

Reforming tax systems in South and South-West Asia

Government challenges in financing development through tax system

Countries should have significant resources to invest in sustainable and inclusive development. A common yardstick to gauge this is the tax-to-GDP ratio, a measure of the economic importance of the public sector in the economy. On average, South and South-West Asia's tax-to-GDP ratio is 12.6 per cent, one of the lowest in the world, below that of other developing countries in the Asia-Pacific region, at 15.2 per cent, and much lower than that of OECD countries, at 25.1 per cent.² Several countries in the subregion have tax-to-GDP ratios under 10 per cent, with Afghanistan's being the lowest at just 7.6 per cent.³

Given the considerable financing requirements of the 2030 Agenda, the current tax-to-GDP ratios will not suffice. Investing in domestic resources through smarter tax policies and more inclusive public expenditure is the largest untapped finance opportunity for those countries.⁴ The 10 countries in the South and South-West Asian subregion are unlikely to achieve the Sustainable Development Goals without comprehensive reforms to improve this situation. Domestic resource financing must be infrastructure- and public service-intensive to support the fundamental transformations under way in South and South-West Asia, such as urbanization, women's empowerment, youth bulge and population ageing; such financing is also needed for the transformation from labour-intensive agriculture to capital-intensive industry and services.⁵

It is possible and advisable to increase the tax-to-GDP ratio in this subregion, because the ratio is considerably below its potential. Recent studies suggest that developing countries in the Asia-Pacific region are realizing only one half to two thirds of their tax potential.⁶

Challenges facing tax systems

South and South-West Asian countries have different tax structures and therefore face different challenges. Such diversity is reflected in their average tax rates (Table 1). Tax rates by themselves do not explain the diversity of tax systems; specific country circumstances must be considered. For instance, the fragile security situation and weak government control over parts of Afghanistan pose great challenges for the collection of taxes. In Sri Lanka, the 2018 budget is aimed at streamlining the corporate income tax system and reducing exemptions in order to improve compliance and increase revenues.⁸

Table 1. Average tax rates, by type, in selected countries in South and South-West Asia

	Indirect	Corporate	Individual	Social security (Employee)	Social security (Employer)
Afghanistan	0	20	20	20	50
Bangladesh	15	25	30	0	0
India	15	34.61	35.43	12	125
Pakistan	17	31	20	0	0
Sri Lanka	11	28	16	8	12

Source: KPMG Tax Rates Online Tool.

To the extent that generalizations can be made, though, tax systems in South and South-West Asia are complex, inefficient and not very conducive to the collection of large tax volumes. For example, while it has been acknowledged that its goods and services tax has reduced the complexity of its taxation system, India's tax laws still are perceived to be second most complex in the Asia-Pacific region – after that of China.⁹

Financial contributions by people and businesses to their Government depend on the perception of the public goods and services received, such as education or health care. Inefficiency in the tax system does not favour inclusion, which in turn lowers tax morale. The result can be a vicious cycle of tax avoidance which hampers financing decent public goods and services, and subsequent low-quality, exclusionary service delivery.

Factors limiting tax system effectiveness

The complexity of the structure and composition of tax systems in South and South-West Asia stems from the multiplicity of taxes, cumbersome assessment procedures, inefficiency of tax administrations, delays in resolving disputes, unequal exemptions granted to certain groups and corruption.

An element that can aggravate such complexity is the highly decentralized structures of countries in the subregion. Subnational public expenditures are one third greater than subnational public revenues in Bangladesh. They are twice as large in India and more than six times as large in Pakistan.¹⁰

Because of such complexity, the subregion's tax systems tend to be dependent on indirect taxes for most tax revenue. Value added taxes (VAT) have often been introduced without differentiation and adopt various rates and exemptions

during passage of legislation in order to appease key interest groups, or attempt targeting to lighten the burden on those left behind.¹¹ Each modification imposes additional complexities, making tax administration more difficult. India's recent introduction of national and state goods and services taxes occurred after some delay; its final form currently affords goods and services exemptions for food and agricultural products. Sri Lanka increased VAT rates from 11 to 15 per cent in 2015 and expanded VAT to include telecommunications and private health care¹², but left food and medicine VAT exempt. In Bangladesh, a new VAT law increasing the rate from 11 to 15 per cent was supposed to be implemented in 2017; implementation has been delayed until 2019 after resistance from special interest groups.¹³

Heavy reliance on indirect taxes means that those who are wealthier pay relatively less tax, because indirect taxes have regressive scale effects. Fragmented indirect taxes and regressive tax revenue streams can be addressed and offset by direct taxation policies, pro-poor public spending and more effective tax administration. However, South and South-West Asian countries face additional challenges in all three areas, leaving regressiveness as a key characteristic of subregional tax systems.

Collection of personal income tax and property tax is below potential as a result of high thresholds and various exemptions, thus making tax administration burdensome and inefficient. In 2013, the subregion's share of personal income tax in total tax revenue was only 14 per cent on average, the lowest in Asia and the Pacific.¹⁴ Tax reforms in various countries have increased personal income tax thresholds over time, decreasing the scope of their tax net.¹⁵ By taking such measures, countries "untax" or remove the tax burden for the vast majority of the poorer population, in particular those who work informally,¹⁶ but they also leave much of the population permanently outside the tax administration system. Property taxes also contain numerous exemptions, often being undervalued and poorly implemented. In Pakistan, the level of undervaluation has been estimated at 45-80 per cent.¹⁷

Corporate tax rates in many South and South-West Asian countries are not much lower than those in other regions of the world, mirroring the relatively high rates for businesses in developing countries. However, corporate taxes across countries also contain numerous exemptions in an attempt to increase investment and encourage productivity. These exemptions can be arbitrary and create vested interests in maintaining special conditions when economies and structures have substantially changed. In Pakistan, broad discretion in exemptions to the payment of corporate taxes meant for industries involved in the China-Pakistan Economic Corridor and in special economic zones has led to exemptions being applied to unrelated projects.¹⁸

The problem of adding complexity to each tax is that it burdens the tax administration and its capacity for accurate, timely and transparent tax collection. Across the subregion there are large gaps in capacity to administer the complex tax web. As a result, on one hand the frequent thresholds and exemptions leave large shares of the population outside the tax system. On the other, the complexity of the tax system delays tax administration and gives extensive discretion to

working-level officials to make tax assessment decisions, thus making those decisions less transparent and reducing overall accountability. A simpler progressive tax system with fewer loopholes and greater manageability would outperform designs that are only better on paper.¹⁹

Small tax bases are a key constraint, driven by informal economies, loopholes, exemptions and poor administration for obtaining compliance. Afghanistan's small tax base includes a miniscule group of large taxpayers contrasted with the wider potential taxpayer population that is largely non-compliant and unidentified.²⁰ In Bangladesh, the top 10 large taxpayers paid more than 78 per cent of VAT collected by the large taxpayers unit, and 50 per cent of all tax revenue collected by the unit came from just one company.²¹ For business and corporate taxation in Nepal about 1,000 companies contribute half the tax revenue.²² Pakistan had only 750,000 payers of income tax registered in 2014 in a country of 190 million people; moreover, almost half (46 per cent) of the 1,167 members of the 6 houses of parliament (national assembly, senate and four provincial assemblies) paid no tax at all, thus demonstrating the weak tax morale even among legislators.²³

Tax competition and base erosion also hampers domestic resource mobilization. Countries in the subregion have responded with tax competition, among other investment incentives, for attracting corporate presence into the country with benefits of tax flows, productivity and employment, although the evidence for these gains is weak.²⁴ At the same time, multinational enterprises are more strategic in their use of profit shifting and transfer pricing to erode traditional tax bases and take advantage of arbitrage gains in tax loopholes between countries.

Policy recommendations

Countries in South and South-West Asia need to design tax systems and taxes that incentivize and accelerate transitions to sustainable economies and environmentally friendlier technologies. Inclusive tax design requires addressing perverse effects in two areas: gender equality and environmental sustainability. Tax design is gender-blind; personal income tax structures are often based on traditional household models of a male head of household and breadwinner, with women being dependents. Rates typically penalize secondary income earners, mostly women, with higher marginal tax rates and fewer options for tax deductions.²⁵ Greater gender mainstreaming in tax design should be matched by improved pro-poor gender-responsive budgeting to empower women and promote equal voice and control in society and the economy.²⁶

In leveraging technology, both filing tax returns and making payments relate to the complexity of tax systems. Both operations should be done electronically, and countries in the subregion have been active in opening up so that taxpayers can file their tax returns electronically and make payments electronically as well. Afghanistan has introduced electronic filing for large taxpayers and plans to roll out a system for medium-sized taxpayers in the coming year.²⁷ The country also has an electronic revenue collection system for making payments.²⁸ Bangladesh and Nepal have recently introduced electronic filing and a payments

system which simplifies individual and VAT processes. In Nepal, 98 per cent of income and VAT returns were filed electronically in 2016.²⁹

Tax and spending coordination and negotiation between different levels of government is critical for revenues collected centrally to be spent effectively at the state and municipal levels. This is very country-specific. Specific tools that countries can use to identify bottlenecks may be, for example public expenditure benefit-incidence analysis, which can capture the distributional impacts of public spending across categories of gender, geography and social groups. That tool showed that access to and utilization of public spending is regressive in India, with gender-differentiated patterns.

Increasing the tax base often requires country-specific approaches. In 2017, Bangladesh increased the number of individual tax filers from 1 million to 1.55 million by requiring tax submission from all government officials with monthly salaries exceeding 16,000 taka (about \$190) and by requiring private sector managers and executives to file returns so that their employers would not be fined.³⁰ In contrast, Bhutan increased personal income tax filers by more than 10 per cent in the 2016 financial year, despite reduced exemptions, because individuals were encouraged to file their returns in order to claim refunds owed to them as a result of tax changes.³¹

Environmental and green taxes that internalize negative externalities are necessary, but their design needs to accommodate two challenges. First, to create adequate national and subregional markets for environmental taxation and emissions-type trading systems to allow enterprises to internalize costs for the first time. Second, to maintain good principles of tax design towards universal, simple and transparent rules with a few rates that allow for less discretion but greater accountability.

Greater transparency in decisions and processes would encourage greater tax morale when people are confident that there is equity and a level playing field when it comes to paying taxes. Across the subregion, publishing tax information increases transparency and accountability. Pakistan set an important good example by becoming the fourth country in the world to introduce a regular complete directory of registered taxpayers and the total amount of tax they paid.³²

Tax reforms, tax policies and changes often differ from their initial proposals before the negotiation and passage of legislation, which can be confusing if complying with the new rules is not clear and simple. Public information campaigns will improve transparency, and enable people to anticipate and plan for costs and compliance. In Afghanistan, a new VAT law came into effect eight months after its official publication and included no reactive penalties, which gave time for businesses to check on how to comply with the law.³³ However, the same country's 2015 Tax Administration Law came into effect from the date of publication, giving taxpayers no time to prepare how to comply. The publication of the law was delayed and not announced, with many taxpayers subsequently finding out about the bill only after they had received penalties for

not complying with it.

Tax reforms can have unintended consequences and negative results, which policymakers should carefully try to anticipate. To drive up tax filing and non-cash transactions, Pakistan in 2015 imposed a withholding tax on bank transactions targeting both large bank cash transactions (exceeding 50,000 rupees, or approximately \$435) and all non-cash transactions at the rate of 0.4 per cent, with tax filers being able to claim refunds for this tax. Instead of encouraging tax filing, the withholding tax has had a negligible effect on revenue but has led to declines in private deposits and a large increase in the amount of currency in circulation, double the annual rate of the last decade.³⁴

Finally, countries should address base erosion and profit-shifting (BEPS). India has been active in promoting the OECD BEPS Initiative, as it passed amendments in its domestic law to be in line with BEPS regulations.³⁵ While BEPS may not be equally important for all countries, regional coordination and integration can be useful for learning from each other. Increasing the corporate tax base and avoiding erosion requires unanimous cooperation for reversing eroding tax incentives and for coordinating treatment of multinational enterprises to close tax loopholes between countries. The subregion already has structures for regional cooperation and integration, such as the South Asian Association for Regional Cooperation (SAARC), which could be more active to tackle BEPS.

¹ The countries considered in South and South-West Asia are: Afghanistan, Bangladesh, Bhutan, India, the Islamic Republic of Iran, Maldives, Nepal, Pakistan, Sri Lanka and Turkey.

² OECD Statistics. Figures differ; country reports and measures are different by time, aggregate and definition.

³ IMF Government Statistics Database (accessed 14 February 2018).

⁴ Cathal Long and Mark Miller, Taxation and the Sustainable Development Goals: do good things come to those who tax more? ODI Briefing Note, April 2017. Available from www.odi.org/sites/odi.org.uk/files/resource-documents/11695.pdf.

⁵ United Nations, Economic and Social Commission for Asia and the Pacific (ESCAP), *Finance for Climate Action in Asia and the Pacific: A Regional Action Agenda to Access Debt Capital Markets*. ST/ESCAP/2803 (Bangkok, 2017).

⁶ ESCAP, *Economic and Social Survey of Asia and the Pacific 2014: Regional Connectivity for Shared Prosperity*. Sales No. E.14.II.F.4.

⁷ KPMG Tax Rates Online Tool. Available from <https://home.kpmg.com/bg/en/home/services/tax/tax-tools-and-resources/tax-rates-online.html>.

⁸ Economist Intelligence Unit (EIU), *Sri Lanka Country Report, February 2018* (New York, 2018).

⁹ Complexity refers to the perceived level of difficulty in interpreting the tax law and rules in the relevant jurisdictions. Source: Deloitte, *Shifting sands: risk and reform in uncertain times – 2017 Asia Pacific tax complexity survey*.

¹⁰ ESCAP, *Economic and Social Survey of Asia and the Pacific 2017: Governance and Fiscal Management*, Sales No. E.17.II.F.8 (Bangkok, 2017). Available from www.unescap.org/publications/economic-and-social-survey-asia-and-pacific-2017.

¹¹ For example, in India the first goods and services tax proposal contained one universal rate and no exemptions. The final legislation contains five rates (Source: The Economic Times. Available from <https://economictimes.indiatimes.com/topic/goods-and-services-tax>) and various exempted categories that must be defined, categorized and reported in tax returns.

¹² International Monetary Fund, Sri Lanka staff report for the 2016 Article IV Consultation and request for a three-year extended arrangement under the extended fund facility; staff statement, and statement by the Executive Director for Sri Lanka, IMF Country Report, No. 16/150 (Washington, D.C., 2016). Available from www.imf.org/external/pubs/ft/scr/2016/cr16150.pdf.

¹³ Economist Intelligence Unit, *Bangladesh Country Report, February 2018*. (New York, 2018).

¹⁴ As an unweighted average. Latest data available are from the IMF Government Statistics Database.

¹⁵ Bhutan, Ministry of Finance, *National Revenue Report 2016-2017*. (Department of Revenue and Customs, 2017). Available from www.mof.gov.bt/wp-content/uploads/2014/07/NRR2016-17.pdf.

¹⁶ Rising income levels translate into higher tax intake when there is deliberate government action to modernize the tax system and incentivize formalization of the economy (Besley and Persson, 2014)

¹⁷ Roy Bahl, Musharraf Cyan and Sally Wallace, The potential of provincial taxation. In *The Role of Taxation in Pakistan's Economic Revival*. Jorge Martinez-Vazquez and Musharraf Cyan, eds. (Karachi: Oxford University Press, 2015).

¹⁸ Asad Ali Abbasi, A conversation about CPEC. Online magazine of the Institute of Asia and Pacific Studies, University of Nottingham. (United Kingdom, 2017). Available from <https://iapsdialogue.org/2017/06/06/a-conversation-about-cpec/>.

¹⁹ ESCAP and Oxfam, Taxing for shared prosperity: policy options for the Asia-Pacific region. Briefing Paper. (Oxford and Bangkok, 2017). Available from www.unescap.org/sites/default/files/Taxing%20for%20shared%20prosperity%20in%20Asia-Pacific.pdf.

²⁰ Chantal Grut, How much do I need to pay? Changes to Afghanistan's tax law cause chaos and confusion. Afghanistan Analysts Network. 23 March 2017.

²¹ World Bank, Bangladesh development update: more, better, and inclusive jobs can boost growth. Bangladesh Development Update. 27 September (Dhaka, 2017).

²² GIZ, Supporting the Tax Authorities in Nepal (Germany, 2018). Available from www.giz.de/en/worldwide/17876.html (accessed 3 January 2018).

²³ See endnote 10.

²⁴ See endnote 19.

²⁵ Ibid.

²⁶ Ibid.

²⁷ William Byrd and M. Khalid Payenda, Revenue growth in Afghanistan continues strong but future uncertain. Peace Brief, No. 219. February. (Washington, D.C., United States Institute of Peace, 2017).

²⁸ Afghanistan, Ministry of Finance, Afghanistan on the road to self-reliance: a year in progress. Progress report (Kabul, Afghanistan, 2017).

²⁹ See endnote 22.

³⁰ World Bank, Bangladesh development update: more, better, and inclusive jobs can boost growth. Bangladesh Development Update. 27 September (Dhaka, 2017).

³¹ See endnote 15.

³² Pakistan, Federal Board of Revenue (FBR), Tax directory: for the year ended 30 June 2016 (Islamabad, 2017).

³³ See endnote 20.

³⁴ State Bank of Pakistan, *Annual Report 2017* (Special Section 1: impact analysis of withholding taxes on cash withdrawal and banking transactions). (Islamabad., 2017).

³⁵ Ernst and Young (EY), India focus on BEPS – base erosion and profit shifting. Available from www.ey.com/in/en/services/tax/ey-india-beps-focus.

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