

Toward a More Business Friendly Tax Regime

Key Challenges in South Asia

Anna Reva



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Abstract

This paper discusses competitiveness-related issues surrounding the design and administration of corporate and value added/sales taxes in four South Asian countries—Bangladesh, India, Pakistan, and Sri Lanka. The paper is based largely on analysis of tax legislation; in addition, data from the World Bank's enterprise surveys, the Doing Business report, as well as industry studies are used for evidence on tax compliance costs for business. The review of tax regulations in the region shows several commonalities: (1) widespread

use of tax incentives to support selected industries, types of firms, and industrial locations; (2) many exemptions from value-added taxes as well as the practice of levying multiple indirect taxes on the same base; and (3) high costs of tax compliance for businesses. The paper discusses the consequences of tax policies for the competitiveness of South Asian producers, describes the main problems in tax administration, and outlines key directions for reforms.

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Toward a More Business Friendly Tax Regime: Key Challenges in South Asia

Anna Reva

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Executive Summary

Tax policy is one of the most important aspects of a country's business environment. It creates an incentive framework for private sector development and generates the revenue needed to fund essential public goods. Tax policy should raise revenue without major distortions to the decisions of firms. Tax regulations should have minimum influence on what to produce or consume, where to locate a production facility and how to produce goods. This paper focuses on analysis of competitiveness related issues surrounding the design and administration of corporate and value added/sales taxes in four South Asian countries – Bangladesh, India, Pakistan and Sri Lanka.

In South Asia, governments systematically use tax policy to achieve objectives beyond revenue collection, supporting the development of certain industries, types of firms or locations. This is done through tax incentives – exemptions, tax holidays, deductions and reduced rates for certain types of taxpayers. The effectiveness of tax incentives in increasing investment or facilitating regional development has not been evaluated in South Asia. While the benefits of existing tax policies are not clear, the negative impacts are obvious – 1) distortions to firms' investment decisions; 2) increased compliance and tax administration costs and 3) reduced government revenue.

Corporate tax policies in South Asia distort investment decisions as firms are given incentives to specialize in certain products or economic activities based on tax schemes rather than economic rational. Corporate tax incentives are granted to less productive firms (small businesses and those involved in agriculture or traditional industries), random economic activities (e.g. beauty centers in Sri Lanka or compressors in Bangladesh) and high tech industries such as IT. All four South Asian countries provide corporate tax preferences for firms locating in special economic zones and lagging regions.

Generous corporate tax incentives require a higher tax rate compared to what would have been needed if all firms were subject to the same tax regulations. Indeed, corporate tax rates in South Asia are higher than in other developing regions. One reason for that is a narrow tax base due to widespread tax concessions. So, while tax incentives may benefit the privileged firms, they worsen the overall investment climate and put a disproportionate pressure on a narrow range of taxpayers.

Consumption taxes in the region suffer from two main problems: 1) multiple exemptions and reduced rates and 2) cascading of indirect taxes that are levied on the same base. Value added taxes (VAT) in South Asia have numerous exemptions from general rules and rates often differ at the sub-product category, which distorts firms' consumption and production decisions. Furthermore, multiple indirect taxes are levied on the same base. This increases the cost of goods and services and reduces competitiveness of South Asian businesses.

Complex tax legislation with different rules for different taxpayers increases compliance costs for firms and creates opportunities for corruption. It is also prone to abuse. Producers of goods that are subject to tax holidays (for example, cement in Sri Lanka or boilers in Bangladesh) may be manufacturing other products as well but shifting most of their profits to the good that is eligible for tax incentives. In countries with many VAT exemptions, firms may misclassify their goods to avoid tax liability. Enforcement of tax regulations with multiple deviations from general rules requires continuous monitoring and frequent audits to prevent tax evasion. Complex tax laws also increase compliance costs for firms and opportunities

for corruption. Businesses in South Asia spend more time complying with tax regulations than in most other regions and corruption is common, particularly in Bangladesh and Pakistan, where over a quarter of firms are expected to give bribes when dealing with tax officials.¹

Tax revenues are low in South Asia, which contributes to macroeconomic instability and constrains government spending on essential public goods. Although corporate tax rates in the region are above global average and VAT/sales tax rates are comparable to the global average, tax revenue is lower than in countries at similar levels of economic development.² Low revenue contributes to macroeconomic instability and limits government spending on infrastructure, education and other essential public services, which has a negative impact on the investment climate and socio-economic growth more broadly.

Reform of tax legislation in South Asia should aim at elimination of most special schemes and creation of an incentive neutral tax policy. This will broaden the tax base, level the playing field for all types of investments and improve revenue collection. Reform of tax administration should make paying taxes less costly and prevent non-compliance. Better revenue collection will allow reducing corporate tax rates without sacrificing essential public spending. Lower tax rates and a more predictable tax policy and administration will help improve investment attractiveness of South Asian countries.

¹ World Bank. Enterprise Surveys

² World Bank. World Development Indicators

I. Introduction

The fundamental objective of taxation is to finance government expenditure. Governments in developing countries sometimes use taxation to fulfill other goals - promote industrial policies, support economic activities deemed to employ the poor and facilitate development of lagging regions. This is achieved through tax incentives – exemptions, tax holidays, deductions and reduced rates for certain categories of taxpayers. While the evidence regarding the efficacy of such policies is mixed (James, 2013), selectivity in applying tax regulations has several negative impacts: 1) it distorts resource allocation decisions as firms make investments based on tax schemes rather than business rational; 2) it creates administrative complexities and increases enforcement and compliance costs and 3) it reduces government revenue.

There is a large literature on challenges and good practices in tax policy design and administration in developing countries (see for example, Heady, 2002, Keen and Simone, 2004 and Bird and Wilkie, 2012). Fiscal experts agree that tax policy should raise revenues without major distortions to the decisions of firms (Easson and Zolt, 2002, Bird and Wilkie, 2012 and OECD, 2010). Taxes are distortive by nature. Corporate income taxes (taxes on profits) reduce returns on capital and discourage investment (Johansson et al 2008). Consumption taxes (sales tax and value added tax (VAT)) reduce spending (Easson and Zolt, 2002). The distortionary effect of taxes increases proportionally to the tax rate (Bird, 2008). Governments can keep the negative effects of corporate and consumption taxes at a minimum by setting the tax rates at the lowest possible level given the revenue needs and by imposing a single rate on a broad base (Bird and Wilkie, 2012; OECD, 2010; World Bank, 2009).

Broadening of tax bases has been a high priority for many developing countries (IMF 2011, Bird, 2008, Heady, 2002). Such reforms help improve the business climate by establishing a level playing field for all firms and by allowing to reduce the overall tax rate. Expansion of tax bases also results in greater public revenue, which gives governments space to invest in a number of public goods (such as electricity, infrastructure or education) and contributes to macroeconomic stability essential for investment attraction. Furthermore, tax legislation with similar rules for all taxpayers reduces compliance costs and supports small business growth and formalization (World Bank, 2009).

For corporate income tax, coverage can be expanded through reduction of tax incentives (see for example Zolt, 2013, Bird and Wilkie, 2012). For indirect taxes, a VAT on goods and services with few exemptions has become popular throughout the world in lieu of its advantages over other types of indirect taxes, such as multistage turnover taxes or single stage taxes at the manufacturing/wholesale/retail level. A detailed discussion of the benefits of the broad based VAT is provided in Lent et al (1973), Ebril et al (2001) and Pomeranz (2012). In short, a broad based VAT eliminates cascading associated with turnover taxes and removes incentives for firms to vertically integrate; it can be waived for exports to support international competitiveness and its self-enforcing mechanism facilitates higher compliance (Heady, 2002). To ensure neutrality and non-interference with market processes, VAT has to be applied to all sectors of the economy.

This paper provides an analysis of competitiveness-related issues surrounding the design and administration of corporate and consumption taxes in four South Asian countries – Bangladesh, India, Pakistan and Sri Lanka. Whenever possible, tax regimes in South Asia are compared with the prevailing international practices. The paper is based largely on the analysis of tax legislation. Additionally, data from

the World Bank's enterprise surveys, the Doing Business report and industry studies are used for evidence on tax compliance costs for business.

Despite some reform effort over the past decade, South Asian tax systems remain complex with different regulations for different industries and types of firms. South Asian governments have introduced a number of changes to their tax laws in an effort to simplify tax systems and improve revenue collection. Corporate income tax rates were reduced throughout the region. India replaced an old fashioned sales tax that did not offer input credit with VAT; Pakistan made some progress in reducing the number of VAT exemptions; Sri Lanka unified the VAT rate at 12%;³ and Bangladesh is working towards introduction of new VAT legislation, which will be in line with international standards. Nevertheless, a number of distortions remain – tax rates differ by type of industry, product and firm. This policy results in misallocation of resources, creates an unfair tax burden on firms that do not benefit from special schemes, and provides disincentives for firm formalization. It also increases the costs of tax administration, creates opportunities for corruption and results in public revenue losses.

The rest of this paper is organized as follows: section II discusses corporate tax regime in the region, section III outlines key weaknesses in the design of consumption taxes; section IV describes the main challenges in tax administration; and section V offers conclusions and suggestions for policy actions.

II. Corporate Income Taxes

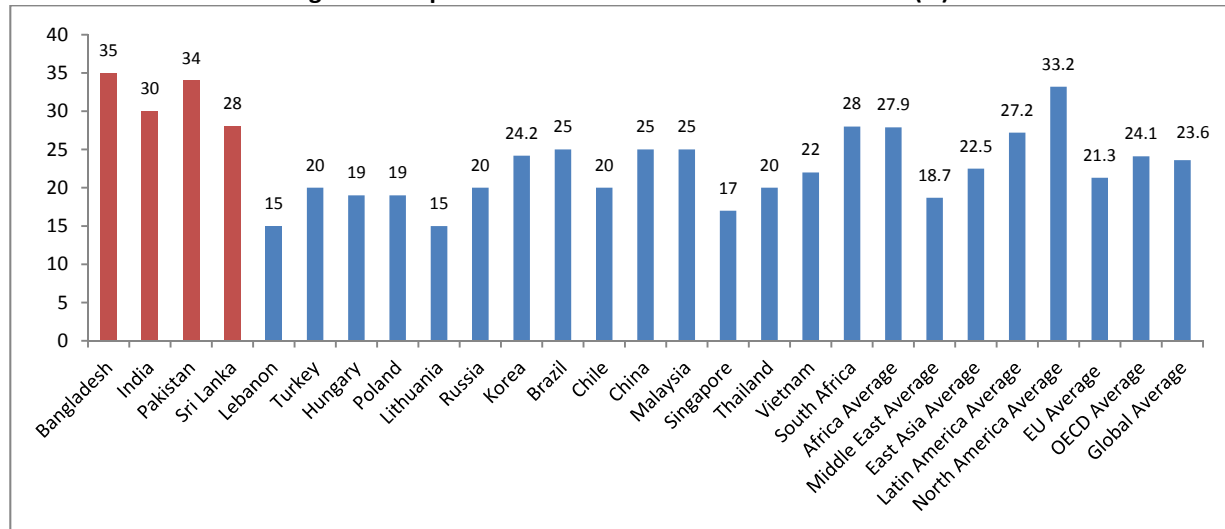
Corporate income tax rates in South Asia are higher than in other developing regions. The average corporate income tax rate for Bangladesh, India, Pakistan and Sri Lanka is 32% compared to the global average of 24%⁴ (Figure 1 below). Corporate income tax rates have gone down in all regions over the past decade. While South Asian countries have followed the trend, they started with higher initial rates and reduced them by a smaller percentage than elsewhere in the world. Over the past decade, corporate income tax rates went down by 11% in the four South Asian countries compared to 20% globally (Table 1 below).

One reason why tax rates are relatively high is a narrow tax base. A number of sectors, economic activities and types of firms are exempt from taxation or enjoy reduced rates. To maintain macroeconomic stability and compensate for revenue losses associated with tax incentives, governments need a higher tax rate than what would have been required if all firms were subject to the same tax regulations.

³To be reduced to 11% in 2015 budget

⁴ KPMG. 2014. Corporate Tax Rates Table <https://www.kpmg.com/GLOBAL/EN/SERVICES/TAX/TAX-TOOLS-AND-RESOURCES/Pages/corporate-tax-rates-table.aspx>, accessed on November 15, 2014

Figure 1. Corporate Income Tax Rates around the World (%)



Source: Author's Calculations based on KPMG.2014. Corporate Tax Rates Table and Bangladesh National Board of Revenue. 2014.

Notes: The rate for India is for domestic companies; the rate for Bangladesh is for companies not listed on stock exchange

Table 1. Corporate Income Tax Rates in South Asia in 2004 and 2014, %

Country	2004	2014	% change
Bangladesh	37.5	35	6.7
India	35	30	14.3
Pakistan	35	34	2.9
Sri Lanka	35	28	20
Global Average	29.5	23.6	20

Source: KPMG. 2014. Corporate Tax Rates Table; KPMG Corporate Tax rates Survey 2004; Pomerleau, K, 2014 and India Ministry of Finance 2004

Preferential treatment of certain sectors and activities

All four South Asian countries provide tax incentives to specific economic activities, often without a clear rational. Agricultural income receives special tax treatment throughout the region (Table 2). In Bangladesh, select agricultural activities, such as poultry farming and production of corn and sugar beet, receive tax concessions. In India and Pakistan, agricultural income is largely untaxed. In both countries, only the states or provinces have a constitutional right to collect agricultural income taxes. In India, agricultural income taxes are levied in only six states with plantation agriculture (large scale commercial cultivation of cash crops such as tea, coffee or cotton).⁵ Farmers have the option of paying taxes based on agricultural income or the amount of land owned.⁶ In Pakistan, all four provinces tax agricultural income but in implementation “the income tax” actually functions as a land tax, which is paid by large landholders based on the acreage of land owned.⁷ In Sri Lanka, agricultural income is taxed at a reduced rate of 10%.

⁵ Rajaraman, Indira. 2004. “Taxing Agricultural Income in a Developing Country: A Possible Approach”, World Bank, Washington DC

⁶ Ibid

⁷ Pakistan Institute of Legislative Development and Transparency.2011. “Taxing the Agriculture Income in Pakistan”, Briefing Paper No.42, Islamabad, Pakistan

The rationale behind concessional treatment of agricultural income is questionable as the policy protects the source of income without differentiation between poor and wealthy farmers. The current policy provides disincentives for firms and individuals to move away from agriculture to higher productivity sectors. It also creates opportunities for tax evasion as taxpayers can abuse the legislation by declaring business income as agricultural income to avoid taxation.

Table 2. Taxation of Agricultural Income

Bangladesh	Select agricultural activities are subject to tax exemptions: all income from poultry farming (up to June 30, 2015); 50% of income from the production of corn and sugar beet.
India	Agricultural income is not taxed by the federal government; only six states levy agricultural income taxes.
Pakistan	Agricultural income is not taxed by the federal government. At the provincial level, agricultural income tax functions as a land tax levied on large landholders.
Sri Lanka	Agricultural income is taxed at a reduced rate of 10%. New investments in agriculture above USD 378,000 are subject to 4 -12 year tax holidays depending on investment amount.

Sources: Bangladesh Income Tax at a Glance 2014-15; India Income Tax Act 1961; Pakistan Institute of Legislative Development and Transparency, 2011; Sri Lanka Inland Revenue Act, No. 10 of 2006

Within manufacturing and services, a number of economic activities are granted tax concessions as well (Table 3). Tax holidays are the most common tax incentive in the region, used widely in Bangladesh, Pakistan and Sri Lanka. In Bangladesh, 5-10 year tax holidays are available for about 20 industries (including exports of handicrafts, agro-processing, pharmaceuticals and boilers⁸). In Pakistan, five year tax holidays are granted to all new manufacturing firms. In Sri Lanka, most manufacturing and select service firms are subject to 4-6 year tax holidays and a reduced tax rate of 12% upon expiration of the holidays if they invest over USD 378,000. Differential tax treatment of firms and industries distorts resource allocation decisions and discriminates investments that do not fall in the preferred type category.

India used to grant tax holidays to a number of economic activities but “grandfathered” most such provisions during 2010-2013. Newly established 100 percent export oriented manufacturers or software producers as well as mineral oil refiners are eligible for 10 years of tax holidays if they commenced their operations prior to April 1, 2012. Exporters of handmade wood articles are eligible for similar tax holidays if they started their operations prior to April 1, 2010; and five year tax holidays are granted to new hotels established during 2008-2013 and located close to World Heritage sites.⁹ Grandfathering tax incentives for existing investors may be an effective compromise to push for corporate tax reform in other South Asian countries. While India’s reforms were a step in the right direction, the country continues to rely on tax deductions for certain industries and firms. In particular, select industries receive generous deductions for capital expenditures that equal or even exceed the amount invested.

Table 3. Main Tax Preferences for Manufacturing and Services

Country	Tax Incentives
Bangladesh	Tax Holidays for New Firms Five to ten year tax holidays (depending on geographic location) are available for new firms in the following industries:

⁸ Bangladesh National Board of Revenue. Income tax at a Glance 2014-15
http://www.nbr-bd.org/IncomeTax/Income_Tax_at_a_Glance_2014-15.pdf

⁹ Ministry of Finance, India. Income Tax Department. Income Tax Act 1961 as amended by Finance Act, 2014

	<ul style="list-style-type: none"> • Pharmaceuticals, biotechnology and chemicals: pharmaceuticals; barrier contraceptive and rubber latex; basic chemicals or dyes; biotechnology; tissue grafting; insecticide or pesticide; petro-chemicals; bio-fertilizer; preservation of food and disinfection of medicinal equipment • Machinery and appliances: basic ingredients of electronic industry (e.g. resistance, capacitor, transistor, integrator circuit); boilers; compressors; computer hardware; textile machinery • Energy efficient products: brick made of automatic hybrid Hoffmann kiln technology; energy efficient appliances • Agro-processing: processing of locally produced fruits and vegetables <p><i>100% of income is exempt only in the first two years of a firm's operation; exemptions go down to 20% towards the end of the tax holiday period</i></p> <p style="text-align: center;">Tax Exemptions</p> <ul style="list-style-type: none"> • Services: information technology enabled services or nationwide telecommunication transmission network business (exempt up to June 30, 2019) • Export of handicrafts (exempt from tax up to June 30, 2015) • All exports: An amount equal to 50% of the income derived from export business is exempt from tax
India	<p style="text-align: center;">Tax Holidays for Agro-processing</p> <p>A 10-year tax holiday equal to 100% of profits for 5 years and 30% of profits for the next 5 years for:</p> <ul style="list-style-type: none"> • Processing, preserving and packaging of fruits or vegetables and for storing and transporting food grains • Processing, preserving and packaging of meat, poultry, marine or dairy products <p style="text-align: center;">Tax Deductions in Computing Total Income</p> <p>Capital expenditures in select sectors: 150% of capital expenditures incurred are eligible for tax deductions for:</p> <ul style="list-style-type: none"> • Setting up a cold chain facility or a warehousing facility for storage of agricultural produce • Production of fertilizer • Building and operating a hospital with at least 100 beds <p>100% of capital expenditures are eligible for tax deductions for:</p> <ul style="list-style-type: none"> • Building and operating a hotel of two star or above category • Bee-keeping and production of honey and beeswax • Setting up a warehouse facility for storage of sugar • Developing a housing project under affordable housing or slum redevelopment schemes • Setting and operating an inland container depot or a container freight station <p>Employment of new factory workers: manufacturing companies employing over 100 workers (50 workers after March 31, 2016) can deduct 30% of wages for new regular full time employees for three years, provided the increase in the number of regular workers is at least 10% over the previous year.</p> <p>Skill development: deduction of 150% of expenditure on skill development projects subject to adherence to the guidelines issued by the Central Board of Direct Taxes</p>
Pakistan	<p>New industrial undertakings receive 100% tax credit for five years if they are set up between July 1, 2011 and June 30, 2016</p> <p>IT-enabled services (exempt from tax until June 30, 2016):</p> <ul style="list-style-type: none"> • Export of computer software • IT-enabled services (e.g. call centers, medical transcription, graphics design, accounting services, HR services, telemedicine centers, insurance claims processing)
Sri Lanka	<p style="text-align: center;">Tax Holidays for New Firms</p> <p>New firms are eligible for tax holidays subject to minimum investment requirements. The duration of tax holidays is longer for larger investments.</p> <p>Investments of LKR 50—300 million (USD 378,000 – 2.3 million) receive 4-6 year tax holidays</p> <ul style="list-style-type: none"> • Manufacturing (all products other than liquor and tobacco) • Services: IT, software development, knowledge/business process outsourcing, healthcare, education, beauty care, cold room and storage facilities, tourism, sports/fitness centers and creative work • Agriculture, Fishing and Agro-processing

	<p>Larger Investments of LKR 300 - 2,500 million (USD 2.3 million – 18.9 million) are subject to 6-12 year tax holidays</p> <ul style="list-style-type: none"> • Manufacturing: boats, pharmaceuticals, tyres and tubes, motor spare parts, furniture, ceramics, glass ware or other mineral based products, rubber based products, cosmetic products, food products produced of locally cultivated products, construction materials, electronic goods and any project of light or heavy engineering • Exports: non-traditional export goods (all products other than black tea, rubber, coconuts and latex) • Services: All services that qualify for tax holiday under a smaller investment bracket (except for creative work) • Agriculture (food and industrial crops, horticulture, animal husbandry) <p>Import-substitution:</p> <ul style="list-style-type: none"> • A 5-year tax holiday is granted to enterprises engaged in production of certain items to replace imports subject to the following investments: a) cement - USD 50 million, b) milk powder USD - 30 million, c) pharmaceuticals - USD 10 million and d) fabric – USD 5 million. <p><i>Upon expiration of tax holidays, investors are subject to a rate of 12% (unless mentioned otherwise below)</i></p> <p style="text-align: center;">Reduced Tax Rates and Open-ended Exemptions</p> <p>Manufacturing:</p> <ul style="list-style-type: none"> • Manufacture of animal feed and handloom products as well as petroleum exploration are taxed at 12% • Profit from domestic sales of locally manufactured garments and bags made out of materials supplied by export-oriented companies that export at least 60% of their products is taxed at 12% • Profits in foreign currency by manufacturers of textiles, leather products, footwear and handbags from supplies made to foreign purchasers that establish headquarters in Sri Lanka are exempt from tax • Manufacture and distribution of organic fertilizer is exempt from tax <p>Services:</p> <ul style="list-style-type: none"> • Operation of storage facilities, development of software, supply of labor and education services is taxed at 10%; • Construction work and supply of services to exporters is taxed at 12%
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Sources: Bangladesh Income Tax at a Glance 2014-15; Bangladesh Income Tax Manual Part 1; India Income Tax Act 1961; Pakistan Income Tax Ordinance Act 2001; and Sri Lanka Inland Revenue Act, No. 10 of 2006.

Preferential schemes for specific types of firms

In South Asia, tax liabilities often differ by type of firm (domestic vs. foreign, publicly vs. non-publicly traded company, new vs. old, small vs. medium or large). These policies distort business environment and discourage fair competition. In India, corporate tax rates differ by type of ownership: domestic companies are subject to a tax rate of 30 percent while foreign companies are taxed at 40 percent.¹⁰ Such policies clearly discourage FDI. In Bangladesh, companies listed at stock exchange are subject to a reduced tax rate of 27.5 percent, while all other companies are subject to a rate of 35 percent.¹¹ This regime likely aims to promote development of capital markets, however it effectively discriminates against most domestic companies.

New firms are subject to tax holidays in all countries of the region if engaged in targeted economic activities (Table 3 above) or located in lagging regions and special economic zones (Table 5). The effectiveness of this policy is questionable as few firms make much profit in the first years of operation. Short term tax holidays benefit highly profitable firms that would invest even without special tax preferences and create incentives for engaging in activities with a quick return on investment. Long term incentives will put existing firms at a disadvantage. Furthermore, tax preferences for new firms are prone

¹⁰ India Ministry of Finance.2014. Finance Bill 2014.

¹¹ Bangladesh National Board of Revenue. 2014. Income Tax at a Glance 2014-15

to abuse as older firms may attempt to close and reopen their operations to continue enjoying the benefits. Thus, the governments' objective of encouraging new investment runs the risk of motivating firm reorganization and shrinking the tax base (for more information on the impact of tax incentives for new firms, see James, 2013 and Easson and Zolt, 2002).

Small firms are eligible for tax concessions throughout the region (Table 4). In Bangladesh, firms with annual turnover below 3 million taka (USD 38,000) are exempt from corporate taxes.¹² In India, firms with annual turnover below INR 10 million (about USD 162,000) face an effective tax rate of 2.4% (they are allowed to declare taxable income at 8% of turnover, which is then taxed at a regular rate of 30%). In Pakistan and Sri Lanka, small firms are subject to reduced rates. However, firms that are considered "small" in these countries will not fall in this category in many developed states as annual turnover thresholds have been set at a rather high level. In Pakistan, "small firms" are those with the annual turnover of less than PKR 250 million (about USD 2.4 million) and fewer than 250 employees. Such firms are subject to a reduced tax rate of 25%.¹³ In Sri Lanka, firms with annual turnover below LKR 500 million (USD 3.8 million) are taxed at a rate of 12% - more than twice lower than firms with larger sales volumes.¹⁴ The special treatment of small firms is often justified as a means to compensate for banks' failure to provide loans to small business. Yet, such policy has a negative impact on productivity and competitiveness as it discourages firms from exploiting economies of scale and growing their operations. It also creates incentives for larger firms to break down their operations into smaller units to reduce tax burdens, which increases administrative costs for firms and reduces public revenue.

Table 4. Special Treatment of Small Firms

Country	Concessions for Small Firms
Bangladesh	Firms with annual turnover below 3 million taka (USD 38,000) are exempt from corporate taxes
India	Firms with annual turnover below INR 10 million (USD 162,000) can declare taxable income at 8% of turnover, which is taxed at the regular rate of 30%. Effectively, the tax rate for such firms is 2.4% of turnover.
Pakistan	Firms with annual turnover below PKR 250 million (about USD 2.4 million) and fewer than 250 employees are subject to a reduced tax rate of 25%
Sri Lanka	Firms with annual turnover below LKR 500 million (USD 3.8 million) are taxed at a reduced rate of 12%

Sources: Bangladesh Income Tax at a Glance 2014-15; India Income Tax Act 1961; Pakistan Income Tax Ordinance Act 2001; and Sri Lanka Inland Revenue Act, No. 10 of 2006

Larger investments receive preferential tax treatment in Sri Lanka. Most manufacturing, agribusiness and certain service firms are subject to 4-6 year tax holidays if they invest above USD 378,000. Longer tax holidays are available for select economic activities with investments above USD 2.3 million and the duration of tax holidays increases with the amount of investment. Firms investing above USD 18.9 million are eligible for 12 year tax holidays. This policy favors foreign companies, well established domestic investors and capital intensive firms. The benefits of this approach are not clear. Some fast growing firms (e.g. IT, financial, consulting and a number of other service companies) do not require a significant upfront investment. Furthermore, it is hard to judge whether five new investments below a certain threshold are less beneficial for the economy than one investment above such threshold.

¹² Ibid.

¹³ Pakistan Federal Board of Revenue. Income Tax Manual. Part I. Income Tax Ordinance, 2001. Amended up to June 30, 2014.

¹⁴ Sri Lanka Inland Revenue Department. Inland Revenue Act, No. 10 of 2006, incorporating amendments up to April 30, 2013

Location-based incentives

Generous tax incentives are available to firms locating in special economic zones (SEZs) and less developed regions (Table 5). Bangladesh and Pakistan grant 10-year tax holidays to firms based in special economic and export promotion zones. Until recently, India provided 15-year tax holidays (with 100% tax exemption on export income in the first five years) for firms in SEZs. Starting from fiscal year 2011-12, SEZ tenants in India are subject to the minimum alternate tax of 20%.¹⁵ All four countries also provide tax holidays to firms located in less developed regions.

Table 5. Location-based Corporate Tax Incentives

Country	Type of incentive
Bangladesh	<ul style="list-style-type: none">• 10 year tax holidays for investments in export promotion zones made prior to December 31, 2011; for investments made thereafter the following incentives apply – first two years – 100% tax exemption, third and fourth years – 50%; and fifth year – 25% tax exemption• 10 year tax holidays for High Tech Parks and 100% exemption of taxes for all exports• 10 year tax holidays for new undertakings in target industries in Rajshani, Khulna, Sylhet, Barisal and Rangpur divisions (excluding City Corporation area) and Rangamati, Bandarban and Khagrachari districts; 5 year tax holidays for select districts in Dhaka and Chittagong divisions
India	<ul style="list-style-type: none">• 10 year tax holidays with 100% tax exemption are available for new firms that establish operations in the Northeastern Region prior to April 1, 2017. Existing firms can benefit from the same tax incentives if they increase the value of fixed capital investment in plant and machinery by at least 25%.
Pakistan	<ul style="list-style-type: none">• Firms located in Special Economic Zones enjoy a 10-year income tax holiday• Firms established between July 1, 2014 and June 13, 2017 and involved in processing and preserving of locally grown fruit are granted 5-year tax holidays in Balochistan, Malakand Division, Gilgit Baltistan and FATA
Sri Lanka	<ul style="list-style-type: none">• Five year tax holidays are available for new firms in the Eastern Province and lagging regions subject to a minimum investment of LKR 30 million (USD 229,000) before April 1, 2010. Upon expiration of the tax holiday, firms are taxed at 5% in the first post-exemption year, 10% in the second and 15% in the third post-exemption year.

Sources: Bangladesh Board of Investment, Bangladesh Hi-Tech Park Authority and Bangladesh Income Tax Manual Part 1; India Income Tax Act 1961; Pakistan Income Tax Ordinance 2001; Sri Lanka Inland Revenue Act, No. 10 of 2006

There is little evidence that location-based tax incentives are effective. Many developing countries offer tax deductions and exemptions to enterprises based in Special Economic Zones, yet evidence from global studies shows that this type of incentives does not compensate for poor location or inadequate facilities nor does it improve the overall zone performance.¹⁶ Furthermore, tax holidays often attract investments with short term horizon and do not benefit longer term projects that generate profits beyond the tax holiday period.¹⁷ In South Asia, some special economic zones are occupied to full capacity and are doing well in terms of job creation and exports. This good performance is explained largely by quality infrastructure and convenient location close to ports, highways and major cities with skilled workforce. Such SEZs/EPZs do not have difficulty finding tenants and would do well even without special tax incentives. On the other hand, zones located in less central and disadvantaged locations remain under-occupied despite availability of tax benefits.¹⁸

¹⁵ Bakshi, Ishan. 2014. Why SEZs in India have failed. Business Standard, December 4, 2014. New Delhi, India http://www.business-standard.com/article/economy-policy/fin-min-rejects-tax-breaks-for-sezs-114112800861_1.html

¹⁶ See, for example, James, Sebastian (2013)

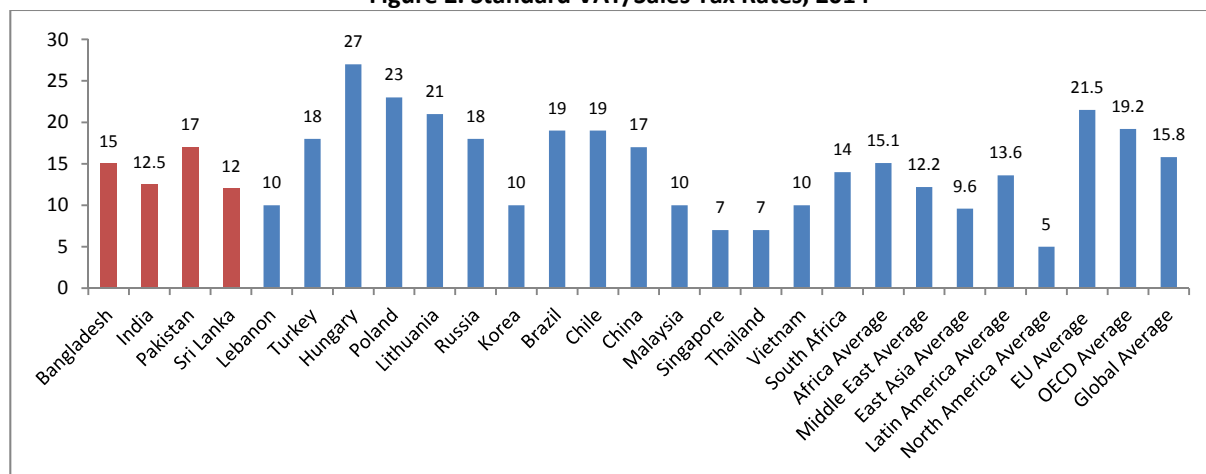
¹⁷ World Bank. 2008. Special Economic Zones: Performance, Lessons Learned and Implications for Zone Development

¹⁸ See for example, Farole, Thomas and Gokhan Akinci (2011) for evidence on Bangladesh

III. Consumption Taxes

Consumption tax rates in South Asia are not high by international standards (Figure 2). The average VAT/sales tax rate for Bangladesh, India, Pakistan and Sri Lanka is 14.1% compared to the global average of 15.8%. There has been little change in VAT rates in South Asia and globally since 2006.

Figure 2. Standard VAT/Sales Tax Rates, 2014



Source: Author's calculations based on KPMG. 2014. Global Indirect Tax Rates Table

Note: the average for Middle East is based on data for four countries that have VAT/sales taxes. In India, standard VAT rates vary from 12.5 to 15% depending on the state.

South Asian countries have been actively trying to reform their consumption taxes over the past decade. India introduced VAT legislation throughout the country by 2008 to replace the old fashioned sales tax, which did not offer input credit. Pakistan made some progress in broadening its Sales Tax base; the Sales Tax in Pakistan is charged in VAT mode and is hereinafter referred to as VAT. Sri Lanka unified the VAT rate at 12%¹⁹ and extended VAT coverage to wholesale and retail trade in 2013.²⁰ Bangladesh developed new VAT legislation based on international standards in 2012, although implementation has been postponed until 2016.

Despite the reform efforts, VAT in all four countries has a narrow base because of a long list of items eligible for exemptions or reduced rates. As a result, VAT in the region functions as a highly differentiated tax and distorts consumption and production decisions. Another important problem is cascading of indirect taxes, when the same product or service is taxed more than once as it passes through the various stages of production-distribution chain. This increases the final cost of goods and makes South Asian producers less competitive in domestic and foreign markets.

Preferential treatment of certain products and services

VAT legislation in South Asia suffers from a number of exemptions and reduced rates. Some of the exemptions, for example, for food items are used to protect consumption of the poor, which is common throughout the world. However, rather than granting VAT exemptions to broad food categories (e.g. all

¹⁹ Sri Lanka will reduce its VAT rate to 11% in 2015 budget

²⁰ International Monetary Fund. 2014. Sri Lanka. Article IV Consultation. IMF Country Report No. 14/285. September 2014

vegetables, fruit, cereals), VAT legislation states specific product types that are exempt, e.g. red chilies in Pakistan (green chilies are treated differently for some reason), palm oil in Sri Lanka (but not other types of vegetable oil), most vegetables in the Indian state of Nagaland but not onion, garlic and ginger. Similarly, a number of related non-food goods are subject to different VAT rules. India, Pakistan and Sri Lanka also grant VAT exemptions for inputs and machinery to support specific industries.

VAT exemptions distort consumption and production decisions and increase compliance and enforcement costs due to classification issues. Exemptions can distort consumption decisions when exempt products compete with non-exempt during sales to final consumers. Exemption of intermediary inputs from VAT may increase the cost of final goods as buyers are not allowed input tax credit on purchases of exempt items, so that part of the value added in a final product is taxed more than once.²¹ This creates incentives for producers of VAT exempt items to self-supply and undertake more activities down the supply chain than they otherwise would, so that value added at the intermediate stages is not taxed. For example, firms whose outputs are VAT exempt have an incentive to supply their own security, cleaning, technical support and other services rather than contract them out and face irrecoverable VAT bills.²² Furthermore, VAT exemptions increase tax compliance and administration costs (as well as opportunities for tax evasion), particularly for firms producing both VAT exempt and non-exempt products.²³ The narrative below discusses differential treatment of goods and services for VAT purposes in each of the four countries.

In Bangladesh, the current VAT legislation is characterized by a narrow base and widespread use of presumptive taxation. Most unprocessed food items and a number of raw materials such as skins and hides, wood, wool, cotton and jute are exempt; VAT exemptions are also granted to six categories of services (Table 6). Under the VAT Law, the government can fix tariff value for certain items, so that VAT is levied on a presumptive basis on some notional value rather than on the actual transaction value. For example, tariff value for mild-steel products produced from re-rollable scraps is TK 4000 (USD 51) per metric ton.²⁴ Furthermore, over 20 services are taxed according to fixed value addition bases of 10, 25, 30 and 60 percent.²⁵ The resulting VAT rates are 1.5, 2.25, 4.5 and 9 percent. For example, VAT on the construction service is calculated on 30% of the base (30 x 15%), for a total rate of 4.5%.²⁶ Suppliers of

²¹ Consider the following example: *Firm B buys taxable inputs from firm A for \$100 and pays VAT at the rate of 15% for a total of \$115. Firm B produces an exempt product and adds value of \$30. It cannot claim any input credit and sells its output to firm C at \$145. Firm C produces a taxable good but since it has paid no VAT on B's product it cannot claim any input tax credit on it. Had firm B been liable for VAT, it would sell its product to firm C for \$149.5 (\$130 +19.5 VAT) and claim \$15 as input tax from the government. So, the tax the firm actually transmits to the government would be $19.5 - 15 = \$4.5$, which is 15% of 30 (firm B's value added). For whatever price firm C sells its product, it can claim 19.5 as input credit if firm B is liable for VAT. If firm B is exempt, the \$15 input tax becomes additional revenue to the government, which is likely to translate into increased cost of the final product.*

²² Mirrlees, James et al. 2011. *Tax by design*. Institute for Fiscal Studies. Oxford University Press

²³ Ibid

²⁴ Bangladesh National Board of Revenue. Value Added Tax <http://www.nbr-bd.org/valueaddedtax.html> accessed on March 10, 2015

²⁵ Ahmed, Nasiruddin. 2013. *Improving Tax Compliance in Bangladesh: A study of Value Added Tax*, Institute of Governance Studies, BRAC University

²⁶ Saleheen, Ahmed and Noore Siddiquee. 2013. "Tax Innovation or Excise Duty in Disguise? Deviations and Distortions in Value-added Tax in Bangladesh". *International Journal of Public Taxation*, April 2013.

goods and services taxed on a presumptive basis are not allowed to claim input credit. The highly differential application of VAT legislation in the country results in a major disconnect between the VAT paid by producers and the value added by them.

Table 6. VAT Exemptions, Reduced Rates and Presumptive Taxation in Bangladesh

Exemptions for Goods	Most unprocessed agricultural products and select raw materials (cork, wood, cotton)
Exemptions for Services	Six main categories of services: <ul style="list-style-type: none"> • basic services for living (agriculture-related services: e.g., packing or sorting of food grains and vegetables; storage and preservation of agricultural goods, seeds, meat and fish); • social and welfare services (e.g. medical and educational services); • culture- related services (e.g. TV and radio broadcasting, artwork, social and sports clubs); • financial services; • transport services; and • personal services (e.g. dancers, actors, translators, plumbers, wood, mason and electrical workers)
Presumptive Taxation of Manufacturing Items	101 products are taxed based on notional tariff values at production stage
Reduced Rates for Services ("truncated VAT")	21 services are taxed at reduced rates of 1.5%, 2.25%, 4.5% and 9%.
Special Treatment of Wholesalers and Retailers ("trade VAT")	Wholesalers and retailers are taxed at 1.5% of total sales, provided that they do not avail of input credit.

Source: Bangladesh National Board of Revenue <http://www.nbr-bd.org/valueaddedtax.html> ; Bangladesh Value Added Tax Act, 1991; and Ahmed. N. 2013.

India has two types of VAT – a Central Value Added Tax (CENVAT) charged by the federal government on goods manufactured in India and a state level VAT charged on the sale of domestic and imported goods. CENVAT functions like a production tax and is paid by a manufacturer, who passes its incidence on to customers. The standard CENVAT rate is 12%; there are also lower rates of 0% and 6%. Indian states have a constitutional right to levy VAT (former sales tax) only on goods through retail and wholesale. A lot of products are subject to exemptions or reduced rates, so state level VAT is a highly differentiated tax. The standard VAT rate varies from 12.5 -15% and the reduced rate from 4-5% depending on the state. Gold, silver, precious stones and articles made of these materials are subject to a rate of 1%. The list of products eligible for exemptions and reduced rates is determined at the state level, which increases compliance costs for firms buying and selling goods across states. For example, in the state of Nagaland, 73 types of products are exempt, 350 are subject to a rate of 4% and 172 are subject to a rate of 12.5%. The rates often differ at the sub-product category (Table 7) and similar types of goods are subject to different rates.²⁷ Most industrial inputs are taxed at a reduced VAT rate of 4-5%,²⁸ which violates VAT design principles, as this tax provides credit for inputs used in the production of final goods.²⁹

²⁷ Government of Nagaland, Department of Finance. Nagaland VAT Act, 2005: VAT Schedule of Rates

²⁸ Rao, M. and R. Rao. 2005. Trends and Issues in Tax Policy and Reform in India

²⁹ See, for example, Keen, Michael and Ben Lockwood. 2007. The Value Added Tax, Its Causes and Consequences. IMF Working Paper WP 07/183

Table 7. Examples of exemptions and reduced tax rates for similar types of products in Nagaland, India

Schedule I. Exempt Goods	Schedule IV. Goods Taxable at 4%	Schedule V. Goods taxable at 12.5%
Fresh milk, pasteurized milk, curd, lassi, buttermilk and saturated milk	Cottage cheese; skimmed milk powder and UHT milk	Milk products including powder milk, condensed milk, ghee, cheese, butter oil, ice creams, margarine whether or not bottled, canned and packed
Hatchable eggs and livestock, fresh meat, fish, prawn and other aquatics	Non-hatchable eggs, processed meat, poultry and fish	Meat, poultry, fish, sea fish, fruit and vegetables preserved and sold in air tight containers
Fresh vegetables, including potatoes, and fruits	Onion, garlic and ginger	Dry fruits, nuts and kernel such as almond, pista, dry grapes, figs, apricots, walnut and cashew; fruit sold in preserved form
Bread unbranded	Branded bread	Bakery products, including biscuits of all varieties, cakes, pastries and pizza breads
Handicrafts, handlooms, handloom fabrics, idols made of clay, earthen pot and clay lamps; khadi garments and goods; indigenous handmade musical instruments	Clay, including fire clay, fine china clay and ball clay	Handlooms machinery and parts and accessories thereof; electrical and electronic musical instruments; chinaware, porcelain and stoneware articles
Textiles of all varieties	Cotton and cotton waste; fibers of all types and fiber waste; polyester staple fiber and fill; silk fabrics	
	Polymers or propylene in primary forms	Articles made of all kinds and forms of plastic
	Aluminum, copper and lead ores and concentrates	Articles made of aluminum, copper and lead
	Nuts, bolts, screws and fasteners; tools	Tools and wear parts such as twist drills, taps, reamers, spanners, screw-drivers, files, cutting pliers, hammers, cutters, dies, and button bits
	Toys, excluding electric toys	Toys of all kinds including electrical and electronic toys
	Plastic footwear	Footwear of all kinds excluding plastic footwear and hawai chappals.
	LCD panels, LED panels and parts	Television sets and component parts and accessories thereof

Source: Government of Nagaland, Department of Finance. Nagaland VAT Act, 2005: VAT Schedule of Rates

Pakistan and Sri Lanka's VAT laws have a number of exemptions. Most goods in Pakistan are subject to a standard VAT rate of 17%. A reduced rate of 5% is applied to six product types – soybean meal; oil cake and other solid residues; direct reduced iron; oilseeds meant for sowing; cotton; and plant and machinery not manufactured locally. Sri Lanka has one VAT rate of 12% (to be reduced to 11% in 2015 budget). Both countries have developed long lists of exemptions and use VAT to support select industries or even industrial locations by exempting inputs and machinery (Table 8). The exemption of inputs is not appropriate in a VAT tax as full credit is available for all inputs used in production. These provisions are likely a remnant from the pre-VAT sales tax legislation. There is no documented evidence on whether VAT exemptions have contributed to the growth of the sectors the policy aims to support but they clearly create distortions, complicate tax administration and increase the scope for tax evasion.

Table 8. Main VAT Exemptions in Pakistan and Sri Lanka

Pakistan	Sri Lanka
Live Animals and Agricultural Products: <ul style="list-style-type: none"> Live animals and poultry; meat (sheep, goat, poultry) and fish whether fresh, frozen or preserved; eggs Live plants, edible vegetables (except ware potato and onions), fruit and fruit juices whether fresh, frozen or 	Agricultural Products: <ul style="list-style-type: none"> Rice, wheat, cardamom, cinnamon, cloves, nutmeg, mace, pepper, coconuts, rubber, latex, tea, rice flour, wheat flour, bread, infants' powdered milk, eggs, liquid

<p>otherwise preserved but excluding those bottled or canned</p> <ul style="list-style-type: none"> • Red chilies, ginger and turmeric excluding those sold in retail packing and bearing brand names and trademarks • Sugar beet, sugar cane • Milk, cream, yogurt, whey, butter, cheese • Edible oils <p>Inputs and Machinery for Select Industries:</p> <ul style="list-style-type: none"> • Raw materials for the manufacture of pharmaceutical active ingredients • High efficiency irrigation equipment and green house equipment if used for agriculture sector • Machinery and equipment for marble, granite and gem stone extraction and processing industries • Components of energy saving lamps • Supply of domestically produced cotton seed meant exclusively for sowing • Cattle feed and poultry feed • Compost (non-commercial fertilizer locally produced) <p>Machinery and Equipment for Industries in Select Locations:</p> <ul style="list-style-type: none"> • Plant, machinery and equipment imported for setting up fruit processing and preservation units in Gilgit-Baltistan, Balochistan and Malakand Division up to June 30, 2019. • Plant, machinery and equipment imported for setting up industries in FATA up to June 30, 2019. • Construction materials for development of Gwadar EPZ infrastructure. Machinery, equipment and other project related items including capital goods, for setting up of hotels, power generation plants, water treatment plants and other infrastructure related projects within 30 km from Gwadar <p>Miscellaneous:</p> <ul style="list-style-type: none"> • Drugs and medical equipment • Silver and gold in unworked condition • Periodicals and books • Glass bangles • Erasers, exercise books, pens, pencils, pencil sharpeners, colors in sets • Sewing machines for household use • Bicycles 	<p>milk (not made out of powdered milk or any grain) and powdered milk</p> <ul style="list-style-type: none"> • Locally manufactured coconut oil, palm oil and coir fiber <p>Inputs and Machinery for Select Industries:</p> <ul style="list-style-type: none"> • Raw materials for the manufacture of spectacles and spectacle frames • Raw materials for the manufacture of energy saving bulbs • Import of machinery for import substitution sectors that also enjoy 5-year corporate tax holidays – pharmaceuticals, milk powder, fabric and cement • Yarn for textile industry; dyes for handloom industry • Agricultural machinery, tractors and fertilizer; animal and shrimp feed (excluding poultry feed) • Items and spares for the poultry industry • Milk processing machinery • Machinery used for rice milling industry • Machinery and equipment for manufacture of grain mixed bakery products • Machinery and equipment for the use of leather and footwear industries, manufacture of bags and fashion jewelry • Machinery used for the production of rubber or plastic products, sunglasses and perfumes • Machinery used for construction industry <p>Machinery and Equipment for Industries in Select Locations:</p> <ul style="list-style-type: none"> • Machinery for new undertakings located in the Eastern Province <p>Miscellaneous:</p> <ul style="list-style-type: none"> • Drugs, ayurvedic preparations and equipment used by the disabled • Diamonds, pearls, precious or semiprecious stones, precious metals, gold coins; locally manufactured jewelry • Books • Computers and computer accessories • Mobile phones • Lightweight electrical and electronic items • Telecommunications equipment • Locally developed software; telecommunications services
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Source: Pakistan the Sales Tax Act 1990 (updated through Finance Act, 2014), Schedule Six;
Sri Lanka Value Added Tax Act No 14 of 2002 (incorporating amendments up to 2013), First Schedule

Cascading of Indirect Taxes/Double Taxation

South Asian countries levy multiple indirect taxes on the same base, which results in cascading (tax on tax) and increases the cost of final goods and services eroding competitiveness of producers. In Bangladesh, supplementary duty (an excise-like tax) is charged in addition to VAT on a wide range of domestically produced and imported goods (including food products, construction materials, cosmetics, hygiene items, fabrics, clothes, household items, motor vehicles) and select services (hotels, restaurants and SIM cards). Rates vary from 20-60 percent for food, clothes and household items to 350% for alcohol drinks. Supplementary duty paid on inputs cannot be claimed as input credit for VAT by purchasers, which

results in cascading. Another feature of Bangladesh's VAT law is that it has a narrow definition of inputs for tax purposes and excludes labor, land, buildings, office equipment and transport. This provision increases the cost of final goods and services.

In India, the existence of both central and state level VAT on manufacturing results in tax cascading on industrial goods. This is because no input credit is available for VAT levied at the central level. There is also a Service tax charged at the rate of 12% by the central government in VAT mode.³⁰ The Service tax is not integrated with VAT on goods leading to either under or over-taxation of "bundled goods" – products that represent a mixture of goods and services. For example, software upgrades (which are goods) can be supplied as part of a contract for software repair and maintenance services.³¹ The so-called "value added services" provided as part of telecommunication services (wallpaper for mobile phones, ring tones, weather reports) include supplies that may be considered goods. Under the current legislation, both the states and the federal government can tax only parts of such bundles, which creates the possibility of gaps or overlaps of taxation.³² In addition to VAT, both the central government and the states levy several other indirect taxes (Box 1). This results in cascading of taxes and undermines competitiveness of Indian producers.

Box 1. Cascading of Indirect Taxes in India

India has multiple indirect taxes that are not integrated with each other. The central government levies CENVAT on manufactured products, Service tax, and Central Sales tax on interstate sale transactions. Taxes charged by state governments include state level VAT and entry tax (on entry of goods into certain states). The Service and CENVAT tax are not integrated, so manufacturers are not eligible for input credit on services used to produce industrial goods. The sale of goods is taxed at the state level on top of the taxes already levied by the Central Government through CENVAT. The central sales tax (CST) is charged at 2% on interstate sale of goods and fragments India's internal market. It is collected by the origin state and does not allow for any credit. CST also has high administrative and compliance costs. There are frequent delays on state border check points, where CST is collected, resulting in higher logistics costs for producers.³³

The multiplicity of indirect taxes reduces competitiveness of Indian producers. The share of indirect taxes can be as high as 30% of the retail price in India.³⁴ In fact for some goods, such as cars, the total tax burden can vary from 58% for small vehicles to 90% for large ones.³⁵ Some of these taxes are not reimbursable and are estimated to add 4-6% to the cost of exported goods.³⁶

In Pakistan, there is double taxation of select services (e.g. banking, insurance and franchise services) that are taxed both by the Federal Board of Revenue (through the Federal Excise Duty) and by provincial

³⁰ The Service Tax rate will be increased to 14% in the FY15-16 budget.

³¹ Poddar, Satya and Ehtisham Ahmad. 2009. "GST Reforms and Intergovernmental Considerations in India", Ministry of Finance, India

³² Ibid

³³ Bhattacharya, Arvind, Ravi Srivastava and Nimisha Jain. 2010. "Indian Manufacturing: The next Growth Orbit". Boston Consulting Group

³⁴ Ibid.

³⁵ The Economist. 2014. "Revving Up in India". June 16, 2014

³⁶ Bhattacharya, Arvind, Ravi Srivastava and Nimisha Jain. 2010. "Indian Manufacturing: The next Growth Orbit". Boston Consulting Group

authorities through the sales tax (both the Sales Tax and Federal Excise Duty are charged in VAT mode). This has resulted in numerous appeals by taxpayers who were subject to double taxation.

In Sri Lanka, a Nation Building Tax is levied on 2% of turnover for manufacturers, importers and service providers.³⁷ This tax is not integrated with VAT and increases the final cost of goods.

Upcoming Reforms of Indirect Taxation

Bangladesh and India embarked on major reforms of indirect taxation, which are expected to come into force in 2016. These reforms will widen tax bases, ensure equal treatment of all economic activities and remove cascading. Policy changes will be accompanied by strengthening tax administrations. Pakistan and Sri Lanka are pursuing incremental reforms to their VAT legislation and no major changes are planned in the near future.³⁸

Bangladesh adopted a new VAT law in 2012 that removes most of the current distortions. The new law provides for much broader use of input tax credits as all taxed inputs will be creditable if used to produce taxable supplies. VAT will be levied on actual sales rather than arbitrary tariff values or truncated bases and tax officials will no longer have the right to determine value added or sales values based on the data for similar transactions. Uniform VAT rates and rules will apply to all sectors and economic activities with very few exemptions. Furthermore, the list of goods subject to supplementary duty will be reduced. The law was initially expected to come into force in July 2015 but implementation has been postponed for a year due to delays in software procurement and ongoing reform of Bangladesh's tax administration.

The Government of India committed to launching the most ambitious tax reform in decades – introduction of Goods and Service Tax (GST). GST will introduce uniform taxation rules across all states and create a single national market. It will merge most indirect taxes (e.g. CENVAT, Service Tax, state VAT, entry tax, CST) into a single levy, which will remove cascading and simplify compliance. The tax base will be broadened with goods and services receiving the same treatment. Tax revenue will be divided between states and federal government based on a formula acceptable to both. The reform is expected to increase economic activity, encourage formalization, promote faster economic growth and boost public revenue. In order for GST to be rolled out, Parliament has to adopt a constitutional amendment and the new law should be ratified by state governments. The launch of GST is planned for April 2016.

IV. Tax Administration

South Asia's tax regulations are complex and difficult to administer and comply with. Complexity stems from availability of special schemes, reduced rates and exemptions for different sectors, locations, types of firms or products. Furthermore, tax laws are often written in archaic or vague language and are changed frequently, which makes it difficult for a typical SME firm to understand its tax liabilities and gives room

³⁷ Sri Lanka Inland Revenue Department. Nation Building Tax <http://www.ird.gov.lk>

³⁸ Pakistan established a Tax Reform Commission in September 2014 to modernize the tax system. Different options for reforming VAT (including introduction of a single stage sales tax) have been suggested but no agreement has been reached to date on the design of reforms.

for interpretation of tax rules to both firms and tax administrators, creating opportunities for leakages and corruption.

South Asian governments frequently alter tax regulations. The changes may be minor, yet frequent amendments create uncertainty about tax regulations and make compliance more difficult. In all four South Asian countries income tax regulations are changed at least annually at the time new budgets are planned. In Bangladesh and Pakistan, the changes are much more frequent. In Bangladesh, 18 changes to VAT and 16 to income tax law occurred through issuing new Statutory Regulatory Ordinances (SROs) in 2014.³⁹ The changes were even more frequent in Pakistan - 20 and 16 changes to VAT and income tax laws respectively occurred through SROs over the same time frame.⁴⁰ Such frequent changes mean that taxpayers should continuously follow tax notifications published in the official Gazette to stay informed about their tax obligations. Unpredictable tax rules worsen the business climate and may deter potential investment.

Complex and frequently changing tax legislation is prone to abuse. For example, producers of goods subject to tax holidays (e.g. boilers in Bangladesh) may be manufacturing other items as well but shifting most of their profits to boiler production to qualify for tax breaks. Location-based incentives are also prone to fraud as multi-unit firms often divert profits through an entity that is eligible for tax holidays. A study on India found that businesses established front offices in Jammu and Kashmir that qualified for area-based incentives while production happened outside the state.⁴¹ The study also showed that multiunit firms outside the special economic zones took advantage of tax incentives by transferring profits to the units located in the zones.⁴² Another common type of abuse of tax holidays for new firms is when existing businesses close and reopen their operations under a new name to extend the duration of tax exemptions. In countries with several VAT rates (particularly for related products) and multiple exemptions, firms may misclassify their products (mostly final goods) to reduce or avoid taxation. Monitoring compliance is particularly difficult when the same product is subject to different VAT rules depending on the end use (e.g. local cottonseed in Pakistan is exempt if used for sowing; dyes for handloom industry are exempt from VAT in Sri Lanka).

Enforcement of tax legislation with multiple deviations from general rules requires continuous monitoring to prevent leakages, increases information requirements of tax authorities and creates additional burdens for under-resourced tax administrations in the region. It also hurts businesses. To enforce compliance, tax administrations require firms to keep elaborate records and may need to conduct frequent tax inspections and audits.⁴³ While tax compliance costs for business were not estimated in South Asia, they are likely to be substantial. Complex and frequently changing rules put small firms at a particular disadvantage as tax compliance has a large fixed cost component. Eichfelder and Vallancourt (2014) report that tax

³⁹ Bangladesh National Board of Revenue. VAT SRO http://www.nbr.gov.bd/SRO_vat.php?lan=eng and Income Tax SRO http://www.nbr.gov.bd/SRO_income.php?lan=eng

⁴⁰ Pakistan Federal Board of Revenue. SROs/Notifications <http://www.fbr.gov.pk/SROS.aspx?view=SROS&ActionID=6&ArticleID=>

⁴¹ James, Sebastian. 2013. Tax and Non-tax Incentives and Investments: Evidence and Policy Implications, World Bank, Washington DC

⁴² Ibid.

⁴³ For evidence from global studies on the costs of administering tax incentives, see James, S. 2013

compliance costs can reach 10% of turnover for small businesses; World Bank studies on developing countries show similar results.⁴⁴

Firms in South Asia spend more time complying with tax regulations than in most other regions (Table 9). In all four countries, most of the time is spent to comply with VAT regulations. One reason for that is because VAT returns are filed monthly while corporate taxes are paid less frequently – 1-5 times per year.⁴⁵

The administrative burden of tax compliance is hardest in Pakistan where firms have to make 47 payments and spend 594 hours (or 74 man days per year) dealing with tax regulations vs. 12 payments and 175 hours in high income OECD countries.⁴⁶ Eighty seven percent of time spent on dealing with taxes (or 514 hours per year) in Pakistan is spent on VAT compliance.⁴⁷ As mentioned earlier, the sales tax regulations are frequently amended through SROs, which increases compliance costs. In India, Bangladesh and Sri Lanka, firms spend 105, 140 and 142 hours respectively to comply with VAT.⁴⁸ In India, this time also covers compliance with the Central Sales Tax on interstate movement of goods. Every state in India has multiple sales tax check-points along its national highways and borders to monitor movement of goods through its territory and prevent evasion of taxes.⁴⁹ This arrangement increases firms' tax compliance and logistics costs. The planned introduction of GST in 2016 will eliminate the Central Sales Tax and reduce firms' tax compliance costs.

In Bangladesh, paying VAT often entails direct negotiation with the tax officials. The current VAT law gives them significant discretionary powers to fix for each tax period the minimum amount of sale, amount of value addition and base value for payable tax for the suppliers of goods and services in cases where tax officials consider that the books of accounts do not show correct sale values, receipts or invoices are not available or tax returns are believed to contain false information.⁵⁰ In such instances, tax officials have the authority to assess VAT liability

Table 9.
Paying Taxes in South Asia vs. Other Regions

Country	Payments (number per year)	Time (hours per year)
Bangladesh	21	302
India	33	243
Pakistan	47	594
Sri Lanka	47	167
<i>Comparator countries and regional averages</i>		
Lebanon	19	183
Turkey	11	226
Poland	18	286
Russian Federation	7	168
Korea, Rep.	10	187
Chile	7	291
China	7	261
Malaysia	13	133
Singapore	5	82
Thailand	22	264
Vietnam	32	872
South Africa	7	200
EAP	26	204
ECA	21	234
LAC	30	366
MENA	17	220
OECD high income	12	175
SSA	38	311

Source: World Bank. Doing Business 2015

⁴⁴ Tax compliance costs for small business were estimated at 16% of turnover in Uzbekistan (IFC 2010), 8% in Ukraine (WB.2010) and 5% in South Africa (WB. 2007).

⁴⁵ World Bank. Doing Business 2015

⁴⁶ The indicators of number of payments and hours spent complying with tax regulations cover a number of different taxes and levies, including corporate income tax, VAT/Sales tax, social security contributions, employer paid – pension contributions, property tax, education cess, vehicle and fuel taxes. For more information on methodology, see Doing Business 2015 Report.

⁴⁷ World Bank. Doing Business 2015

⁴⁸ World Bank. Doing Business 2015

⁴⁹ Ernst and Young. Retailers Association of India. 2013. "Movement of Goods in India"

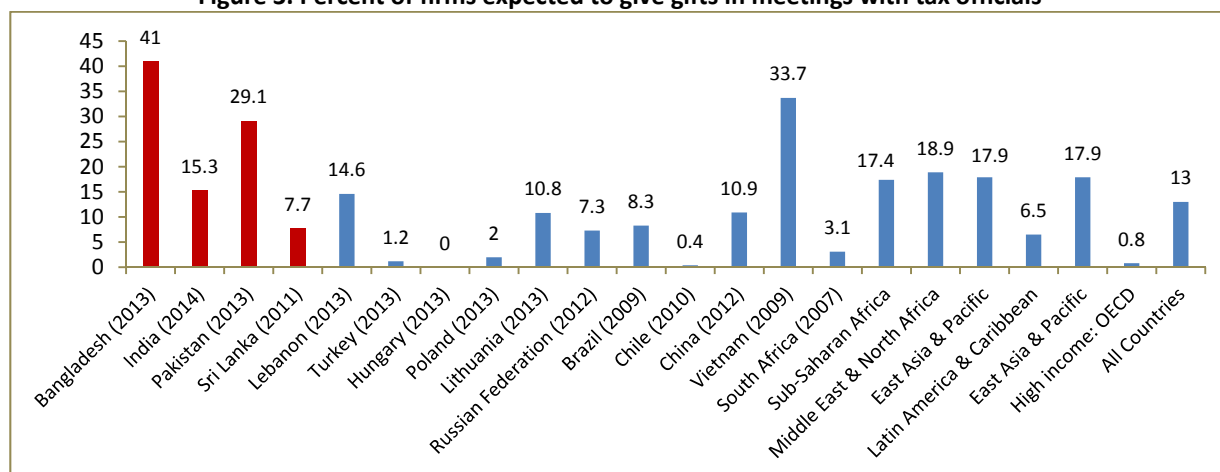
⁵⁰ Salehen, Ahmed. 2013. The Use of Discretions in Taxation: the Case of VAT in Bangladesh. E-Journal of Tax Research (2013), vol. 11, no. 1, pp 97-111

based on information on similar taxable goods and services rather than taxpayers' actual sale.⁵¹ This creates opportunities to define tax liability on a case by case basis, disadvantages suppliers that want to sell at a discount price, and leads to abuse and corruption. Such practices will be outlawed with the introduction of the new VAT legislation in 2016.

Good taxpayers are subject to disproportionate pressure from tax administrations.⁵² One reason for that is because tax administrations are guided primarily by revenue targets, which are set at the beginning of the year. Top level tax officials then pressure their subordinates who in turn pressure good taxpayers to contribute more revenue. VAT refunds to exporters are often postponed particularly in the last quarter of the financial year; furthermore, VAT is not always fully refunded. For example, apparel exporters in India have complained that some of the indirect taxes and levies are never refunded and that refund rates are subject to drastic and sudden changes without a reason.⁵³ The problem appears to be common for exporters in all South Asian countries. Such practices have a highly negative impact on cost competitiveness of domestic producers and may deter FDI.

Paying taxes in South Asia is often associated with corruption. Poor training of tax officials, low salaries, lack of incentives, inadequate use of IT systems and numerous loopholes in the legislation are among the factors that contribute to corruption in the tax system. In Bangladesh and Pakistan 41% and 29% of firms respectively are expected to give gifts when dealing with tax officials (Figure 3). Such rampant corruption hurts business, particularly SMEs, undermines confidence in government institutions and reduces willingness to pay taxes.

Figure 3. Percent of firms expected to give gifts in meetings with tax officials



Source: World Bank. Enterprise Surveys

Taxes are paid by a minority of firms in South Asia that have to contend with relatively high corporate tax rates and poor tax administration. Most firms do not pay any taxes (due to informality and availability of legal exemptions) or reduce their tax liabilities through various schemes. This regime results in a

⁵¹ Ibid

⁵² This is well documented in the First Report of the Tax Administration Reform Commission in India. Interviews with tax experts working in South Asia suggest that the problem of disproportionate pressure on good taxpayers due to revenue targets is common throughout the region.

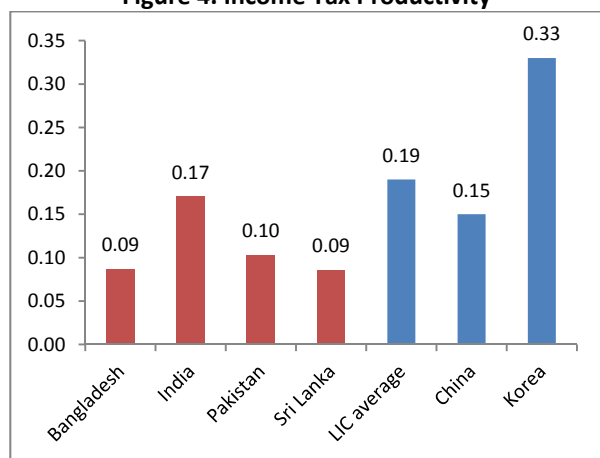
⁵³ Apparel Export Promotion Council, India. 2013. Agenda Note for Consideration of Inter-ministerial Workshop on Apparel Sector.

disproportionate burden on good taxpayers and public revenue losses. For example, in Pakistan, a country with a population of 180 million, only 1.2 million individuals and firms file income tax returns, of which half are corporate income tax filers. Some 118,000 entities are enrolled in the sales tax system but only 15,000 actually pay any tax.⁵⁴ India has a population of over a billion people yet only about 619,000 companies filed corporate tax returns for FY 12-13 (of which 46% reported losses or no profits and did not have to pay taxes); the number of non-corporate firms (e.g. partnerships) filing tax returns was about 849,000.⁵⁵

Manufacturing firms bear a disproportionate burden of taxation in India and Pakistan (recent studies were not available for the other two countries). In India, manufacturing contributes less than 20% to GDP but over 60% of federal tax revenue (for direct and indirect taxes).⁵⁶ In Pakistan, the respective figures are 23% and 66%.⁵⁷ This is because agriculture and high end services (such as software development) enjoy a special status while low end services are typically provided by small firms, which are subject to reduced corporate tax rates. Manufacturing activities are also more visible and easier for revenue authorities to tax. Given that within manufacturing, a number of activities and industrial locations enjoy special privileges, the tax burden falls disproportionately on a few industries and firms.

Revenue productivity of income and VAT taxes is weak in South Asia owing to narrow bases and low compliance. Revenue productivity measures the amount of revenue in percent of GDP collected for each percentage point of the tax rate.⁵⁸ It could be used as a proxy for estimating actual vs. potential revenue collection. As could be seen from figures 4 and 5, revenue productivity in South Asia is weaker than the average for low income countries and comparator East Asian economies. Income tax productivity in the four countries ranges from 9 to 17 percent and VAT productivity from 22 to 26 percent. Low revenue productivity points to tax base erosion and weaknesses in tax administration.

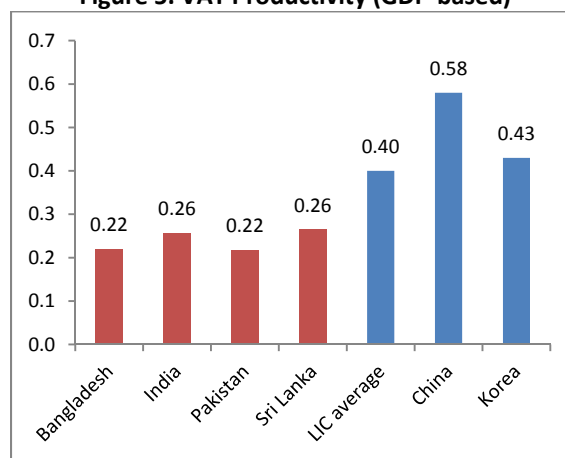
Figure 4. Income Tax Productivity



Source: World Bank. 2012. Creating Fiscal Space through Revenue Mobilization

Note: LIC =Low income country

Figure 5. VAT Productivity (GDP-based)



Source: World Bank.2012. Creating Fiscal Space through Revenue Mobilization

⁵⁴ IMF.2013. Pakistan 2013 Article IV Consultation and Request for an Extended Arrangement under the Extended Fund Facility. IMF Country Report No 13/287, Washington DC

⁵⁵ India Ministry of Finance. Revenue Foregone under the Central Tax System: Financial Years 2012-13 and 2013-14

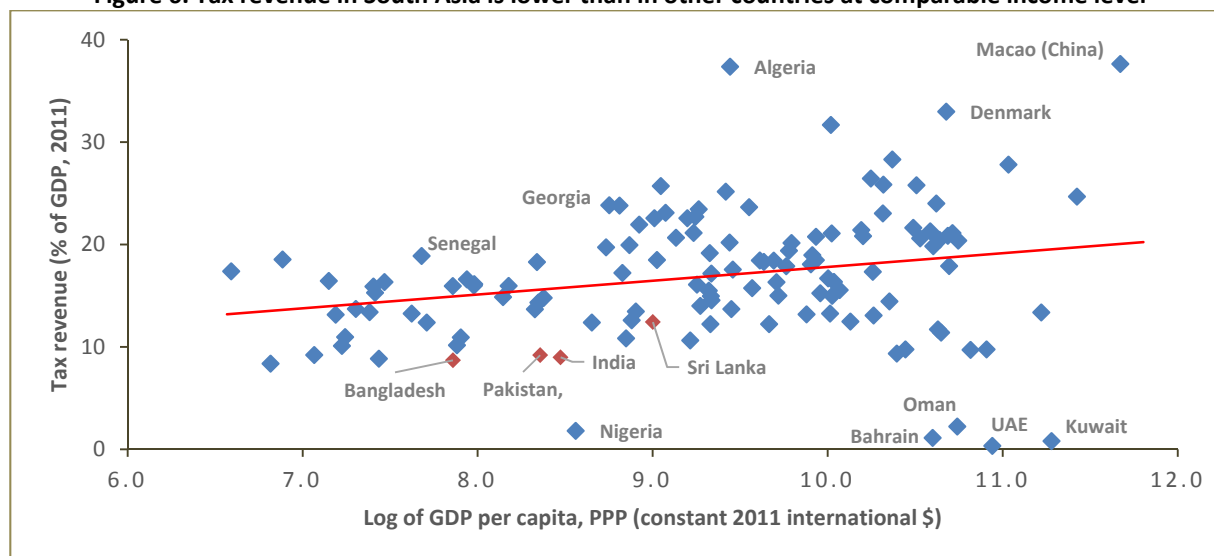
⁵⁶ D H Pai Panandiker. 2014. Higher tax revenue from higher growth, June 24, 2014. Reuters

⁵⁷ World Bank. 2009. Pakistan Tax Policy Report

⁵⁸ VAT productivity is calculated as the ratio of VAT revenues to GDP divided by the standard VAT rate; a similar formula applies to calculation of income tax productivity.

Narrow tax bases, widespread evasion and poor tax administration translate into low revenue collection. Tax revenues in South Asia are lower than in other countries at similar development levels (Figure 6). Low revenue constrains government spending including on infrastructure, education and other essential services. South Asian countries have been spending less than emerging economies or developing countries in other regions at comparable levels of per capita income.⁵⁹ Low revenues also contribute to persistent fiscal deficits, high government debts and macroeconomic instability, which hurt the investment climate and economic growth more broadly.

Figure 6. Tax revenue in South Asia is lower than in other countries at comparable income level



Source: World Bank. World Development Indicators

V. Conclusions and the Way Forward

Tax policy is one of the most important aspects of a country's business environment. It creates an incentive framework for private sector development and generates the revenue needed to fund essential public goods. It is also a political battleground as governments strive to balance the objectives of maximizing revenue, encouraging business growth, ensuring equity and winning electoral support. In South Asia, governments have systematically used tax incentives to promote development of certain industries, types of firms or locations. The effectiveness of tax incentives in achieving these objectives in the region has not been evaluated. While the benefits of existing tax policies are not clear, the negative impacts are obvious - distortions to firms investment decisions, increased tax administration and compliance costs as well as public revenue losses.

Tax policies in South Asia distort investment and consumption decisions as firms are given incentives to specialize in activities and products based on tax schemes rather than economic rational. There is little evidence that tax incentives in South Asia address market failures. They are granted to less productive businesses (small firms and those involved in agriculture and traditional industries), high tech industries

⁵⁹ World Bank. 2012. Creating Fiscal Space through Revenue Mobilization, Washington DC

(e.g. pharmaceuticals and IT) and random businesses, i.e. those that do not have an obvious association with large positive externalities (e.g. boilers and compressors in Bangladesh or beauty and fitness centers in Sri Lanka).

Tax incentives come at a price. They reduce government revenue, add to administrative costs and open the door for political favoritism. Indeed, once tax preferences have been granted to one group of taxpayers, others get organized and put pressure on politicians to receive similar tax treatment. Thus, even if initially tax schemes are designed for a small group of taxpayers, gradually the list of eligible activities, industries and firms almost inevitably grows up. India and Pakistan publish annual revenue foregone statements, which provide an estimate of the cost of tax concessions. This is good practice that would benefit other countries of the region as such reports give greater transparency to the policy making process. In fiscal year 2013-14, the total cost of all tax concessions (direct and indirect taxes, customs and excise duties) amounted to about INR 5.7 trillion (USD 90 billion) in India and PKR 477.1 billion (USD 4.7 billion) in Pakistan.⁶⁰ This is about 4.8% and 2% of these countries' GDP respectively.

There are no estimates of any potential benefits (e.g. in terms of increase in domestic production, value added or new jobs) that tax expenditures, particularly tax incentives, helped create. Such cost benefit analysis will be very useful in informing public debate on tax incentive policies. Studies in other countries show that where tax incentives have contributed to new job creation, this occurred at significant cost to the economy. A 2008 World Bank study found that the Yemeni government spent about USD 6,000 for each of 8,000 jobs that investment incentives helped create – more than six times the country's per capita income.⁶¹ A 1999 World Bank study estimated that investment incentives in Thailand cost the government 16 times the average annual wage of an industrial worker.⁶²

While tax incentives often aim to attract FDI and stimulate business growth, they are not the most effective tool for this purpose. Findings from global studies show that tax incentives on their own do not have a significant impact on foreign direct investment. The World Bank's Investment Advisory Surveys in developing countries found that factors related to business climate (e.g. ease of import and export, regulatory framework, infrastructure) were more important as a primary motivation for investment than tax incentives.⁶³ So, improvement of regulatory climate, including by introducing a transparent tax policy and administration that treat all investors equally, will do more to attract investment than special tax schemes.

Similarly, there is no evidence that VAT exemptions in the region helped support select industries or economic activities. Such practices break VAT chain and result in economic distortions. Another problem is that multiple indirect taxes are levied on the same base. This increases the cost of goods and services and reduces competitiveness of South Asian businesses.

⁶⁰ India Ministry of Finance. Revenue foregone under the Central Tax System: Financial Years 2012-13 and 2013-14 and Pakistan Ministry of Finance. Pakistan Economic Survey 2013-14: Tax Expenditure. *In both countries, most of the tax expenditure is on indirect taxes.*

⁶¹ James, Sebastian. 2013. Tax and Non-tax Incentives and Investments: Evidence and Policy Implications, World Bank, Washington DC

⁶² Ibid

⁶³ Ibid

Complex tax regulations with different rules for different types of taxpayers increase opportunities for fraud and corruption and are more costly to administer and comply with. Tax incentive schemes with a large number of beneficiaries are difficult to enforce. Tax administrations require more sophisticated data systems and more frequent and detailed audits to prevent fraud in countries that offer a lot of exemptions from general tax rules. Even with these efforts, a significant amount of revenue is lost annually to illegal activity from businesses that do not qualify for tax concessions but falsify documentation to look like they do.

Tax policies in South Asia resulted in narrow tax bases and low government revenues. Indeed, even though corporate tax rates are above global average and VAT rates are comparable to global average, tax revenue is lower than in countries at similar levels of development. Low tax revenues result in inability of governments to fund public goods (such as infrastructure, education systems or courts) that are important for attracting investment in all sectors. They also contribute to fiscal imbalances and macroeconomic instability that have a negative impact on investment climate and economic growth more broadly.

The Way Forward

The reform of tax legislation in South Asia should be guided by several important principles. Tax legislation should have minimum influence on what to produce or consume, where to locate a production facility and how to produce goods. It should also offer stability and any changes should be preceded by sound economic analysis on the costs and benefits for the economy and impact on taxpayers. There is broad consensus that a reasonable tax rate with minimal exemptions broadens the base, levels the playing field for all types of investments and increases revenue collection.⁶⁴ For example, Egypt removed most tax exemptions and reduced corporate income tax from 40 to 20 percent in 2004. The number of tax returns filed in just one year jumped by 50 percent and the tax revenue increased from 7 to 9 percent of GDP even though tax rates were halved.⁶⁵

Governments in South Asia should consider eliminating most special corporate tax schemes. This can be done by grandfathering existing privileges, i.e. firms that are currently eligible for tax holidays will continue enjoying them until expiration but no new tax concessions for specific industries or firms will be allowed. Keeping or granting of tax concessions should be based on clear criteria available to the public. For example, investments of public good character – e.g. in R&D, infrastructure, environmentally friendly technologies, can receive special tax treatment because of social benefits and positive externalities that they yield. Such practices are common in OECD countries.

Any public support to small firms should aim at encouraging their growth. Current policies in South Asia are incentivizing the opposite outcome. Small firms are eligible for reduced rates, presumptive taxation and exemptions (in the case of Bangladesh). This creates an incentive for firms to stay small or underreport their profits. A better way to support small firms is to make compliance with tax regulations (for both income tax and VAT) easier by simplifying reporting requirements and reducing the number of payments.

⁶⁴ See, for example, Bird, Richard and Scott Wilkie. 2012. Designing Tax Policy: Constraints and Objectives in Open Economy, International Center for Public Policy, Georgia State University

⁶⁵ World Bank. 2009. A Handbook for Tax Simplification, Washington DC

The ultimate goal of VAT reforms is to have a broad based tax that will cover most goods and services. Exemptions and reduced rates should be kept at a minimum and classified in broad categories as opposed to long lists of items defined at the sub-product level. For example, all medicines, medical equipment, food, books and periodicals can be exempt. Provision of exemptions or reduced VAT rates for inputs and machinery used by certain types of firms is hard to justify on policy grounds. These incentives would make little difference to the ultimate tax burden of firms as VAT on such purchases is creditable. If the objective is to relieve exporting firms of the cash flow and compliance burden, then the solution lies in improving VAT administration and provision of prompt refunds to exporters. Multiple cascading indirect taxes should be replaced by a single levy. If properly implemented, the announced reforms of indirect taxes in Bangladesh and India could offer useful lessons for other countries in the region. Sound evaluation of the design and impact of these reforms will be necessary.

Simpler and broad based corporate and VAT taxes will be easier to administer and comply with. Tax systems that have similar rates and rules for most taxpayers reduce opportunities for evasion and encourage voluntary compliance. Reform of tax administration can make compliance less costly. Priorities for reform include streamlining business processes, reducing processing times, cutting the number of annual tax payments (which is currently among the highest in the world), making greater use of IT systems (including online filing) and providing taxpayer education services. Countries that frequently change tax rules and procedures should consider instituting a cap on the number of SROs that can be issued throughout the year. Several measures can be taken to better detect fraud and non-compliance, including through regular risk based audits and use of third party information (e.g. from banks, customs, land registration records) to prevent tax evasion.

Broadening the tax base and strengthening public administration will improve revenue collection. This will create space for reducing corporate income tax rates (that are currently higher than in other developing regions) without sacrificing essential public spending. Lower rates and more predictable tax policy and administration will increase investment attractiveness of South Asian countries. Tax reforms will have a stronger impact on business and investment growth if implemented as part of a wider reform package to improve the regulatory environment.

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