CHAPTER 2

SOUTH ASIA

Growth in South Asia rose to an estimated 5.5 percent in 2014 from a 10-year low of 4.9 percent in 2013. The upturn was driven by India, the region's largest economy, which emerged from two years of modest growth. Regional growth is projected to rise to 6.8 percent by 2017, as reforms ease supply constraints in India, political tensions subside in Pakistan, remittances remain robust in Bangladesh and Nepal, and demand for the region's exports firms. Past adjustments have reduced vulnerability to financial market volatility. Risks are mainly domestic and of a political nature. Sustaining the pace of reform and maintaining political stability are key to maintaining the recent growth momentum.

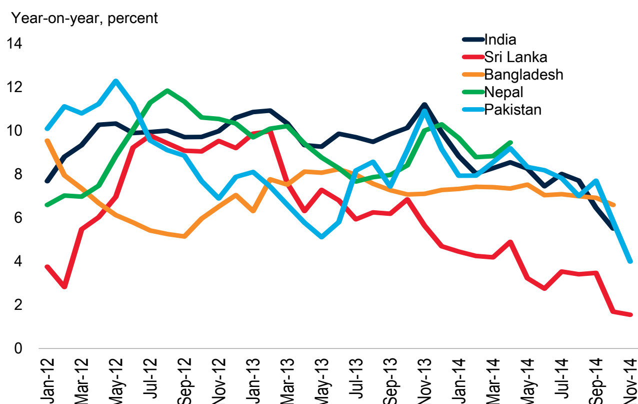
Recent Developments

Economic activity in South Asia began to revive in 2014 as India, the largest economy in the region, emerged from two years of modest growth. Growth in the region is estimated to have accelerated to 5.5 percent in 2014 from 4.9 percent in 2013, the slowest in a decade (Table 2.9). In India, a slow economic recovery is underway, helped by a sharp slide in inflation to multiyear lows and improving export momentum in line with rising demand from the US, a major trading partner. With the reform agenda building momentum and current account vulnerabilities considerably diminished compared to 2013, currency and equity markets came under some pressure but were less affected than other emerging market peers during an episode of global financial volatility in December 2014. The improvement follows a sharp slowdown in the previous two years—to the weakest growth in nearly a quarter of a century—during which high inflation and a perception of policy paralysis had depressed domestic investment, while growing macroeconomic imbalances increased vulnerability to volatility in global financial markets.

Improved political stability supported activity elsewhere in the region, except in Afghanistan and, in the second half of the year, in Pakistan. Activity in Bangladesh began to normalize in 2014 as social unrest abated from a spike in the run-up to national elections in January 2014 (Table 2.10). With government spending offsetting softness in private demand, the economy is (officially) estimated to have grown by 6.1 percent in FY2013–14, ostensibly because increased agriculture and service sector growth outweighed the decrease in industrial growth. Reconstruction efforts in Sri Lanka since the end of the civil war in 2009 have raised growth to an average of 7.5 percent. Growth was further bolstered by robust exports and strong FDI and remittance inflows especially in the first half of 2014. In Afghanistan, a difficult political transition following presidential elections in 2014 has weighed on activity and undermined fiscal resource mobilization amidst a challenging security environment. Growth in Pakistan,

FIGURE 2.27 Inflation

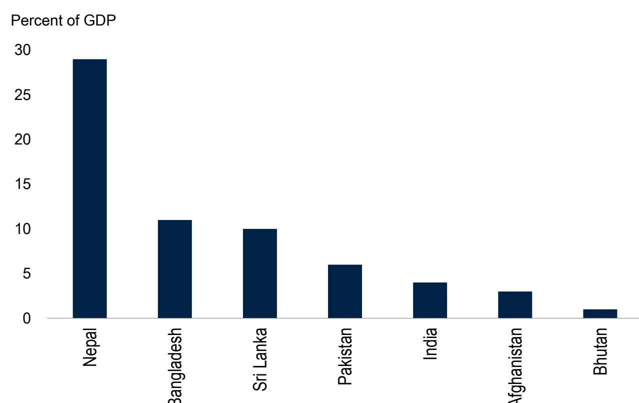
Inflation is easing across the region, in part because of favorable base effects.



Sources: Haver and World Bank.

FIGURE 2.28 Remittances, 2013

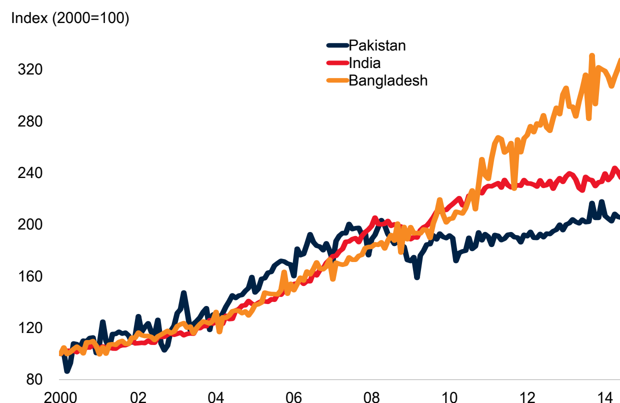
Remittance inflows are large in some countries.



Source: World Bank Remittances Database.

FIGURE 2.29 Industrial output

Industrial output has grown more slowly in India and Pakistan than in Bangladesh.



Sources: Haver and World Bank.
Note: Based on seasonally adjusted data.

the region's second largest economy, accelerated to 5.4 percent in FY2013-14 from 4.4 percent the previous year, reflecting a lull in political turmoil and increased macroeconomic stability under an IMF support program. However, a spike in political unrest in the second half of 2014 has taken a toll on confidence and activity.

With inflation easing, room for central banks to loosen policy is growing. Weakening global oil prices, fading pass-through from currency depreciations in 2013 (India, Pakistan and Sri Lanka) and the lagged effect of monetary tightening in 2013 (India and Pakistan) made for lower headline inflation in the region (Figure 2.27). In India and Pakistan, part of the decline in inflation also stems from favorable base effects, which drove the moderation in food price pressures in the second half of the year despite poor monsoons in India and Pakistan and drought in Sri Lanka. Nevertheless food inflation, which tends to have large second round effects on core inflation (Anand et al., 2014) remains elevated, particularly in India and Bangladesh.

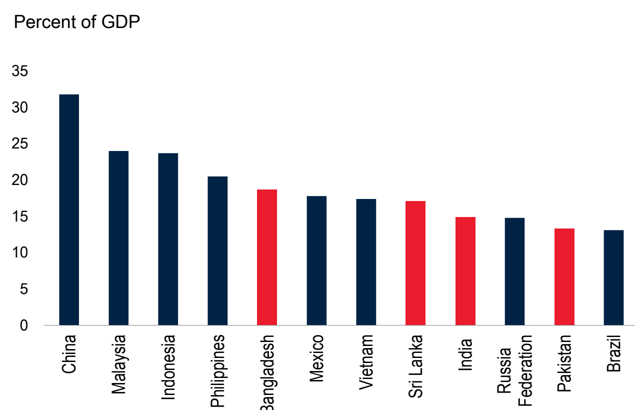
With inflation falling to an 11-year low in Pakistan, the central bank lowered its benchmark rate in November. In India, a revised monetary policy framework, with an implicit objective of 6 percent inflation by 2016, is gaining credibility. The Indian central bank has held policy rates constant following a slight increase in early 2014, but has eased reserve requirements to boost credit growth and indicated that rate cuts could be possible if inflation momentum eases further.

A recovery in exports, declining oil import bills and strong remittance inflows are helping to narrow current account deficits. A particularly sharp compression occurred in India where the deficit printed at 2.2 percent of GDP in Q3 2014, a 4.7 percentage point decline relative to its peak in Q4 2012. Some two-fifths of this improvement was due to stronger exports, and another two-fifths due to a decline in gold imports as a result of administrative restrictions. With the trade balance continuing to improve in line with falling global energy prices, restrictions on gold imports have been recently eased. In Pakistan, concessional inflows, and migrant remittances, helped shore up the currency, rebuild reserves, and reduce external financing pressures. Sustained remittance inflows in 2014—which are a sizeable share of GDP in several countries—helped offset large trade deficits in Bangladesh, Nepal and, to a lesser degree, Sri Lanka (Figure 2.28). In Afghanistan, aid flows continued to offset the large trade deficit, and help sustain a current account surplus. In Sri Lanka, the current account deficit narrowed in the first half of 2014, supported by robust exports, strong remittances and tourism receipts. Current account deficits in Bhutan have exceeded 20 percent of GDP in recent years, owing to large imports related to the construction of hydropower projects and some domestic overheating pressures, but have been comfortably financed by robust aid inflows.

Capital inflows rose across the board in 2014. Several countries tapped international bond markets, including Pakistan, which issued US$2 billion of international bonds in April and US$1 billion in *sukuk* bonds in November, and Sri Lanka which raised US$ 1billion and US$500 million, respectively, in January and April. In India, cumulative foreign portfolio investments crossed US$30 billion by the end of Q3 2014 (up from less than US$4 billion in 2013 and the highest since 2010), enabling the central bank to steadily rebuild reserves.

FIGURE 2.30 Share of manufacturing in GDP, 2013

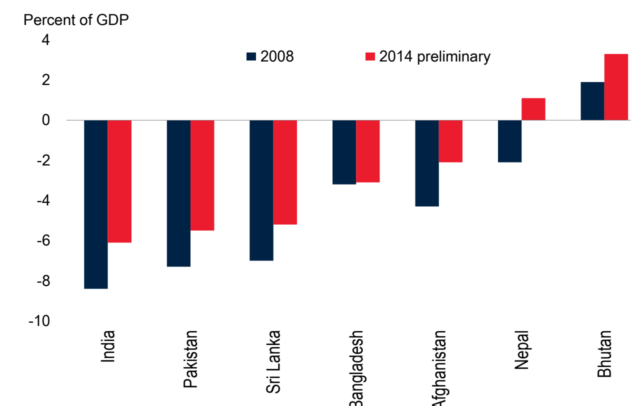
The share of manufacturing in India and Pakistan is lower than in peers.



Sources: Haver and World Bank.
Note: Data for China is for 2012, the latest available.

FIGURE 2.31 Fiscal balances

Fiscal consolidation is a priority for several countries in the region.



Source: World Bank.

Indian financial markets came under some pressure in December amid heightened global risk aversion. However despite the correction, stock indices remain close to multiyear highs, while the Indian rupee has held up much better than other major emerging market economies. The resilience of capital flows and asset markets has partly reflected improved (India) or healthy (Bangladesh) current account balances, robust growth prospects (India, Bangladesh), and ample global liquidity as a result of accommodative monetary policies in the Euro Area and Japan.

Stagnant or declining shares of manufacturing in GDP in the region's two largest economies are symptomatic of substantial supply-side bottlenecks and lagging reforms. Onerous labor regulations, cumbersome bureaucracies, underinvestment in human capital, and large infrastructure deficits have undermined the region's competitiveness, making it hard for low-cost labor-intensive manufacturing to thrive and to compete against the more flexible economies of East Asia. Added to this, cyclical weakness in recent years has meant that industrial output has expanded slowly in the post-crisis period (Figure 2.29), posing challenges of coping with a rapidly growing labor force.[1]

As a consequence, manufacturing's share of economic output in India has stagnated over the past decade while in Pakistan it has trended down to near the bottom of the range for major developing or emerging market economies (Figure 2.30). In contrast, in Bangladesh the share of manufacturing in GDP has gradually increased, reflecting the impact of a program of reforms (notably investments in human capital), begun over a decade ago, which have enabled a successful integration into global supply chains. Despite civil conflict, a similar trend is visible in Sri Lanka, the result of a liberalization started in 1977. There is evidence too that the labor intensity of manufacturing has increased over time in Sri Lanka (Chandrasiri, 2009).

Reform momentum has picked up in India. After several years of stalled progress, the newly elected government has begun to implement measures to cut red tape, raise infrastructure investment, deregulate key parts of the economy, and shrink the role of government. If successfully implemented, these reforms should support the recovery currently underway by bolstering confidence and private investment. Implementation stepped up during the fourth quarter, with the opening up of the coal industry to private investors, a deregulation of diesel prices to reduce the fiscal subsidy bill, a relaxation of labor market laws, and a linking of cash transfers with efforts to increase financial inclusion. Financial sector reforms, started in 2013, included efforts to increase private sector participation in a banking sector dominated by state owned banks, and to improve the monitoring of systemic risks. The positive effects should last over the medium term, through easing supply-side constraints.

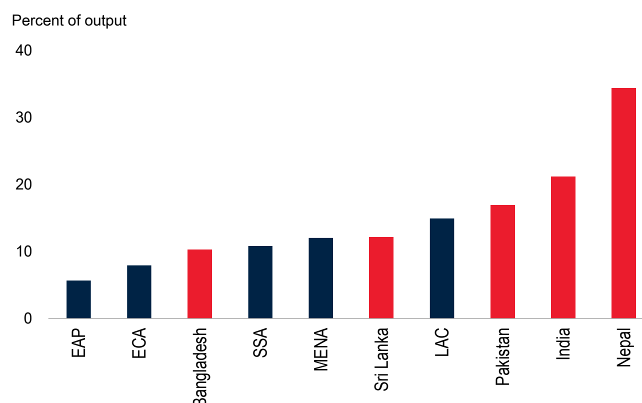
Fiscal deficits remain large in the region (Figure 2.31) and government debt ratios are high in some countries (Bhutan, India, and Pakistan), constraining policy space. Successful fiscal consolidation will require long-term reforms to expenditure management notably subsidies, as well as tax reforms given extremely low tax to GDP

[1]India's working-age population is projected to rise by 127 million between 2010 and 2020, Pakistan's by 26 million, and Bangladesh's by 19 million (UN Population Statistics, 2014).

ratios relative to peers. The latter in particular will be necessary to ensure fiscal sustainability and increase the resource envelope for critically needed poverty reducing expenditures (Box 2.3). Fiscal reforms are underway in Bangladesh and Pakistan (as part of ongoing IMF-supported programs) and in India and Sri Lanka. Bhutan's public debt ratios exceed 90 percent of GDP; mainly external (denominated in Indian rupees), these are related to major hydropower projects financed by India and should decline once these projects start to produce and Bhutan's electricity exports to India increase. Deficits in India should gradually decline as revenues improve in line with activity, and as the government rationalizes subsidies and reduces its stakes in major public corporations. Political deadlock in Afghanistan during most of 2014 led to a deteriorating fiscal situation, with declining revenues and an unfinanced fiscal gap. The country will likely need additional financing to fund government spending, while maintaining security.

FIGURE 2.32 Electricity losses, 2011

Electricity transmission and distribution losses are substantial.



Sources: World Bank and World Development Indicators.
Note: Darker bars indicate GDP-weighted averages for developing country regions.

Outlook

Supported by a recovery in domestic demand, especially investment, regional growth is expected to steadily accelerate toward 6.8 percent by 2017. The implementation of reforms and deregulation in India should lift FDI. Investment, which accounts for about 30 percent of GDP, should strengthen, and help raise growth to 7 percent by 2016, although this is contingent on strong and sustained progress on reforms. Any slackening in the reform momentum could result in a more modest or slower pace of recovery. In Pakistan, growth is expected to decelerate in FY2015 as a result of simmering political tensions. As these subside, the economy should begin to recover. However the pace of this recovery should remain slow on account of persistent energy shortages and a troubled security situation.

Soft oil prices will also raise real incomes and support consumption and help ease current account pressures across a region of energy importers. Meanwhile the region's smallest economies will be lifted by strengthening growth in India, which provides official financing flows to Afghanistan, Bhutan, and Maldives, remittances to Bangladesh and Nepal, and tourism to Maldives and Nepal.[2] In Bangladesh, growth will be supported by continued robust remittances and recovery in private consumption demand if political stability is sustained in 2015. In Sri Lanka, with elections due in 2015, growth in the near term will be buoyed by higher investment and government spending, while continued strong remittance inflows should support private demand. Growth in Bhutan is expected to accelerate as the Dagacchu hydropower project goes into production and, in both Bhutan and Nepal, the construction of hydropower projects (as part of recent investment agreements with India) will support a positive outlook. In Afghanistan, stronger growth is conditional upon an easing of political uncertainties and stability following the withdrawal of international forces from the country.

Export momentum is expected to build in line with strengthening global import demand in high-income countries, particularly in the United States and the Euro Area, the two largest markets for South Asian exports. In Pakistan, preferential market access by the EU could boost export performance unless continued energy supply shortages hamper exporting companies. In Bangladesh, exports are projected to improve after transition to better enforcement of factory safety standards and working conditions. However, wage pressures in the absence of productivity gains could erode its competitiveness. Given the high obstacles to trading across borders, trade facilitation reforms in the region could significantly boost integration into global trade.[3]

[2]Trade and financial integration between India and South Asia's other large economies (Bangladesh, India, and Pakistan) is small compared to other developing regions. This limits the spillovers from India to these countries (Ding and Masha , 2012).

[3]South Asia ranks among regions with the highest costs of trading across borders after Sub-Saharan Africa. For instance, it takes about 33 days to comply with all procedures to export or import, versus an average of 21 days to export, and 7.5 days, to import in other developing regions (World Bank, 2014h).

Supply-side bottlenecks continue to hold back growth in the baseline forecast, particularly in Sri Lanka and Bangladesh where economies are operating at close to capacity. With power generation unlikely to keep pace with growing demand in the region, shortages are expected to persist in the near term, including in Bangladesh, India, Nepal, and Pakistan. In India, stagnating coal production has already resulted in repeated shortages in supplies to power plants. In both India and Pakistan, substantial transmission and distribution losses (Figure 2.32), insufficiently high user prices, and subsidies to special interest groups have resulted in repeated bailouts for the energy sector. In India, these represented a fiscal cost of 1 percent of GDP in 2001 and again in 2011 (Pargal and Banerjee, 2014); in Pakistan, 1.4 percent of GDP in 2013 (IMF, 2013b).

Risks

Risks are mainly domestic in nature, predominantly of a political nature, and are roughly balanced. Downside risks include mainly political tensions and slowing reform momentum that fails to address banking sector weakness, energy bottlenecks, and weak business environments. Improved growth prospects for South Asia are predicated on the implementation of structural reforms to ease supply side constraints, which are substantial, and put government finances on a sustainable footing. Disappointments could weaken confidence, depress investment, trigger a reappraisal of growth prospects and reversal of investor sentiment, and, in Pakistan, derail financing under the IMF-supported program. On the upside, faster implementation of reforms in India and elsewhere than assumed in the baseline scenario would improve the outlook.

Among external risks, slower growth in the Euro Area, an important trading partner for South Asia, would affect South Asia's exports. India's openness to global financial markets leaves it exposed to sustained increases in financial market volatility, which could be triggered by a reappraisal of growth prospects or by geopolitical risks. However, risks on this front have receded considerably with the narrowing of India's current account balances since 2013. Tensions in Ukraine or conflict in the Middle East could sharply raise global energy prices. Since the region is a heavy energy importer, and governments offer generous fuel subsidies, this could widen current account and fiscal deficits and push up inflation. In India, despite recent deregulation of diesel prices, restrictions on the pace at which state-run oil companies can pass on higher prices to consumers remain in place.

On the positive side, regional growth might surprise on the upside if global energy prices continue to decline further than projected. This would raise real household incomes and encourage consumption spending, and ease fiscal and current account pressures. The positive effects of this would, however, be tempered by softer migrant remittances from high income oil-exporting countries. Finally, there remains the potential for stronger than expected growth in the United States, where the recovery is looking increasingly healthy, and from the Euro Area if recently announced monetary measures successfully support growth.

Policy Challenges

The region has significant policy challenges, which include the following.

- Electricity supply remains unreliable. In India, electricity supply investment could become increasingly constrained by raw material shortages (notably of coal, used to generate about 70 percent of electricity needs). Although reforms to increase private-sector participation and to auction some 200 coal mines to the private sector are important first steps, coal output will likely rise only slowly given still substantial impediments before the bulk of these can be put up for auction. In Sri Lanka, progress on augmenting and diversifying power-generating capacity has eliminated power shortages, and enabled a reduction in electricity tariffs during 2014 (which were among the highest in the world). Nevertheless, the country remains heavily dependent on hydropower, which contributes between one-third to one-half toward the country's energy needs. Regional progress on energy sharing remains slow, although there have been positive steps, including about US$2 billion worth of agreements between India and Nepal in 2014 that would help develop the latter's hydropower resources and substantially raise electricity exports to India over the medium term.

- Weak bank balance sheets continue to impede financing for an upturn the investment cycle. Stressed bank loans (including restructured loans) exceed 10 percent of loans in Bangladesh, Bhutan, India, and Pakistan. Restructured and problem loans need to be recognized as nonperforming, even though this would impair capital (with possible need for fiscal support). Banking system reforms, in particular aimed at strengthening human resources,

improving nonperforming loan management, and raising capital ratios would help to improve financial intermediation. Such reforms are especially needed in India, where state-owned banks account for close to three-quarters of banking assets.

Most countries in South Asia need to rebuild fiscal policy space, having used buffers since 2009 (Chapter 3). Successful budget consolidation in the near term, and sustainability over the longer term, hinge upon revenue mobilization, through tax policy reforms.

- Measures to simplify the tax system, broaden the tax base, and improve compliance will be critical for fiscal consolidation efforts (Box 2.3). Momentum on tax reform, notably the introduction of a value-added tax, has been weak, despite low revenue mobilization compared with other developing countries. Tax administrations systems are extremely weak in several countries in the region.

- If the benefits of tax reforms are to be fully realized, however, they will need to be complemented by efforts to improve the quality and efficiency of public spending. Public financial management tends to be weak across the region. Both Nepal and Maldives face considerable challenges on the expenditure side (as opposed to revenue mobilization which is the case with the rest of the region) with Nepal struggling with budget under-execution (Nepal) and fiscal deficits growing in the Maldives, despite strong revenue growth, due to persistent and large expenditure overruns.

- The fiscal cost of food and fuel subsidies is also heavy. Energy subsidies alone amount to between 6-10 percent of revenues in India and Bangladesh, and 30 percent in Pakistan (IMF, 2013b). The decline in international crude oil prices over the past year has lowered fuel subsidy bills, making it easier to liberalize diesel prices. India has taken advantage of the window of opportunity to reduce and reform subsidies. Other governments in the region should follow.

TABLE 2.9 South Asia forecast summary

(Annual percent change unless indicated otherwise)

	00-10[a]	2011	2012	2013	2014e	2015f	2016f	2017f
GDP at market prices[b,e]	6.9	7.3	5.0	4.9	5.5	6.1	6.6	6.8
GDP per capita (units in US$)	5.2	5.8	3.5	3.4	4.1	4.7	5.3	5.5
PPP GDP[c]	6.8	7.3	4.9	4.8	5.5	6.1	6.6	6.8
Private consumption	5.9	9.0	5.5	4.1	5.3	5.9	6.2	6.2
Public consumption	6.3	6.0	7.2	4.8	6.1	5.6	5.3	5.3
Fixed investment	10.4	10.7	4.4	-0.2	6.5	9.6	9.8	8.8
Exports, GNFS[d]	12.9	18.0	7.2	5.2	5.8	6.4	6.9	6.9
Imports, GNFS[d]	11.0	16.3	9.4	-0.2	4.7	7.4	7.8	7.1
Net exports, contribution to growth	-0.3	-0.7	-1.2	1.3	0.0	-0.7	-0.7	-0.5
Current account balance (percent of GDP)	-0.8	-3.1	-4.1	-2.0	-1.1	-1.2	-1.3	-1.3
Consumer prices (annual average)	6.2	9.8	9.5	9.6	6.9	…	…	…
Fiscal balance (percent of GDP)	-7.4	-7.6	-7.2	-6.9	-6.7	-6.5	-6.1	-5.8
Memo items: GDP at market prices[e]								
South Asia excluding India	5.0	5.0	5.1	5.7	5.8	5.7	5.8	5.9
India (at factor cost)[f]	7.5	6.6	4.7	5.0	5.6	6.4	7.0	7.0
Pakistan (at factor cost)[f]	4.2	2.7	3.5	4.4	5.4	4.6	4.8	4.9
Bangladesh	6.1	6.5	6.5	6.0	6.1	6.2	6.5	7.0

Source: World Bank.

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.

a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.

b. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

c. GDP measured at PPP exchange rates.

d. Exports and imports of goods and non-factor services (GNFS).

e. National income and product account data refer to fiscal years (FY) for the South Asian countries, while aggregates are presented in calendar year (CY) terms. The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Bhutan, Nepal, and Pakistan report FY2012/13 data in CY2013, while India reports FY2012/13 in CY2012.

f. Historical data is market price basis and forecasts are factor cost basis.

TABLE 2.10 South Asia country forecast

(Real GDP growth at market prices in percent and current account balance in percent of GDP, unless indicated otherwise)

	00-10[a]	2011	2012	2013	2014e	2015f	2016f	2017f
Calendar year basis[b]								
Afghanistan								
GDP	12.8	6.1	14.4	3.7	1.5	4.0	5.0	5.1
Current account balance	0.0	3.1	3.9	3.7	4.1	0.3	-1.9	-1.9
Bangladesh								
GDP	6.2	6.5	6.3	6.0	6.1	6.4	6.8	7.0
Current account balance	0.6	-1.5	0.5	2.0	0.8	0.8	0.6	0.5
Bhutan[c]								
GDP	8.7	7.9	5.1	2.0	5.5	7.9	8.4	8.6
Current account balance	-13.9	-32.6	-23.0	-25.0	-21.9	-26.2	-26.6	-27.9
India								
GDP at factor cost (% annual growth)[d]	7.3	7.9	4.9	4.7	5.5	6.2	6.8	7.0
Current account balance	-0.8	-3.4	-5.0	-2.5	-1.3	-1.5	-1.6	-1.6
Maldives								
GDP[e]	7.0	6.5	1.3	4.7	5.0	5.3	4.3	4.3
Current account balance	-12.6	-18.1	-10.6	-6.5	-8.1	-7.3	-8.1	-7.6
Nepal								
GDP	3.9	4.1	4.3	4.6	5.2	4.8	4.6	4.5
Current account balance	0.5	2.5	3.9	6.9	5.8	4.9	3.8	2.8
Pakistan								
GDP at factor cost (% annual growth)[d]	4.2	3.1	4.0	4.9	5.0	4.7	4.9	4.9
Current account balance	-1.3	-1.0	-1.0	-1.9	-1.2	-1.1	-1.0	-0.9
Sri Lanka								
GDP	5.2	8.2	6.3	7.3	7.8	7.5	6.8	6.5
Current account balance	-3.3	-7.8	-6.7	-3.9	-3.6	-3.4	-3.1	-2.9
Fiscal year basis[b]								
Bangladesh								
GDP	6.1	6.5	6.5	6.0	6.1	6.2	6.5	7.0
India								
GDP at factor cost (% annual growth)[d]	7.5	6.6	4.7	5.0	5.6	6.4	7.0	7.0
Nepal								
GDP	3.9	3.4	4.9	3.8	5.5	5.0	4.7	4.5
Pakistan								
GDP at factor cost (% annual growth)[d]	4.2	2.7	3.5	4.4	5.4	4.6	4.8	4.9

Source: World Bank.

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

b. Historical data is reported on a market price basis.National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Afghanistan, Maldives and Sri Lanka, which report in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Bhutan, Nepal, and Pakistan report FY2012/13 data in CY2013, while India reports FY2012/13 in CY2012. GDP figures presented in calendar years (CY) terms for Bangladesh, Nepal, and Pakistan are calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity. Historical GDP data in CY terms for India are the sum of GDP in the four calendar quarters.

c. GDP data for Bhutan is on a CY basis, but Current Account data is on a FY basis.

d. Historical data is market price basis and forecasts are factor cost basis.

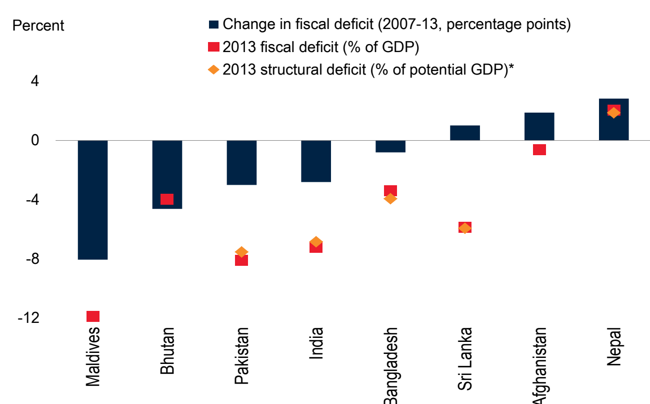
e. Data for Maldives is GDP data at basic prices (i.e excluding taxes and including subsidies).

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

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

FIGURE B2.3.1 Fiscal deficits

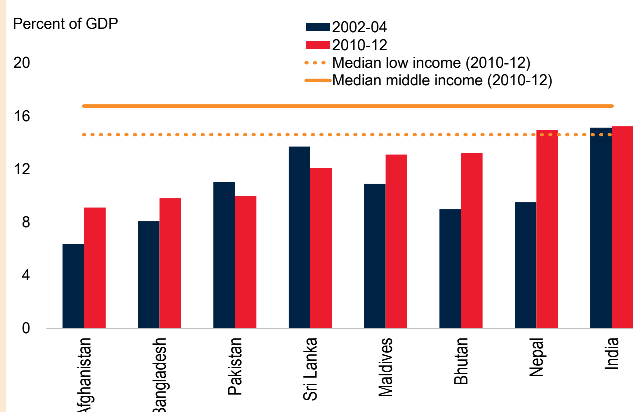
Fiscal space has diminished in South Asia since the 2008/09 crisis



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

FIGURE B2.3.2 Tax to GDP ratios

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



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

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

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

Revenue trends

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

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

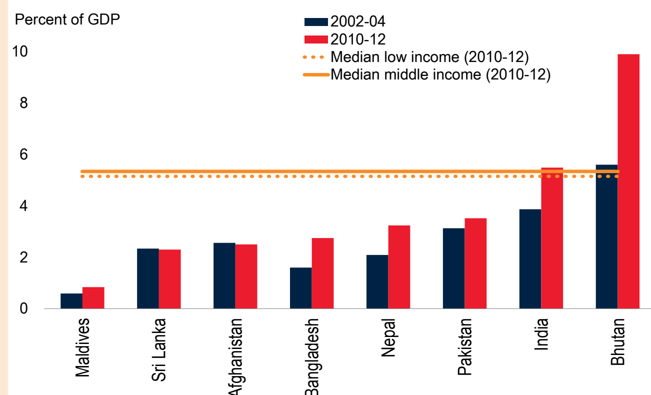
[1]The main authors of this box are Poonam Gupta and Tehmina Khan.

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

BOX 2.3 *(continued)*

FIGURE B2.3.3 Direct tax revenues

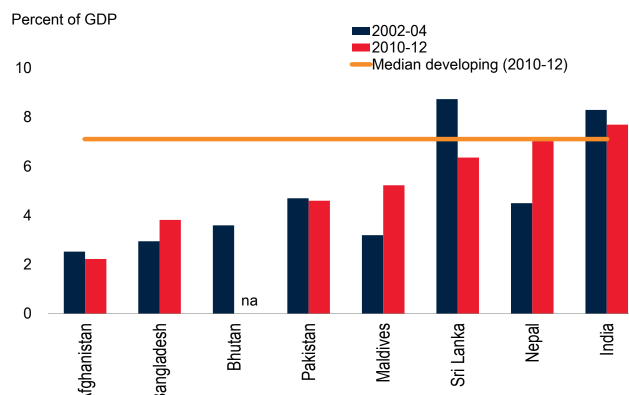
SAR countries struggle to raise revenues from direct taxes.



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

FIGURE B2.3.4 Indirect tax revenues

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



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

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

Challenges in revenue mobilization

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

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

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

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

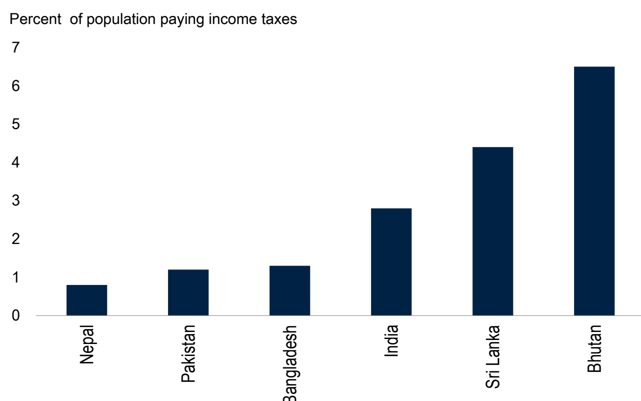
[3]Bangladesh is an exception in that there has not been much rationalization of personal and corporate tax structures.

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

BOX 2.3 *(continued)*

FIGURE B2.3.5 Tax payers

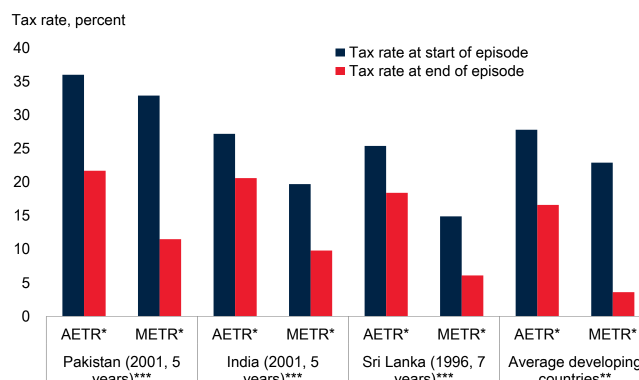
Only a small share of the population pays income taxes in SAR countries



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

FIGURE B2.3.6 Tax rates

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



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

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

Reform priorities

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

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

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

BOX 2.3 *(continued)*

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

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

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

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