Ready Made Garment (RMG) companies have become members of parliament (MPs) at different times (Rashid 2008). A more recent estimate is that 35 MPs in the current parliament (i.e. 10% of all MPs) are RMG owners (*New York Times* 2012), while an alternative estimate puts the number at 29 (Ahmed et al. forthcoming).



renovation of the existing policy framework.<sup>18</sup> More informally, many firms have been equally reluctant to see any dramatic reduction in the politicisation, permeability and corruption of tax administration. While these elements can be a source of tension and unpredictability, for those with strong political relationships they can also be a means to reduce tax liabilities significantly and increase predictability.

While both large and small firms have opposed reform, both their priorities and political strategies have differed. Larger firms have been most concerned with defending existing incentives, exemptions and special regimes – contained in the Income Tax and VAT Acts – as well as informal practices that serve to reduce the effective tax burden. Their lobbying has been grounded in financial support for both leading parties, and in close relationships between political and economic elites. Unsurprisingly, firms that enjoy the most extensive benefits under the current system – including those in the RMG sector – have led lobbying efforts, while other firms have been comparatively marginalised. By partial contrast, small and medium enterprises (SMEs) have been more consistently mobilised in opposition to VAT, out of a fear of improved enforcement and increased compliance costs. This reflects their small size and frequent informality, and has been reflected in success in pushing for retention of a widely applied presumptive tax regime for small firms. Unlike larger firms, their political influence is grounded in their potential for collective action, with the retail and wholesale sectors in particular being well organised nationally and capable of generating political and economic instability.

### **3.3 Political elites, informal networks and the prevailing equilibrium**

The story told thus far resembles standard explanations of the difficulty of tax reform: entrenched and unified resistance among business taxpayers and tax administrators has made reform politically untenable. However, on closer inspection this simple story quickly appears incomplete. It fails to account convincingly for the near total absence of business support for reform despite the pervasiveness of informality, discretion and corruption in administration. Equally, it fails to explain effectively the absence of political leadership for reform in the face of very limited public revenue, increasing fiscal pressure and consistent external pressure for reform. It is therefore necessary to move beyond an atomistic account of individual interest groups in order to capture the interconnectedness of elite interests and the informal norms and networks that have ensured shared benefits from the existing system.

#### **3.3.1 Informality, predictability and political neutrality: business and the existing settlement**

The first issue left unexplained by the simple story told so far is the near total absence of business pressure for reform given the depth of corruption and discretion within the tax administration. While firms stand to benefit from collusion with tax officials to lower tax liabilities, the informality of the existing system exposes them to significant risk of periodic harassment, extraction and uncertainty. It equally opens the door to politically motivated extraction, as political elites may exploit the informality of the existing system to benefit political allies and attack rivals.<sup>19</sup> Given highly charged partisan political competition, Bangladesh's tax system appears on the surface to be well beyond the point at which the potential benefits of collusion are outweighed by the cost of additional uncertainty.

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<sup>18</sup> This resistance has been driven particularly by the Bangladesh Garments Manufacturers and Exporters Association (BGMEA), Bangladesh Knitwear Manufacturers and Exporters Association (BKMEA) and various associations of poultry farm owners.

<sup>19</sup> This is an issue that is widely recognised in low-income contexts, but has not been the subject of focused academic study. It has, though, been a particularly common feature of studies of the exercise of political power in post-Soviet states (see, for example, Ledeneva 2006: 91-103, 142-158).

Why, then, has there not been more support for reform? The answer lies in the fact that while corruption is extremely widespread, it has also been generally predictable, kept within manageable bounds and free of the effects of partisan political competition. This predictability is critical, as a significant body of research has shown that the negative effects of corruption on economic growth are vastly reduced when corruption is predictable. In these cases firms are able to treat corruption simply as an additional, predictable, cost of doing business (Wei 2000; Wedeman 1997; Campos et al. 1999). In Bangladesh these costs are, in the view of most firms, outweighed by the benefits of predictability and low effective rates, thus making the status quo relatively effective – this is reflected in the fact that Bangladesh ranks better than any of its larger neighbours in the ‘Paying Taxes’ component of the World Bank’s *Doing Business* indicators.

While the attractiveness of the existing system to businesses is thus apparent, the greater mystery lies in understanding how and why this predictability has been maintained despite obvious potential for politicisation and abuse. As noted at the outset, Bangladesh has long been home to highly adversarial political competition and a highly politicised bureaucracy. It is correspondingly surprising both that the tax system has not been regularly used as an instrument of partisan political competition, and that the exercise of discretion by the bureaucracy has remained regularised and measured.

Part of the answer lies in the existence of strong informal norms and networks governing tax administration. At the level of day-to-day operations, corruption and negotiation is subject to relatively centralised oversight by deputy commissioners and commissioners, thus serving to discipline and regularise front line practices. This centralisation is critical, as it shifts the analytical lens from decentralised, and unpredictable, corruption to hierarchically organised informal networks managing rents within the NBR.

However, the more important part of the explanation lies in understanding the motivation of the political leadership. While Bangladesh is home to highly adversarial partisan political competition, both political parties have informally agreed that the search for *political rents* should not impinge on the primacy of supporting continued economic growth, and the creation of *economic rents* for key actors in the private sector. Despite highly antagonistic political competition there is a strong commitment to rent sharing in the economic sphere, with continued economic growth serving to expand the size of the economic pie and defend the entrenched position of the two leading political parties (Khan 2010, 2011; Hassan 2012). Consistent with this logic, most firms maintain a good relationship with both leading political parties, including making financial contributions to both sides. The same ethos of equitable rent sharing is apparent among senior tax officials, who explain that it would be unfair for the tax administration to target particular firms, as this would destroy its prospects relative to its competitors.

### **3.3.2 Rent allocation, economic growth and political patronage: political elites and the existing settlement**

The second issue left insufficiently explained by the analysis so far is the absence of a stronger push for reform by the political leadership, despite extremely low levels of revenue collection with which to finance government programmes and patronage networks. The explanation lies in a political leadership torn between two alternative objectives. On one hand, parts of the political leadership have demonstrated a genuine desire for reform and have, at times, taken concrete steps to pursue that goal.<sup>20</sup> These reformers have been motivated both by recognition of the value of increased revenue collection for financing both improved public services and the broader patronage networks on which they rely. On the

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<sup>20</sup> As discussed in greater detail below, the years since 2009 in particular have seen a range of incremental reforms initiated. More broadly, many NBR chairmen and ministers of finance have shown a desire to lead on reform, but have been stifled in those efforts.

other hand, political leaders are not only constrained by the strength of organised resistance, but have come to benefit from the existing tax system. The informality of the system allows it to serve an important political function as a conduit for distributing patronage, as a source of funding for the political leadership and as a means to preserve and support continued economic growth. On balance this combination of political constraints and political benefits has outweighed the desire for reform, as leaders have opted for the certainty of the current system rather than the uncertainty of change.

In order to understand the ways in which the existing tax system has served the interests of political elites it is necessary first to understand the organisation of political influence and control within the NBR itself. The tax administration is formally home to four civil service associations, which have historically wielded important influence in resisting reform initiatives.<sup>21</sup> However, the more telling development has been the progressive superseding of these associations by informal groups that cut across hierarchy, cadre and political party. These informal groups have enjoyed high level political support – reaching as high as the Prime Minister’s Office (PMO) – which has allowed them to wield increasing power over hiring and promotion decisions.<sup>22</sup> Consistent with the discussion so far, these groups have been essentially non-partisan. They have developed close ties to both political parties, with changes in political leadership generally leading to changes in the leadership of these informal networks, but not to broader changes in their role and organisation. Instead, they have drawn their strength and organisation from their ability to distribute financial and professional rewards efficiently, while serving the interests of the political leadership.

The power of these informal groups is reflected in limited hiring of skilled younger staff, the politicisation of internal transfers and promotions, and the fact that NBR staffing was stuck at only about 50 per cent of permitted levels as late as 2011. This influence over hiring and transfer decisions has allowed these informal networks to solidify their power progressively, while gaining influence through increasing control over centralised patronage and corruption networks. Meanwhile, the chairman of the NBR, the nominal leader of reform efforts, has been correspondingly marginalised. A remarkable twenty-six separate chairmen were appointed in the first thirty-eight years of the NBR’s existence. This has reflected control of the appointments process by the political leadership – despite legal provisions calling for internal appointment by the NBR Board – and the repeated removal of chairmen who pursued policies that challenged the interests of the Ministry of Finance (MOF), PMO or powerful business groups (TIB 2011).

The overall administrative environment has thus been one in which the *de jure* roles and responsibilities of officials have been largely supplanted by *de facto* power and authority. This has been based on close links between informal groups within the administration and the highest levels of politics, in a pattern that has matched developments elsewhere within the state (CGS 2006; IGS 2008). Far from aggressively pushing for reform in the face of entrenched resistance, sections of the political elite, led by the PMO, have benefitted directly from the centralised networks of patronage and corruption within the NBR. These connections have served to generate regular funds for political elites, while allowing political leaders to dispense patronage and rents to leading economic actors.

This last point speaks to the importance of direct informal ties linking political elites to leaders within the business community. The business community – and particularly large firms in leading sectors like Ready Made Garments – has acted as a key source of political support and political funding for the political leadership. As noted above, they have offered political support and funding across partisan lines. Rather than competing to elect one or the other

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<sup>21</sup> The Executive Associations, the Bangladesh Civil Service (BCS) Kar (tax) Association, Customs Cadre and Excise, the Non Cadre Inspectors Association and the Ministerial Staff Association.

<sup>22</sup> This is a pattern also seen elsewhere in the Bangladesh civil service, as documented by Huque and Rahman (2003).

political party to power, large businesses have sought the continuation of the broader status quo. This status quo has tested the ability of political leaders from both parties to offer consistent support to leading firms and sectors, and to sustain high levels of economic growth. The ability of political elites to exercise informal influence over senior officials within NBR has, in turn, been critical to this relationship, as the tax system has been an important conduit for delivering economic benefits, and retaining business support.

On the surface it appears that reforming the tax system towards a rules-based system, with uniformly low tax rates, could achieve the same objectives as the current system. It could provide predictability and low tax rates to firms, while raising additional revenue and significantly reducing informality and uncertainty. However, this analysis fails to recognise the broader political role of the existing system, or the uncertainty that the transition to a more formal system would imply. The existing system offers the political leadership control over the distribution of patronage and economic rents through the tax system. In exchange, leading businesses have offered political support and financing that cuts across partisan lines, while control of networks of corruption within NBR has made the tax system itself an important conduit for political financing. Although all actors view the current system as imperfect, it is a compromise that has minimally delivered both economic growth and relative political stability. As such, both political and economic elites appear reluctant to confront the uncertainty, in terms of tax burdens and political alignment, implied by deeper reform.<sup>23</sup> This story closely mirrors broader accounts of Bangladesh's governance, which have similarly emphasised the role of informal institutions in shaping economic and political outcomes. By ensuring the predictable distribution of benefits among political and economic elites, these informal rules of the game have ensured relative political stability and economic growth despite high corruption and dysfunctional formal governance (Khan 2011, 2013; Hassan 2012; Ahmed et al. forthcoming).

## 4 Negotiating reform: the case of VAT reform efforts

The description so far captures the broad contours of the politics governing the tax system over several decades. Following existing literature it is correspondingly possible to think of this system as the outcome of an informal political settlement among powerful interests. However, while such a conceptualisation highlights the persistence of a set of largely informal rules of the game, it obscures the role of political agency in explaining both the persistence of the system and the potential for change (Bates 2010). While key features of the system have been long-lived, this does not imply that these arrangements have been static. Key features of the system have been regularly contested and renegotiated, with continuity maintained through the strategic choices of key actors. By looking at specific instances of tax reform it is possible to capture these political dynamics, and thus to highlight the process of both continuity and change in response to external pressure and shifts in domestic political power.

To this end, the remaining analysis is focused on a detailed exploration of two prominent, and related, reform episodes: the original introduction of VAT in 1991, and subsequent efforts to reform the existing VAT since 2009.<sup>24</sup> The analysis aims to highlight three elements

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<sup>23</sup> Ascher (1989: 464), for example, writes that: 'The frequently negative "reflex" reaction to a new tax reform initiative on the part of many groups is typically due not just to expected losses but also to the risk of incurring costs that cannot be anticipated'.

<sup>24</sup> These are not, of course, the only examples one could choose: despite the persistent lack of major reform, more modest reform has been a regular feature of the tax landscape (Government of Bangladesh Planning Commission

not touched on by the discussion so far. First, the important role played by international actors in generating pressure for reform. External pressure has the potential to disrupt existing political bargains among domestic actors, and we thus seek to capture the process by which the government has bargained with international actors while protecting its core domestic interests. Second, the specific strategies adopted by the government – and other actors – in seeking to negotiate incremental reform within the context of existing informal rules, norms and networks. Finally, the ways in which unexpected political events have opened new spaces for reform by disrupting key features of the existing political bargain around taxation.

#### 4.1 The 1991 VAT reform

The original introduction of VAT was initiated in the 1980s under the military government of General Ershad. It was a response to perilously low levels of revenue collection, which stood at only 7 per cent of GDP, and to consequent pressure from the IMF, which pushed for a highly simplified VAT regime that would maximise administrative simplicity. Operating under external pressure, and fearing resistance from a growing pro-democracy movement, the reform effort was characterised by extreme secrecy from the outset. The design of the law was handled by a small group of officials from the NBR and Ministry of Finance, along with a handful of business leaders, while drafting was carried out in secret by a group of university students, supervised by an IMF economist of Bangladeshi origin.

The reform effort was briefly derailed by the victory of the pro-democracy movement, but the democratically elected Bangladesh Nationalist Party (BNP) (1991-96) quickly agreed to revive reform under continued prodding from the IMF. However, despite the change in government, drafting remained highly secretive apart from a modest expansion in large business representation. As such, most businesses and members of the NBR only became aware of the proposed reform when the draft law was rapidly prepared for implementation and placed before the national parliament. Consistent with government fears, significant resistance immediately emerged from both businesses and segments of the NBR. The opposition Awami League (AL) party in turn attempted to capitalise on the anti-government sentiment, going as far as to threaten *hartal* (general shutdown) unless the VAT law was abolished.

The government responded by seeking a strategy that could simultaneously satisfy powerful local constituencies as well as IMF demands for reform. In practice it was able to do so by drawing on both formal and informal bargains with key stakeholders in reaching a mutually acceptable compromise. The Awami League was persuaded to quieten its opposition after significant lobbying by the reform leadership, and by the World Bank and IMF. It feared being branded irresponsible and 'anti-market' following its defeat in earlier elections, while its willingness to compromise was equally an early example of aggressive partisan political competition being moderated in order to manage key areas of economic regulation. Meanwhile, the political leadership relied on its clientelistic relationship with the elite leadership of the Federation of Bangladesh Chambers of Commerce and Industry (FBCCI) in order to solicit a formal statement of support for the reform. Informal norms and networks again appear to have been critical in persuading large businesses that their interests would be protected following reform, whether formally or informally.

Having reached agreement with these larger actors, the government pursued a series of more explicit compromises in order to address persistent resistance from the broader business community and from front line NBR officials. Small and medium business, particularly in the wholesale and retail sectors, wielded the potential to mobilise disruptive

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2011; Chowdhury 2005; TIB 2011). However, the two VAT reform efforts offer particularly high-profile illustrations of the broader dynamics of reform.

protests and, at the extreme, violence. They were placated with the introduction of the so-called 'package system', which offered small firms a simplified tax regime that would effectively guarantee lower tax burdens and expanded scope for negotiation with tax officials. Meanwhile, NBR officials were granted various concessions allowing them to retain a degree of discretion and control through, for example, continued requirements that prices used in calculating VAT liabilities had to be approved by tax officials. More importantly, NBR officials successfully resisted efforts aimed at reorganising or modernising the administration by drawing on their high-level political patrons to defend the administrative status quo.

However, the most important compromise lay in an agreement to implement the 1991 reform gradually, and with a multiplicity of rates and special regimes. This stands in sharp contrast to the majority of low-income countries, particularly in sub-Saharan Africa, where VAT has been implemented comparatively rapidly and with fewer exceptions.<sup>25</sup> The new VAT was initially applied to only large manufacturing and export industries, both of which were large enough to cope with reporting requirements and had limited liabilities owing to the export of most of their production. Subsequent expansion of VAT coverage was consistently delayed, while the government continued to maintain, and selectively add, special regimes and exemptions. Despite constant pressure from the IMF and World Bank, it was 2004 before VAT coverage had been expanded to all major sectors, and by that time the range of exemptions and discretion that had been added to the law left it resembling the initially envisioned VAT in name only.

This reliance on incremental reform has been a regular feature of government reform efforts, and is best understood as a political strategy for reconciling competing interests. Delayed implementation allowed the government to get the law passed and satisfy external actors, but businesses equally understood that this implied a longer time horizon over which to continue to lobby for delays and exceptions. Put more simply, it created opportunities for a divergence between *de jure* policy and *de facto* realities on the ground, both through incomplete implementation and the gradual proliferation of exemptions. As with other areas of reform, this compromise was made possible by an implicit understanding among elites that core business interests would be defended over time, particularly at the level of implementation. This implicit understanding was, in turn, made possible by the informal norms and networks that underpinned the broader tax system.

## 4.2 VAT reform effort since 2009

Owing to the variety of exceptions and exemptions that came to characterise the 1991 VAT law, it failed to achieve either the revenue productivity or the economic efficiency that had motivated its initial introduction. The result was mounting international pressure to introduce a new law, free of many of the existing compromises. As fiscal pressures facing the country mounted, these demands for reform culminated in the IMF making the introduction of a new VAT law a prominent condition for the negotiation of a new US\$1 billion loan. The tax reform process was initiated by the Ministry of Finance in 2009, and has seen the government seek to negotiate competing reform demands by using many of the same strategies employed during the previous VAT reform process.

As with the previous process, the initial drafting of the law was undertaken in relative secrecy, and led by a local consulting firm, the Policy Research Institute (PRI). The project was led by the same ex-IMF local expert who had led the drafting of the 1991 VAT law, supported by two international consultants who had been involved with the drafting of New Zealand's highly simplified VAT law. The government insisted throughout that the new VAT law would be passed as part of the 2012 budget process, and would then be followed by a

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<sup>25</sup> The commonality of reform measures across low-income countries, generally following the broader outlines of IMF advice, has led Fjeldstad and Moore (2008: 236), for example, to refer to a 'global reform programme'.

revised Income Tax law the following year aimed at reducing and rationalising tax exemptions.

However, when the fully drafted law was finally opened to public scrutiny it quickly elicited major resistance. The most vocal resistance again came from SMEs and NBR officials, both of whom cited capacity constraints and a lack of consultation as their concerns. In practice, however, NBR officials were again primarily concerned with defending existing areas of discretion and control over hiring, while SMEs were focused on preserving the highly advantageous package system for small firms. Resistance from large manufacturing firms was publicly more muted, owing both to their reliance on exports and a presumption that the impact of formal policy changes would be moderated by continued informality in administration. However, large firms began to voice stronger concerns when it became clear that the new law might threaten existing exemptions and the scope for collusion with tax officials.<sup>26</sup>

Confronted by this resistance the government quickly withdrew the proposed reform in May 2011. This decision seemed to be clear evidence of the lack of government commitment to reform, as it abandoned far-reaching reform in favour of more modest, and less politically contentious, initiatives.<sup>27</sup> This followed a common trend in the government's engagement with donors around tax reform, with promises made, but then repeatedly delayed, in an effort to maintain access to external funding.<sup>28</sup> However, unlike in previous years, the IMF responded by redoubling their insistence that a new loan agreement would not be concluded without progress on tax reform. Facing a growing liquidity crisis, the government revived reform plans following the arrival of an IMF delegation, and again began the process of negotiating the formal and informal compromises necessary to satisfy competing interest groups.

Over several months prior to March 2012 the revived legislation was revised to include a range of concessions to key interest groups. This was not simply about offering formal policy concessions, but aimed at preserving key spaces for informality and discretion within the law. The government agreed in negotiations with the wholesale and retail sectors (represented by the *Dokan Malik Samity*) not to eliminate existing special regimes, and most notably the package system, which offered both low rates and predictability to small firms (*The Independent* 2012). In a similar concession to large firms, the government agreed that firms above the threshold for VAT registration would have the option of complying with the standard VAT system or of opting for a 5 per cent turnover tax – a seemingly transparent handout to a subset of firms with more than adequate capacity for compliance. The government likewise agreed to reduce the extent of sanctions for non-compliance dramatically, to the point that many viewed the proposed sanctions as clearly inadequate.

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<sup>26</sup> Large firms were particularly concerned by proposed changes to the Income Tax Law, which threatened existing tax exemptions. Reform of the income tax legislation largely disappeared from the policy agenda around the same time, and speaks to the power wielded by these large firms, as well as prioritisation by the IMF of the VAT reform.

<sup>27</sup> Focusing only on recent years these incremental reforms have been substantial, and are captured in the recent TIB (2011: 4) report which notes, 'introduction of spot assessment and payment of tax through one stop service, two-page tax return, appointment of class I and II officials, inclusion of the national identification number in the Taxpayer Identification Number (TIN) certificate, arrange tax fair, reward highest taxpayers, distribution of "tax-card", introduction of MIS and tax calculator software in the NBR website, online tax assessment and VAT registration at limited scale, make TIN mandatory for specific services like gas and electricity connection, and registration or renewal of fitness certificates for vehicles, imposition of penalty in case of using fake TIN, increase of financial punishment, publication of books and awareness related leaflets, introduction of electronic cash registers (ECRs), and engage four benches of the High Court exclusively to settle tax related cases'.

<sup>28</sup> In the years immediately preceding efforts to reform VAT, multiple donor-funded tax reform projects had reported disappointing results, led by the DFID-funded Reforms in Revenue Administration (RIRA) project and the World Bank funded Modernization and Automation Project (MAP). RIRA concluded in 2008 and DFID initially declined a follow-up project before initiating a new project in 2011. MAP similarly concluded in 2008, with plans for a follow-up Revenue Administration Modernization Project, but the programme was never renewed owing to poor results under MAP.

The largest concessions, however, revolved around preserving administrative discretion for the NBR, and this appears to have been generally welcomed by larger businesses keen to retain scope for the negotiation of tax liabilities. Most notably, the NBR was given power to introduce further VAT exemptions 'in the public interest' – an amorphous concept open to significant collusion between tax officials and large business. In a similar vein, the NBR Board was granted significant scope to interpret important policy and administrative aspects of the law internally, offering further scope for collusion and greater autonomy for the NBR. While the Board was thus given additional discretionary power, a similar provision was put in place offering front line tax officials the power to interpret key legal provisions, rather than such interpretation being reserved for commissioners. This not only offered additional space for collusion with taxpayers, but equally seemed designed to offer younger officers scope to develop individual fiefdoms – thus potentially allowing informal networks within NBR to circumvent more senior officials. Finally, and in the same vein, the government reintroduced rules mandating that firms retain extremely detailed operational information – including product-specific input-output tables – which was widely viewed as offering officials opportunities to extract informal payments.

By late 2012 the government had thus sought to replicate the strategy employed in 1991, preparing a VAT draft to satisfy external demands, while negotiating critical exemptions designed to defend key features of the existing system. This initially appeared to have been successful, as a US\$987 million loan from the IMF was finalised in April 2012, to be disbursed in nine tranches (IMF 2012). However, at the final moment the IMF rejected the compromises embedded in the new draft of the Act.<sup>31</sup> It presented the government with an internal memo detailing issues that would need to be addressed if the second tranche of the loan agreement was to be disbursed.<sup>32</sup>

With a continued urgent need for financing, the government quickly acquiesced to essentially all of the IMF's demands (*The Daily Star* 2013a), while resorting to a strategy of incrementalism and informal agreements in an effort to satisfy domestic constituencies. Mirroring the 1991 VAT law, the critical element of this compromise was a decision to postpone implementation of the new Act until 2015, while postponing changes to the special regimes for SMEs an additional three years, until 2018 (*The Financial Express* 2012). Superficially, this simply represented an effort by the government to postpone the pain of reform beyond elections scheduled for 2014. However, as with the reform programme in 1991, the decision to postpone implementation held for businesses and NBR officials an implicit suggestion that there would be ample opportunity to chip away gradually at the provisions of the Act. Moreover, continued resistance to administrative modernisation, which has not been subject to such strict conditionality, appears almost certain to undermine implementation of the new Act – a fact not lost on many inside and outside of the NBR. It is these implicit promises of continuity, made possible by the informal norms and networks governing the tax system, that appear to have played a major role in allowing superficial reform to move ahead. The extent to which meaningful reform is actually implemented has thus been pushed into an uncertain future.

#### **4.3 Common strategies and shifting political contexts**

Perhaps the most striking feature of these two reform episodes lies in the similarity between the compromises underpinning the 1991 and 2012 VAT laws. In both cases the government

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<sup>31</sup> 'IMF won't loosen strings on loans: The lender says it will not release the second installment of \$1 billion if conditions are not met by Nov' (*The Daily Star* 2012b); 'IMF Asks Government to Alter VAT Bill' (*The Daily Star* 2012a).

<sup>32</sup> Of the retention of significant discretion within the NBR, the IMF wrote that, 'The fundamental features of the VAT should be set out in law, not left to the Board (NBR) to prescribe, as this would jeopardise the stability and predictability of the tax'. Of proposals to require firms to report input-output coefficients it wrote that, 'effective tax agencies do not require such burdensome calculations to facilitate the auditing of taxpayers'. Of plans to introduce a 5% turnover tax as an alternative to the standard VAT, the IMF argued that it 'undermines the very purpose and key objectives of the new VAT by reducing revenue, complicating administration, and severely impeding its operability'.



has sought to satisfy external pressure through *de jure* policy reform, while retaining key formal and informal features of the existing system. It has satisfied domestic constituencies by seeking to retain key areas of discretion and a reliance on incremental reform, the latter relying on an implicit promise that postponing reform will create space for carving out additional compromises in the future. These latter compromises have been made possible because they build on existing informal rules, norms and networks. It is only the strength of these informal practices and relationships that has allowed such a high degree of continuity even in the face of seemingly significant policy reform, backed by considerable external pressure.

However, the more recent reform has gone somewhat further than the 1991 reform, particularly in curbing the legal discretion exercised by NBR officials. In part this is a consequence of much greater insistence of the IMF during the more recent reform episode, as it has used its considerable leverage to reject major compromises. However, the willingness of the government to accept IMF demands also appears to reflect broader political changes, which altered the reform context between the initiation of reform in 2009 and the passage of the VAT Act in 2012.

As noted earlier, the political leadership has long appeared at odds between a desire for greater revenue and a reluctance to alter a system that has offered political financing, stable growth and an important conduit for delivering patronage to key allies. While the existing system has proven extremely stable over time, these conflicts within the political leadership also point to the potential for rapid political realignment. With this potential in mind, recent developments offer insight into the ways in which seemingly inalterable features of the political settlement may become vulnerable to change in response to internal and external events.

One element of this shift has been a sudden decline in the power wielded by informal networks of patronage and corruption within the NBR. In recent years there has been growing pressure for reform in response to external demands from the IMF and the mounting fiscal challenges facing the political leadership. These networks nonetheless remained stubbornly resistant to reform, as they continued to enjoy critical support from the PMO. However, this political balance was disrupted when the strongest NBR ally with the PMO was removed from his post in response to allegations of corruption in the procurement of infrastructure contracts.

The most immediate consequence of this shift was that the comparatively reformist Minister of Finance was able to seize greater control over NBR. On the policy front this led the government to refuse NBR demands that they retain the right to approve prices used in calculating tax liabilities. This provision had always been opposed by businesses – and served only to expose them to petty harassment – and the shift in the political balance made it possible to wipe this provision away. Less obviously, the weakening of informal networks within NBR opened space for the rationalisation of personnel decisions. New hiring was initiated in 2012, while control of the hiring and promotion process by informal networks within NBR has been significantly weakened. The latter was reflected in a massive reshuffling of staff within the NBR initiated at the end of 2012 in an effort to erode the power of those informal networks (*The Daily Star* 2013b). These moves by the Minister of Finance speak to the conflicting incentives facing political elites, and the potential for reform-minded leaders to seize the initiative when opportunities arise.

The second element of the shifting political context has been renewed discussion about the vulnerability of existing informal practices to politicisation along partisan lines. Bangladesh has long been relatively unique in having sustained very high levels of economic growth despite aggressive partisan politics and weak formal governance. This apparent paradox has been made possible by informal norms of rent sharing among political and economic elites,

which have ensured that businesses enjoy low costs, predictability and relative insulation from partisan political competition. Informal norms governing taxation have been a critical part of this broader bargain, and this has historically motivated powerful resistance to tax reform. However, this type of informal settlement is inherently at risk of abuse,<sup>36</sup> owing to high levels of discretion and the weakness of formal rules (Khan 2008b, 2011).

Despite these inherent risks, the existing political balance has been sustained by strong informal norms and networks underpinned by a high degree of trust among political and economic elites (Hassan 2012). However, recent developments have highlighted the limits of this accommodation, and the potential for the tax system to become a tool of partisan political competition. In recent years a subset of the economic elites has sought to challenge the existing political elite, and to gain a greater share of political power. The government has responded aggressively, with the tax system appearing to be used for partisan purposes in punishing those challenging the existing balance of political authority.<sup>37</sup> The message has appeared clear: the tax system will not be employed for partisan political purposes *as long as competing elites do not seek to challenge the political status quo*. These recent episodes have highlighted the inherent potential for the politicisation of highly informal tax practices. While this remains acceptable to the majority of the economic elite who remain satisfied with the prevailing bargain, it has reinforced for some the value of reform that would reduce some of the discretion exercised by tax officials.

The spectre of growing partisan politicisation has not, at least for now, been translated into broad demands for fundamental reform. However, it has offered new support for reform at the margin, contributing to opening additional space for a series of more modest reforms, the passage of the VAT law and aggressive moves by the Minister of Finance to weaken informal networks with the NBR. Meanwhile, it highlights the potential fragility of the informal bargains that have long characterised the tax system, as they depend critically on continued trust in the face of both economic challenges and increasingly acrimonious political competition (Khan 2008b, 2011; Hassan 2012).

## 5 Conclusions

While focusing on the particular case of Bangladesh, the broader goal of this paper has been to link two approaches to understanding the political economy of taxation in developing countries. The first part of the analysis highlighted the role of formal and informal institutions in shaping persistent features of the tax system. The second part of the analysis focused on the micro-level political dynamics governing the negotiation of individual episodes of tax reform. By combining these two perspectives it has been possible to explain the persistence of many key features of the tax system, but to present this persistence as the outcome of the continued negotiation of these rules among competing groups. This has shed light on both the strategies adopted by competing groups in negotiating incremental reform, and on the potential for external and domestic stresses to produce broader shifts in existing informal rules, norms and networks.

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<sup>36</sup> As Khan (2008b: 34) has written of comparatively informal forms of economic governance, 'we would also expect growth to be much more vulnerable to disruption ... the nature of the business-government relationships may be changing independently in many cases because of ongoing changes in the underlying political forces in society. When this happens, the continuation of a particular response to market failure may become untenable even with no further changes in market challenges'.

<sup>37</sup> Perhaps the most well-known example is the case of Grameen Bank founder Muhammad Yunus, who came under attack by the government when he began to engage more actively in politics. As part of this process senior tax officials claim that they were asked to look into bringing a tax case against him. In the same vein, a controversial tax evasion case was brought against Moudud Ahmed, a leader within the opposition BNP party, in early 2012 (*The Daily Star* 2012c).

The persistent weakness of the tax system in Bangladesh is best understood as the product of well-established informal rules, norms and networks that have served the broader interests of political, economic and bureaucratic elites. This political settlement has ensured predictably low rates and the strategic distribution of economic rents, despite the existence of widespread corruption, discretion and informality. However, this system has not been static. Repeated efforts to reform the VAT system – driven to a significant extent by external pressure – have seen the government seek to renegotiate existing rules in ways that satisfy both external actors and key domestic constituencies. In doing so it has drawn on existing informal norms and networks in order to reconcile external pressure for *de jure* policy reform with a desire to preserve key features of the existing system.

Individual reform episodes thus reveal significant continuity, but also highlight the potential for changes in the alignment of power and interests to open new spaces for tax reform. Most notably, recent years have seen informal networks within the NBR begin to be sidelined, with the Ministry of Finance reasserting control over hiring and promotion. This has potentially important implications for the organisation of corruption and patronage within the NBR, and threatens one of the key pillars of the existing political bargain around taxation. Meanwhile, recent instances in which the tax system has been deployed against political opponents have highlighted the risks posed by continued informality, and strengthened support for reform in some quarters. While the tax system in Bangladesh thus speaks to the potential stability of informal rules of the game linking political, economic and bureaucratic elites, it also highlights the ways in which sometimes unpredictable shifts in the political environment can open unexpected spaces for reform (Haggard and Webb 1993: 144).

Finally, while this paper has focused on the tax system, it has sought to illustrate the potential for debates over taxation to act as a lens through which to understand broader political dynamics. Studies of political economy dynamics in Bangladesh have focused on the so-called paradox of Bangladesh, and the existence of an informal political settlement that has ensured the maintenance of a stable growth environment despite the weakness of formal governance. This paper has provided a detailed view of the functioning of precisely this dynamic in the governance of taxation, thus providing a new dimension to these broader accounts.

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