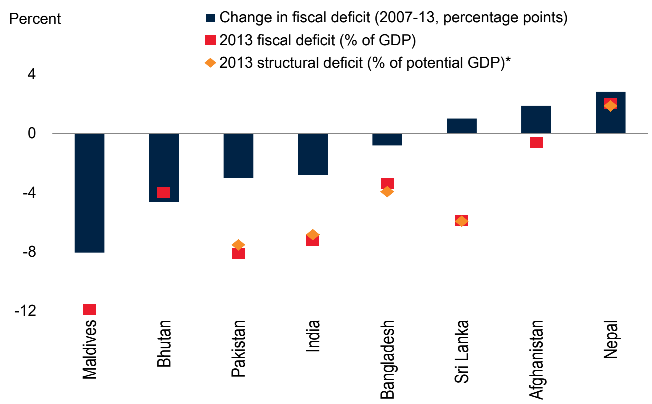
BOX 2.3 Revenue Mobilization in South Asia: Policy Challenges and Recommendations[1]

Low tax-to-GDP ratios in South Asia reflect narrow tax bases, weak tax administrations, and structural factors. In several countries, efforts are under way to address these challenges.

FIGURE B2.3.1 Fiscal deficits

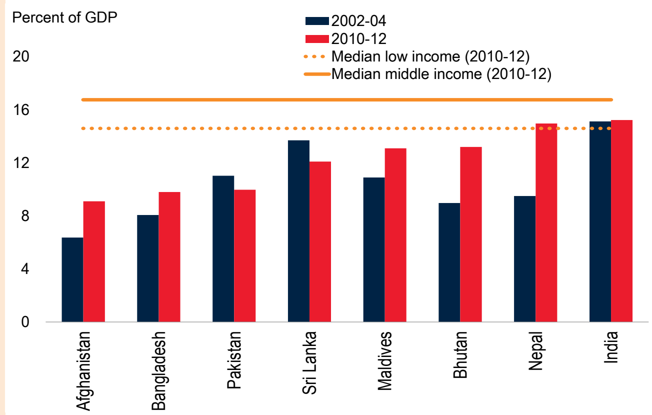
Fiscal space has diminished in South Asia since the 2008/09 crisis



Source: World Bank calculations using data from the World Development Indicators, Government Financial Statistics, and IMF Country Reports.

FIGURE B2.3.2 Tax to GDP ratios

Tax to GDP ratios are low in SAR relative to developing country peers



Source: World Bank calculations using data from the World Development Indicators, Government Financial Statistics, and IMF Country Reports.

Greater revenue mobilization in the South Asia region (SAR) is necessary to reduce macroeconomic vulnerabilities and promote long-term growth. First, fiscal space has diminished since the 2008/09 global financial crisis; average deficits in the region were some 2 percentage points higher than in the pre-crisis period in 2013 and in several countries reached over 6 percent or more of GDP in 2013 (Figure B2.3.1). This has left limited room to counter shocks that could arise from setbacks to global or domestic growth. Second, given extremely low tax-to-GDP ratios (Figure B2.3.2) and debt levels over 60 percent of GDP in some countries, successful fiscal consolidation, and long term fiscal sustainability hinge upon greater revenue mobilization. This has been recognized in consolidation plans by the new government in India and ongoing IMF-supported programs in Bangladesh and Pakistan.

In addition, lower levels of tax collection imply less spending for critical infrastructure and social sector needs than other developing countries at comparable levels of per capita income, despite significant infrastructure bottlenecks, pervasive poverty and lagging human development indicators.[2] A larger revenue envelope is also necessary to fund successful state building in postconflict Afghanistan and strengthening public institutions and public service delivery in other parts of South Asia affected by low-intensity social conflict or unrest. Box 2.3 examines the reasons for poor revenue mobilization performance in South Asia and highlights key reform priorities.

Revenue trends

The larger SAR countries have struggled to increase their tax-to-GDP ratio over the past decade despite ongoing tax reforms. In fact, tax-to-GDP ratios have declined since the early 2000s in Pakistan and Sri Lanka, and stagnated in India. Among the smaller countries, there has been some improvement in revenue mobilization. This can partly be attributed to initial dividends associated with growth, tax reforms, and strengthened tax administration; it may taper off, unless the countries are able to overcome broader challenges in raising tax revenues.

Most governments in South Asia have lagged other developing countries in mobilizing revenues from direct and consumption taxes (Figures B2.3.3 and B2.3.4), despite a growing need for scaling up of such revenues to compensate for falling trade revenue taxes due to trade liberalization (Norregaard and Khan, 2007). India has been more successful than other countries in the region in raising its direct tax ratio, in part because of robust economic growth and improvements in tax administration (World Bank, 2012), but its tax revenues from consumption taxes has fallen over the past decade, as is also the case in Sri Pakistan and Sri Lanka. In India and Pakistan, constitutional restrictions originating in the pre-independence 1935

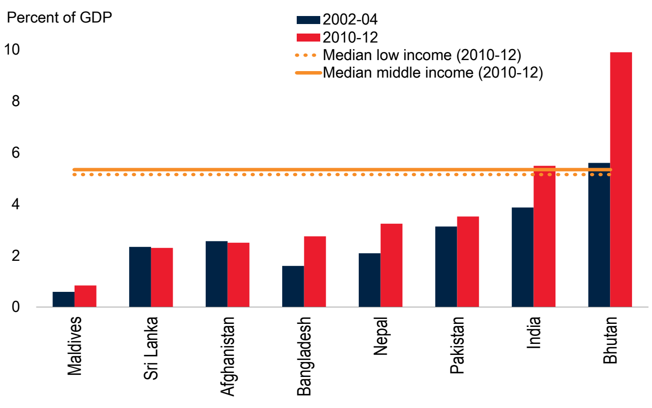
[1]The main authors of this box are Poonam Gupta and Tehmina Khan.

[2]The region needs to invest between US$ 1.7–2.5 trillion (at current prices) in infrastructure until 2020, part of which will need to be financed by governments through higher tax revenues (Andres, Biller, and Dappe, 2013). This implies an annual increase of up to 3 percentage points of GDP from the 6.9 percent of GDP invested in infrastructure by SAR countries in 2009 (See Andres et al., 2013).

BOX 2.3 *(continued)*

FIGURE B2.3.3 Direct tax revenues

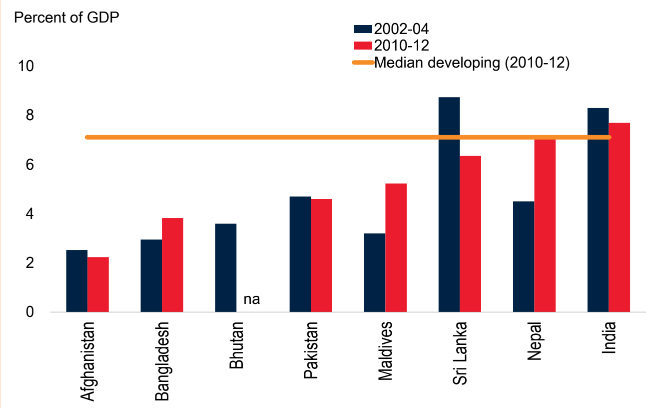
SAR countries struggle to raise revenues from direct taxes.



Source: World Bank calculations using data from the World Development Indicators, Government Financial Statistics, and IMF Country Reports.

FIGURE B2.3.4 Indirect tax revenues

Indirect tax ratios have fallen in most countries over the past decade.



Source: World Bank calculations using data from the World Development Indicators, Government Financial Statistics, and IMF Country Reports.

Government of India Act, that allocate the powers to tax goods and services to distinct levels of government (Keen, 2012), have held back the development and implementation of modern value added tax regimes.

Challenges in revenue mobilization

Weak revenue mobilization in SAR reflects a number of administrative and structural factors. The underperformance of SAR countries in tax revenue mobilization does not appear to be due to the paucity of tax policy reforms: several have undertaken considerable reforms in line with international best practice, transitioning their indirect taxes towards consumption taxes away from taxes on international trade and rationalizing their personal and corporate income taxes, although in the case of Bangladesh, progress even in this context has been small given limited rationalization of personal and corporate tax structures[3].[4] However, tax collection has been held back for several, interrelated reasons:

- *A narrow tax base.* Tax payments tend to be concentrated only among a few taxpayers in South Asian countries. In India, for instance, only 3 percent of the population in India pays the personal income tax, with the figure dropping to about 1 percent in Bangladesh, Nepal, and Pakistan (Figure B2.3.5). Added to this, a plethora of exemptions exist. These have narrowed the tax base, with research indicating a sharp fall in average effective tax rates, and an even larger decline in marginal effective tax rates over the last decade in (Abbas and Klemm, 2012, also see Figure B2.3.6). They have also made tax systems more complex and may have contributed to the emergence of vested interests to resist further reforms. As a result, in most of South Asia, a large proportion of corporate income and trade taxation is collected from a few large corporations and on the import of a few commodities. (World Bank, 2012).

- *Inefficient tax administrations.* SAR countries rank low on some of the common yardsticks of efficient tax administration, typically in the bottom half or the last quartile among the 189 countries ranked in the World Bank's doing business indicators, which can hinder compliance. For instance, time spent preparing and paying taxes for a typical firm in South Asia is more than 300 hours, compared to 200 hours in East Asia and 175 hours in advanced countries (World Bank, 2014h).

- *Structural factors.* Higher shares of agriculture and service sectors in GDP are negatively correlated with revenue to GDP ratios in developing countries, as is poor governance (World Bank, 2012). This is particularly relevant for South Asia, where agriculture has historically been untaxed or undertaxed, while service sectors are also relatively large. Other factors that may impinge on low revenue mobilization include low literacy rates, large rural populations, large informal economies, and poor governance. These factors

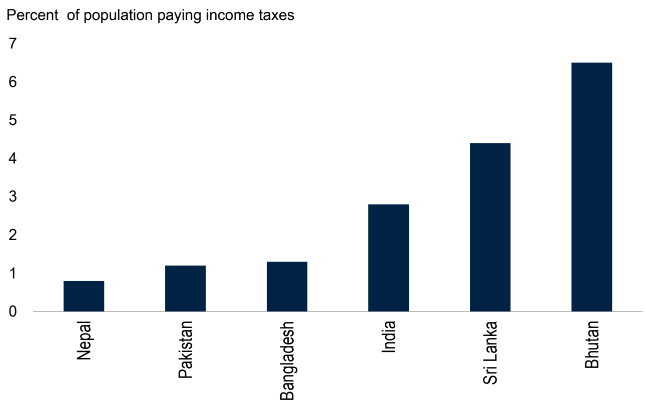
[3]Bangladesh is an exception in that there has not been much rationalization of personal and corporate tax structures.

[4]The coverage of value-added tax in SAR remains narrow, and in many cases confined to the first point of sale, manufacturing or import, rather than extending to the whole value chain.

BOX 2.3 ***(continued)***

FIGURE B2.3.5 Tax payers

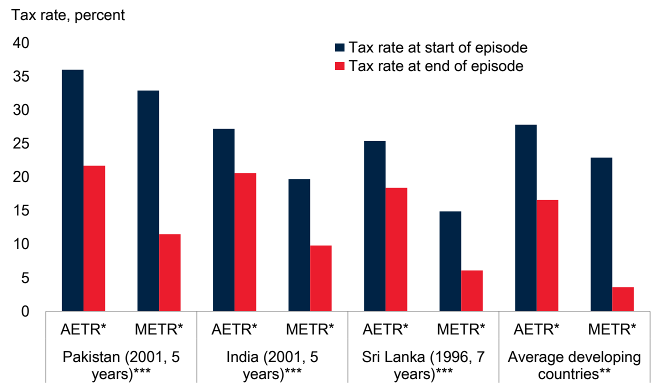
Only a small share of the population pays income taxes in SAR countries



Sources: Asad, 2012; Bangladesh Budget Watch, 2009; Inland Revenue Department, Nepal, 2013; Ministry of Finance, Government of India, 2011; Ministry of Finance, Royal Government of Bhutan, 2010; Sri Lanka, 2012.

FIGURE B2.3.6 Tax rates

Tax incentives have eroded effective rates of corporate tax in South Asia, as elsewhere in the developing world.



Sources: Abbas and Klemm (2012).
Note: *AETR is the average effective rate of corporate tax and measures ratio of the present discounted value of taxes over the present discounted value of the profit of a project in the absence of taxation and affects the decision of where to locate investment (or the effective rate for a profitable project). The METR is the marginal effective rate of taxation and a special case of the AETR, where a project just breaks even, affecting firms' decisions on whether to invest more or not. Data in parentheses refer to the year in which episode of decline in the effective tax rate started, and its duration. Average developing countries data reflect average from a sample of 50 emerging and developing economies.

keep a large proportion of the population and economic transactions outside the tax net, thus lowering tax revenue. In addition, the financial sector is underdeveloped in SAR countries with the implication that financial transactions occur in cash, abetting tax evasion. The countries that have succeeded in increasing the size of their financial sector in the past decade, Bhutan, Maldives, and Nepal. have also managed to increase their tax ratios.

Reform priorities

A second generation of tax reforms is needed in the region given substantial benefits that the additional revenues can bring to the severely resource-constrained governments, and the moderate success of their past reforms. Indeed, empirical evidence indicates that even after taking into account structural factors such as per capita income levels, the share of agriculture and services in national output and integration into global trade, South Asia's revenue performance lags behind peers (World Bank, 2012, IMF 2014c), mainly due to extremely narrow tax bases (in part reflecting weak tax policy design) and weak tax administrations. Accordingly, reform efforts should be focused in the following areas.

Broadening the tax base and simplifying tax structures. By and large, income tax rate structures are relatively simple in South Asia, with the exception of Pakistan and Sri Lanka where both personal and corporate income taxes have complex/multiple rate structures (World Bank, 2012, Lopez-Calix and Touqeer, 2013). However, policy makers across SAR need to review extensive tax exemptions and widely employed tax holidays, which significantly erode corporate, income, and indirect tax bases. Tax coverage should also be increased to sectors that are currently untaxed or undertaxed. For instance, extremely low taxation of the agriculture and service sectors in Pakistan, has raised the tax burden on industry: although industry accounts for only a quarter of GDP, tax revenues from industry are about 60 times more than for agriculture and 5 times more than for services (Lopez-Calix and Touqeer, 2013). More generally, tax policy should refrain from attempting to achieve multiple objectives such as the development of regions or industries, infrastructure creation or choice of technology as it complicates the tax system, increases compliance cost (and potentially the degree of informality), and distorts economic choices.

Strengthening tax administration and improving compliance. The institutional arrangements and organizations for tax administration should be granted more independence, insulated from political influences, and provided adequate financial and technical resources to enhance their data collection and assessment capacity. There has also been limited progress in SAR in moving to e-tax administration due to low literacy and e-literacy, and lack of financial and technical resources. In Pakistan, for instance, Lopez-Calix and Touqeer (2013) argue that the reason for poor outcomes vis-à-vis tax administration

BOX 2.3 ***(continued)***

reforms in the last decade has been the limited uptake and integration of new information technology–based systems.[5] Reforms should be extended, and capacity strengthened, at the subnational and local government level to generate larger revenues at these levels of governments.

While "informality" is widely regarded as being a central challenge for revenue mobilization in developing countries, there is growing concern that the issue is being conflated with that of *noncompliance* (Keen, 2012). This is because to the extent that the administrative and compliance costs associated with bringing small and medium-sized enterprises and low-wage earners into the tax net outweighs the revenue forgone from excluding them, then the optimal tax remitted by them is likely zero. Instead, the challenge is one of ensuring that "hard to tax" professionals (e.g., doctors, lawyers, architects) are within the tax net. Policy recommendations accordingly depend on whether the problem is one of those who do not register to pay taxes at all, or those who are registered but underpay or both, as appears to be the case in South Asia. For instance, in India, the number of taxpayers who declare their incomes to be more than Rs.10 million is 42,800, while in Pakistan only 3.1 million people possess tax numbers. To address the first problem, tax authorities have to invest resources in the identification and registration of taxpayers; in the second case, audit and enforcement are key (Keen, 2012).

Country specific measures. Besides these common challenges for SAR countries, there are country-specific challenges. For Nepal, the sequencing of tax reforms will matter, with small initial changes in specific tax laws likely to yield relatively large improvements in tax revenues. Pakistan is already implementing comprehensive and multipronged reforms spanning tax administration, regulatory reforms, and governance reforms. In light of fiscal decentralization reforms in recent years, the tax administration capacity in the provinces needs to be strengthened to ease financing constraints. Most countries in the region would also likely benefit from considering a bigger role for the value-added tax (VAT) given its inherent advantages over other forms of indirect taxes and evidence that its adoption is likely to lead to greater revenue (Keen and Lockwood, 2010). Bangladesh is currently undertaking reforms to strengthen tax legislation and administration, but the implementation of a new value-added tax regime which would replace an existing non-uniform goods and services tax (GST), a critical element of tax reforms has been repeatedly delayed in the face of considerable public opposition. In Bhutan, where revenues depend to a large extent on hydropower, revenue sources must be diversified for stable and increased revenue generation. Similarly, in Maldives, tax collection relies on tourism, and for sustainable tax collection, revenue sources must be diversified. Finally, in India, the existing GST is fragmented with rates and administration varying by state. A new GST was announced in 2008, but has missed several implementation deadlines although there are signs of progress under the newly elected government. In particular, a constitutional amendment bill for introducing a uniform GST was tabled in the lower house of the Parliament in December 2014. If implemented, as expected in 2015, it is likely to boost revenues by reducing distortions and creating a single market for goods and services. In Afghanistan, delays in introducing a value-added tax have contributed to declining tax revenues alongside weak customs and tax compliance, undermining fiscal stability. In the medium term, extractive industries can make a significant contribution to revenue generation, but this requires legislative and regulatory progress to develop the sector.

[5]Other factors include continued political interference (reflected in high levels of turnover in senior management in the country's main tax agency), and poor audit systems (reflecting a lack of effective centralized, parameter-based risk-audit functions, Lopez-Calix and Touqeer 2013).