

DISCUSSION DRAFT
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Tax Administration

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1 Introduction

Developing countries are increasingly looking to Foreign Direct Investment (FDI) as a way to increase domestic productivity and economic growth, often adopting a plethora of investment incentives to attract FDI. Unfortunately, many countries have not realized the hoped for levels of investment. Foreign investors often encounter myriad obstacles, including: foreign exchange controls; repressive tax rates; restrictions on hiring of non-nationals; wage and salary caps; and miles of bureaucratic red tape (Jenkins and Kuo, 2000: 3). These obstacles represent real costs to investors, and erect barriers to FDI.¹

Objectives and methodology

“Administrative barriers” refers to excessive procedures and processes required of firms to comply with the law. The objective of this study is to examine barriers, or costs, arising from the administration of *tax policy*. It is the practices and procedures of the tax administration which determine whether tax policy is transparent and applied fairly to all taxpayers. Investors want a level playing field, and they expect tax laws to be applied uniformly across all taxpayers, both domestic and foreign. Because actual tax policy is dictated by how the written laws and regulations are administered, tax administration plays a vital role in either erecting or mitigating barriers to FDI.

To examine tax administrative barriers to FDI, I develop two case studies, one for Sri Lanka and one for Bhutan. Using a narrative format, I describe the tax situation faced by investors in each country, focusing on the four general areas of tax administrative barriers outlined in the following section. For each country, I choose two or three components within those major areas and examine how those issues are being addressed within each country. My goal is to present the facts in a context that will spark discussion between the Roundtable participants on how and why these procedures are barriers to FDI and promote dialogue between the participants on ways to address the issues. To this end, I have tried to point out what appear to be salient factors, but it is my hope that these will serve to focus and not limit the discussion by the participants.

The country specific data for these case studies were gathered during visits to Bhutan and Sri Lanka during the last week of February and first week of March 2003. I conducted interviews with tax administrators, tax policy makers, and private sector representatives.

¹ I will not deal specifically with the pros and cons of FDI in this paper, nor will I provide an extensive analysis of FDI in my two assigned countries. Other papers presented at this Roundtable will deal with those issues.

Administrative barriers to investment

Tax administration barriers to FDI take a variety of forms, including but not limited to: requiring taxpayers to spend valuable time at the tax office making sure that the company's file is on the top of the "stack" to ensure timely action; having to hand carry documents from one office to another to qualify for exemptions granted by law; being punished, in the form of excessive scrutiny, for complying with the tax law because of the non-compliance of other taxpayers.

In fact, tax compliance costs are not trivial. In the United States, costs to taxpayers in terms of time spent keeping records, filing returns and other documents, and paying for expert advice from tax attorneys and accountants, etc. are estimated to be equivalent to 20.4% of the tax revenue generated, with businesses' share estimated at 52.8% (Moody, 2003: 1). In other words, each \$1 in taxes paid actually costs \$1.20 when compliance costs are included. Tax compliance costs arise from two major factors: 1) taxing income is inherently complex; and 2) increasingly the tax code is expected to take care of political and social concerns. Moreover, tax laws that are frequently changed and made increasingly complex increase business and investor uncertainty, which in turn decreases investment and economic growth (Moody, 2003: 2). Tax compliance costs cannot be ignored by policy-makers.

Tax administration barriers to FDI generally arise from four basic areas²:

- Inaccessibility of tax laws, regulations, procedures and forms.
- Cumbersome registration procedures and requirements.
- Poor compliance transparency with respect to procedures and regulations, and costly procedural requirements, especially those necessary to qualify for investment incentives, special exemptions and tax refunds.
- Burdensome filing requirements and procedures and poor appeals processes.

Inaccessibility of tax laws, regulations, procedures and forms

If printed or electronic access to tax laws and regulations are not easily available, this forms an obstacle to FDI. A foreign investor wants to know

² There are also myriad issues involved in tax policy and its impediments to FDI, e.g. excessively high tax rates, restrictions on deductible wage and salary payments, limited deductions for what are otherwise reasonable business expenditures, etc. This case study concentrates on tax administration issues, and will deal with policy only as it relates to tax administration. For example, complicated policy often results in complicated and burdensome regulations and procedures.

with certainty what taxes his or her business will be liable for before investing. If the actual laws (in an accessible language) are not published, this creates an air of uncertainty, and a suspicion that the laws may be changed often or that tax laws are applied on an ad hoc basis. This aura of uncertainty is not conducive for business. Moreover, having access to this information without having to physically visit the country (e.g. via the government's web site) sends a message to potential investors that the country is investor-friendly, and that the government is forward thinking.

Cumbersome registration procedures and requirements

In many countries, registration for both business and tax purposes can involve visits to several different government offices and take days, or even weeks. Without such registrations, businesses cannot operate, because importing of inputs, hiring of workers, producing taxable supplies, etc. are impossible without proof of tax registration (usually in the form of a "taxpayer identification number.") These procedures represent a start-up cost to doing business, and can prove to be quite discouraging, especially when coupled with other barriers.

Lack of transparency of procedures and regulations

Many countries create all kinds of special exemptions and incentives, ostensibly to encourage investment. However, if the procedures necessary to qualify for those investment incentives, special exemptions and tax refunds are not transparent and easy to comply with, they are ineffective. While the economic reasoning of these provisions may be good, i.e. exempting inputs from sales taxes, if it is costly to comply with all the checks and balances required, the exemptions might as well be non-existent. In effect, tax administration procedures can negate the intent of the policy. On the other hand, many of these special rules can provide, without adequate monitoring, the opportunity for tax evasion. A delicate balance must be struck between facilitating legitimate business and protecting the fisc.

Burdensome filing procedures and ineffectual appeals

These increase costs of doing business. Every hour that a businessperson must spend in a tax office is an hour of lost productivity for the firm. When tax returns must be filed in person, when desk audits must be performed on each return, when there are many informational returns that must be filed, when full returns are required more than once a year, the costs of compliance rise dramatically. Moreover if, in the process of complying with the law, the firm is basically placed on a "hit list" with most assessments contested, then firms are in essence penalized for complying with the law. This harassment is compounded if the appeals process is lengthy and biased in favor of tax administration.

Component procedures

Within the four major areas giving rise to FDI barriers listed above, I chose two or three component procedures from each country to analyze. In tax administration, components within the FDI barrier areas tend to be interwoven and one impacts strategically on another. For example, in Sri Lanka I examine the interaction of the Board of Investment (BOI) and Inland Revenue as a major component in the general area of “lack of transparency with respect to procedures and regulations.” This issue can not be examined in isolation of the Large Taxpayer Unit within Inland Revenue and its role in dealing with the current BOI firms. I chose this area because it is an area in which progress is being made, and in the section after the case study narrative, I examine how and why these reforms are occurring. I also examine the appeals process in Sri Lanka, which is an area of particular concern to many investors and is an area that has not received much attention from Inland Revenue.

In Bhutan, where FDI is just beginning to be encouraged, tax administration issues are less a problem. FDI issues in Bhutan arise more from tax *policy* than tax administration; therefore, I briefly discuss the more salient of these policy issue. On the tax administration side, I examine the process of obtaining clearance for importing raw materials free of sales tax, which falls in the general area of “lack of transparency of procedures.” In Bhutan, this approval process is a cumbersome and costly process. For foreign investors, and especially exporters, being able to import raw materials free of domestic sales taxes is vital to retain any comparative advantage. On the positive side, the Ministry of Finance has made tremendous reforms in both tax policy and tax administration in the last two years. In some ways, their experiences form an ideal case study in tax administration reform. That experience is the second area on which I will focus my analysis.

Finally, I draw on experiences in Russia and other countries to compare how these countries have chosen to deal with tax administration barriers to FDI in relation to Sri Lanka and Bhutan

2 Case study: Sri Lanka

Tom Jones sat at his desk, looking out at the bright sunlight reflecting off the water. Another beautiful day in Colombo, and he was stuck in the office, nursing writer's cramp. He had spent the last half hour, at least, signing documents so that a shipment of clothing could leave. He couldn't believe the stack of documents when he got to the office that morning, a Saturday. Normally, his junior officer handled these details, but Jones was the only one in the office and the shipment had to leave today. There were 35 pieces of paper that needed his signature, in blue ink no less (it took several minutes to locate a pen the correct color), and now his hand hurt. He looked over the documents. There were customs documents, BOI documents, exchange control documents. The list went on and on. He shook his head in amazement, wondering if the process could not somehow be streamlined.

At least now he could get down to the work he had come in to do—preparing for a meeting with the tax assessor. He was appealing a recent assessment—at least the assessment was recent, the declaration was filed almost three years ago. The laws in Sri Lanka give the Inland Revenue Office three years to dispute self-assessed tax declarations. If more than three years elapse, Inland Revenue cannot challenge the amount. There apparently is quite a backlog, and rather than lose an opportunity to squeeze more revenue from a registered taxpayer, the tax assessor routinely challenges returns as the three-year deadline approaches, keeping the file open for at least another three years and giving the tax assessor time to scrutinize the file more closely. Jones was not looking forward to the appeals process: from start to finish it could take 5 or 6 years, and there seemed to be an unwritten rule that the first two appeals, the first with the tax assessor and the second with his or her deputy commissioner, were never decided in favor of the taxpayer, unless an obvious error had been made. It seemed like a colossal waste of time to go through the first two rounds of appeals, but they were necessary steps to get to the independent Review Board.

This particular case involved taxation of income earned from a spin-off business. Jones brought his clothing manufacturing firm to Sri Lanka 5 years ago, under an agreement signed with the Board of Investments (BOI). One of the attractions for moving the investment to Sri Lanka had been the “one-stop shop” approach offered by the BOI. The firm had negotiated what looked like a “sweet” deal: with a minimum investment of \$150,000 US and the promise to export 80% of output, they were given a three year tax holiday, commencing the first year of profits or the third year of operations whichever came first, and then a concessionary corporate income tax (CIT) rate of 10% for two years, and thereafter, a 15% CIT rate. The 15% rate applies for the life of the firm. Moreover, they also received an exemption from import duties on capital goods and raw materials and an exemption from exchange controls. The company was currently operating under the 10% CIT rate.

Because BOI handles all customs matters for its firms, Jones believed one big advantage of having an agreement with BOI was that he would be spared the usual customs problems associated with actually receiving the exemptions granted the firm; however, he discovered that BOI has its own administrative procedures and problems, and that system does not necessarily operate much smoother than regular customs. At least BOI employees understand how business operates and they are client-oriented. While they have some cumbersome procedures and are not very quick at getting data processed, they do try to facilitate business as much as they can, rather than put up roadblocks. They see their role as that of a facilitator rather than a policeman. That cannot be said about tax administration.

Jones had understood that the agreement with the BOI covered tax on all the firm's business income; however, Inland Revenue has a much narrower interpretation of the exemption, claiming that business income means only income arising from the specific business activity referred to in the BOI agreement. In addition to producing and exporting finished garments, Jones' company had begun importing pre-cut garments, and selling them to other BOI firms in Sri Lanka, which is deemed an export sale. These local firms make the finished garments and then export them out of Sri Lanka. Inland Revenue claims that income from this activity is not covered by the BOI agreement and is demanding a tax payment on that income. Jones was working on getting everything ready for the meeting with their accountant, scheduled for Monday.

As Jones sat trying to familiarize himself with what seemed like ancient history, he grudgingly acknowledged that the tax situation had improved in the last year, with changes in the law and the re-organization of the Large Taxpayer Unit in Inland Revenue. In 2002, the Minister of Finance had placed a priority on simplifying the tax system and improving tax administration. As a result, several taxes were abolished and a value added tax (VAT) established. Of course, as an export firm, Jones had been quite concerned about the VAT refund mechanism, which often does not function well, if at all, in many developing countries.

In the garment industry, the required turnaround time between importing the material and exporting the final garment is very short: there is no time for delays with customs clearance and VAT refunds. The market is extremely competitive and a delay may mean not only a lost sale, but also a lost customer. Fortunately, the VAT refund system in Sri Lanka was working reasonably well. So far, paperwork was processed quickly enough that they had never lost their bond, but the timing was pretty close on more than one occasion. Keeping on top of where the company's paperwork was in the tax office was a constant worry. Jones was sending someone down there almost everyday for the 2-3 weeks between the time the VAT payment voucher was requested and the time it was received. He was not sure that the physical

checking by someone in his office really helped the process along, but it eased his mind a bit.

Jones could not help but wonder if Inland Revenue overly scrutinized BOI firms. He knew there were conflicts between the two agencies. After all, BOI had usurped power from the tax authorities and the Ministry of Finance. A friend from the IMF had explained the Fund's objections to the BOI's effective policy-making power. She explained that there were firms in Sri Lanka that had not paid taxes in over 20 years, yet they were enjoying the benefits generated by public expenditures: an educated workforce; a healthy workforce; a very efficient port facility, etc. She said if Sri Lanka could bring tax rates down so that they are more in-line with other countries and if tax administration can improve its operations and become more service-oriented and more efficient, then companies should not need special incentives to invest. It did seem that the government was giving away tremendous amounts of revenue and harming domestic firms in the process. Of course, given the political instability of the last decade, businesses needed some incentive to even think about investing in Sri Lanka. Fortunately, the ceasefire seemed to be holding and things were looking up.

As Jones finished looking over the tax law (fortunately tax laws are published and readily available from Inland Revenue in Colombo) and the firm's agreement with BOI, he wondered if and when the proposed changes for BOI would become effective. Apparently, the government signed a Memorandum of Understanding with the IMF agreeing to strip BOI of its statutory powers and convert it into strictly an investment promoter. He worried what effect this might have on his firm and its agreement. Of course, the Ministry of Finance was assuring firms that all current agreements would be honored, but given the current budget situation, it was hard to believe that some of the generous terms given by BOI in the past might not be rescinded. Jones sighed, this kind of uncertainty he could do without.

Summary of tax administration issues for FDI

The case of Mr. Jones presented in the previous section highlights the current obstacles faced by foreign investors in Sri Lanka. The investing environment is one of uncertainty, as the Ministry of Finance pursues various reforms in both Inland Revenue and BOI. In interviews with business representatives and professional tax preparers, all mentioned frustration with the appeals procedures. Many asserted that tax assessors are unfamiliar with both the tax law and with business practices. Moreover, they expressed dismay over the pay incentive scheme used in Inland Revenue, whereby bonuses are a function of additional assessments made. This gives assessors the incentive to "find"

additional income, and greatly contributes to the feeling of “harassment” expressed by taxpayers.³

Most taxpayers believe they are treated unfairly as a result of this system.

In fact, the major complaint levied against Inland Revenue is a general impression of inefficiency and lack of a customer and service-oriented staff. Taxpayer service and education have not been a priority of Inland Revenue, and this is evidenced by low compliance (see Table 2A in Appendix B), faulty tax returns (15% of VAT returns require amending because of taxpayer error), and feelings of animosity between taxpayers and tax administration. Taxpayers believe Inland Revenue harasses honest taxpayers rather than attempting to capture tax evaders, and tax administrators believe all firms are trying to cheat the government.

Tax administration reform (and proposed reforms)

In Sri Lanka, crisis has motivated change. When the current government took office in late 2001, Sri Lanka’s economy was suffering. Two decades of conflict between the North and East, the global recession, poor management of public sector enterprises, and ineffective fiscal policies left the nation’s finances “in a state of complete collapse,” according to Minister of Finance Choksy in his Budget Speech 2002.

For the first time in its history, Sri Lanka’s GDP growth rate was a negative 1.3% in 2001, down from a positive rate of 5.6% in 1994. In December 2001, the CPI was 14.2%. The budget deficit, as a percentage of GDP, was 10.8%. Total government revenue as a percentage of GDP declined from 16.8% in 2000 to 16.5% in 2001. Total government expenditures as a percent of GDP increased from 26.7% in 2000 to 27.3% in 2001. Education expenditures, as a percent of GDP, were 2.6%, well below the average of 3.2 to 4% for developing countries. The public debt was 103.4% of GDP in 2001. In 2001, debt service payments were 12.8% of GDP (Choksy, 2002: 1-3). The IMF refused to release the second tranche of the Stand-By Arrangement (Choksy, 2002a: 1).

A new government was elected in late 2001 under a platform of promised reforms. The new government chose to deal with the fiscal crisis by strengthening the fundamentals of the economy. Unlike previous Prime Ministers, the new PM, Ranil Wickremasinghe, did not keep the finance portfolio for himself. Instead, he appointed a Minister of Finance and charged him to deal with the country’s economic problems in a way that would insure long-term economic growth while maintaining a viable social safety net

³ It is interesting that many of the tax officials I spoke to acknowledged their awareness that taxpayers feel “harassed.”

(Choksy, 2002: 8). In his Budget Speech 2002, Minister of Finance Choksy announced, “We must rationalize the fiscal system and remove bureaucratic constraints so as to attract private investment into the formal economy.... The State should be the facilitator, and the private sector the developer of the economy” (Choksy, 2002: 5-6)

The new Minister of Finance began meeting with business and trade organizations, foreign donors, and others to discover the factors negatively affecting private sector development. This was an important step in creating investor confidence in the economic reforms. By reaching out and listening to concerns of business, the new government demonstrated a commitment to creating a proactive policy environment. After listening to those affected by policy, reform measures were then developed to address discovered issues. The reform program was announced in the 2002 Budget Speech, and included the following:

- Creating “Good Governance.” The Minister of Finance declared that this government was committed to improving the planning process, increasing transparency of government by making government expenditures public and requiring Cabinet approval of all expenditures, and de-politicizing the public sector (Choksy, 2002: 7).
- “Freeing the Economy from Excessive Bureaucratic Control.” The new government vowed to simplify procedures and reduce regulation in the areas of customs and tariffs, tax policy and tax administration, labor laws, and land and land titles (Choksy, 2002: 8-9).

In his Budget Speech of 2002, Minister Choksy noted, “Sri Lanka’s tax regime is be-devilled by complexity. Simplification and de-regulation are a critical necessity.... Our tax system has been unable to raise taxes lawfully due. The tax system has become virtually impossible to administer” (Choksy, 2002: 9). (See Appendix B, for a list of tax reforms undertaken in 2002.)

To improve tax administration, Choksy proposed the following:

- Strengthening the Large Taxpayer Unit (LTU).
- Creating a Revenue Authority to oversee Inland Revenue and the Customs and Excise Departments.
- Restructuring the BOI and rationalizing tax incentive programs.

Strengthening the LTU

The Large Taxpayer unit was created in 1995, and re-organized and strengthened in 2002. Now, LTU is under a single commissioner, Mr. Weerasinghe, a former Deputy Commissioner, and LTU handles all taxes owed by the 1200 or so largest taxpayers. (The goal is to have LTU deal with

the largest 1000 companies.) There are currently seventeen assessors and 35 tax officers in the LTU unit. They are in the process of re-organizing their work so that assessors and officers can specialize in certain types of businesses. Previously, one firm might have a different assessor for each tax, which resulted in duplication of effort and multiple requests by the tax office to a taxpayer. Now, teams of assessors and officers are given all the taxes for a firm, with rotation among the teams to reduce the opportunity for personal relationships to develop between tax officials and taxpayers.

Assessment

The re-organized LTU unit works closely with the tax professional community. When Mr. Weerasinghe took over as commissioner of LTU, rather than calling in taxpayers and “harassing” them, he met with the accounting firms (the tax preparers) to discuss their tax delinquent clients and determine which cases were legitimate and warranted further investigation by his office. The commissioner is pro-active, and he is described by the private sector as highly professional and beyond reproach. It is clear that his leadership has been instrumental in creating a more positive relationship between tax administration and taxpayers. He also has earned the respect of his staff, who credit him with creating a more positive work environment in LTU.

Mr. Weerasinghe is committed to creating a taxpayer service and taxpayer education office within LTU. This is an area that Inland Revenue has neglected for too long. Unfortunately, the cultural climate of the organization does not place a priority on serving the taxpayer. According to accounts given by both tax officers and taxpayers, the tax officer/taxpayer relationship is an adversarial one. Taxpayer service is viewed within the organization as a “low status” position.⁴

Creating a revenue authority

The Revenue Authority will be an umbrella organization overseeing the work done by Inland Revenue, Customs Department and Excise Department. The goal is to reduce duplication of work and increase communications between these three departments. The Minister of Finance appointed Ms. Anushya Coomaraswamy as a special advisor to oversee the development of this authority. She is a respected finance officer from the private sector, and her appointment has created confidence within the private sector over the reform process.

The goal of the authority is to increase government revenues and increase service to the taxpayer by improving efficiency and transparency, evaluating

⁴ To what extent this is a result of corruption within the organization is unclear. Certainly a taxpayer service officer would have far fewer opportunities to extract payment from taxpayers than an auditor.

procedures and recommending reforms, and improving communication and coordination across the three departments. It is also hoped that the Revenue Authority will be able to make changes in recruitment and training of personnel in the three departments. Current Civil Service rules create a situation of permanent employment in the public sector, which reduces efficiency.

Assessment

An outside consultant from the U.S. has been retained to evaluate the current situation and develop a proposal for creation of the Revenue Authority. The steering committee of the Revenue Authority is charged with implementation of the Revenue Authority and is comprised of individuals from the private sector as well as representatives from Treasury and the Ministry of Finance. When created, the Board of the Revenue Authority will have members from both the private and public sectors.

There seems to be great hope in the Ministry of Finance that the Revenue Authority will be able to make sweeping changes in the way the three departments (Customs, Excise and Inland Revenue) operate; however, the people I spoke with in Inland Revenue knew very little about the role of the proposed Revenue Authority and how it would affect their operations. The internal politics of creating an office between the Minister of Finance and the Commissioner Generals of these three departments are unresolved, and may present major obstacles in creating a successful umbrella authority. Buy-in from each of the Department Heads will be vital for creation of a successful Revenue Authority. Moreover, the hope of changing civil service employment rules will be extremely difficult in a country that has very extensive labor law protections for workers.

Restructuring the BOI

The Prime Minister and the Minister of Finance are adamant that the BOI be transformed from a policy-making body to a promotion body. This arises, in part, from an agreement with the IMF, which insisted that transformation of BOI be included in the Memorandum of Understanding signed in 2002. It is unclear to what extent the IMF serves as a convenient scapegoat for government, although private sector representatives were aware that pressure to reform BOI was coming from the IMF. Experience has shown that IMF pressure alone rarely results in successful change (failed or stalled fiscal reforms in Russia, Ukraine, and Poland are a few examples), but when that external pressure is coupled with a receptive government that applies internal pressure (often blaming the IMF for having to enact painful reforms) radical change can occur if the ruling party can stay in office long enough to effect the change.

Reform of BOI is deemed important so that the Ministry of Finance can take control of fiscal policy. As Choksy noted in the Budget Speech 2002, “The tax incentive program escalated to such an extent that only the smallest and most vulnerable companies were subject to tax on their enterprise” (Choksy, 2002: 24). The goal of the government is to reduce taxes to a tolerable level for all enterprises, and reserve special tax incentives for very targeted sectors and industries. Toward that end, the corporate tax rate for companies with taxable income less than Rs. 5 million was reduced to 20% in 2002, and in 2003 the rate was reduced from 35% to 30% for all other companies.

Currently, 80% of Sri Lanka’s exports are from BOI firms in the country.⁵ Local firms that sell to BOI firms treat those sales as exports, which complicates tax administration. According to various private sector representatives, the biggest problem with moving BOI functions of tax policy and tax administration to the Revenue Authority is that companies are used to dealing with BOI, which sees itself as a facilitator of business rather than a regulator of business. Firms are convinced that Inland Revenue and Customs will not be able to handle transactions as efficiently as BOI. Moreover, BOI is concerned that the enforcement role they play in insuring that firms followed labor laws, safety regulations, etc. will be lost once they become a pure promotional agency.

While the legislation to transform BOI has been passed, it has not been signed and certified, and staff in BOI professed to be unfamiliar with the legislation. Moreover, they insisted that it would not be effective for several years after it is signed. This opinion was not echoed in the Ministry of Finance or Inland Revenue.

Assessment

While the re-structuring of BOI into a solely promotional entity is a good first step in rationalizing the tax system in Sri Lanka, it is important to note the costs of using the tax code to promote certain kinds of activities, e.g. business investment. Investment incentives create opportunities for “tax leakage,” i.e. they give firms an opportunity to over-state deductions or understate revenues. They greatly increase the complexity of the system, requiring additional record-keeping (so that firms can prove they meet the eligibility requirements of such incentives) and requiring greater audit capabilities of the tax administration. For example, in Sri Lanka BOI firms typically have to agree to export 80% of output as one condition for being granted a tax holiday. While that may not seem to require excessive record-keeping, that requirement, among others, has resulted in the necessity for signing 35 documents to export one shipment. BOI (or Customs or Inland Revenue) is responsible for policing

⁵ BOI officials claim there are 3350 BOI enterprises, but BOI publications indicate that the number is 1500. The difference may be that the officials are including all firms currently operating in Sri Lanka that ever had a BOI agreement, while the 1500 number represents firms currently operating under BOI agreement.

these activities, and because these allowances create incentives for cheating, they also increase compliance costs for all taxpayers. Every tax incentive or preference creates these monitoring and record-keeping requirements, and the costs to both the taxpayer and the tax administration are substantial.

Unfortunately, the government has chosen to effectively reduce the cut in the corporate income tax rate by requiring 50% of taxes saved to be invested in a Human Resource Endowment Fund. The specifics of that fund and its uses have not been announced, creating additional uncertainty for firms. Perhaps even more important than effectively reducing the tax rate cut, this provision increases complexity and creates an opportunity for additional leakage from the system, which means more oversight required by an already over-extended tax administration. By placing restrictions on how firms use their after-tax profits, the government may have negated many of the gains of the tax rate change by increasing compliance costs of firms and monitoring costs of Inland Revenue .

We must recognize that any tax incentive which reduces tax payments for certain government sanctioned activities, reduces the taxable base. (See Appendix D for a discussion of various investment tax incentives.) Current regulations allow BOI to grant full tax holidays for up to five years, depending on the type and place of investment, and then concessionary rates as low as 15% for the life of the firm. One business owner I spoke with told me his firm had received a full tax holiday for 23 years. He characterized that allowance as “ridiculous” and stated that even with only a five year tax holiday they would have made the same investment. It is likely with reasonable corporate income tax rates and a fair tax administration, no tax holiday would have been necessary to attract this investment. Foreign investors expect to pay taxes: they are a cost of doing business. Reputable firms and investors realize that taxes pay for the infrastructure necessary for a profitable business, as well as insuring that there is an educated and healthy labor force. A study conducted by OECD found that a stable, fair, and efficient tax regime were far more important to Foreign Direct Investment (FDI) than tax incentives (OECD, 1993).

Finally, these tax concessions result in the necessity for higher tax rates on those who are being captured in the tax net, and in the case of Sri Lanka, contribute to the overwhelming opinion that Inland Revenue “hassles” taxpayers. The government must question whether these incentives are worth the lost revenues, increased compliance costs, increased administrative costs, and increased taxes imposed on everyone else in the society. Creating a level playing field for all investors, with a stable tax regime with lower rates for all may, in the long-run, promote a higher, sustained economic growth. To this end, re-structuring BOI so that it no longer has statutory power with respect to taxes is a vital first step, but it cannot be the last step.

The appeals process

Inland Revenue has a statutory deadline of 3 years from the time a tax declaration is made to dispute the declared taxable amount. Taxpayers and their representatives complained that tax assessors seemed to wait until the three years had almost lapsed before filing a dispute. When the tax assessor makes an alternate determination no reasons for that are given. The onus is placed on the firm to track down the officer and ascertain the grounds for the dispute. The firm then has the right to appeal, and from the time the tax assessor opens the appeal Inland Revenue has another three years in which to hear the appeal and come to a determination. If the appeal is not heard in that period of time a de facto determination is made in favor of the taxpayer. Unfortunately, tax assessors can delay the official opening date of the appeal. One accounting firm tries to always obtain a signed and dated notice on the day the written request for appeal is made to Inland Revenue. That serves as the official opening date of the appeal process. Unfortunately, it is not always possible to obtain such confirmation of delivery of the appeal.

Typically, the tax assessor who made the original assessment hears the initial appeal, which means the taxpayer does not get an impartial hearing. The tax assessor's deputy commissioner or commissioner hears the next appeal. There is a feeling by the private sector that tax officials are instructed not to rule against the assessor's judgment. The final level of appeal is to an independent Board of Review, comprised largely of ex-commissioners of Inland Revenue. The Board typically takes two to three years to hear the appeal and make a determination. Board of Review decisions are not a matter of public record, so there is no way to know if firms are treated consistently. Moreover, precedents are not established so a firm goes into the process with little or no indication of how the Board typically views similar cases. Because almost all corporate taxpayers appeal every assessment, the length of this process forces firms to keep records for far longer than the 4 years proscribed by law. If a matter of law is at issue, after the Board of Review determination the firm may then appeal the case through the judicial system.

In Tables 1 and 2, I show the appeals situation and the status of cases taken before the Board of Review as of 31 December 2001. The data underscores the seriousness of the appeals process in Sri Lanka: there were more cases filed during 2001 than there were cases settled. Moreover, the Board of Review started the year with 83 cases and only heard 15 of them, fewer than the number of new cases filed.

Table 1: Appeals to Inland Revenue

	Income Tax	Turnover Tax	N.S.L.	G.S.T.	Total
Balance on 01.01.2001	5,133	403	135	390	6,061
No. lodged during the year	3,045	203	342	286	3,876
No. settled during the year	3,153	227	132	305	3,817
Balance on 31.12.2001	5,025	379	345	371	6,120

Source: Administration Report of the Commissioner General of Inland Revenue 2001, September 2002: 29.

Table 2: Board of Review Cases

	No. of Cases
Balance on 01.01.2001	83
Registered during the year	25
Appeals taken up for hearing	15
Orders issued on the conclusion of the hearing	10
Balance outstanding 31.12.2001	88

Source: Administration Report of the Commissioner General of Inland Revenue 2001, September 2002: 30.

Assessment

A lengthy appeals process increases compliance costs, and creates incentives for tax avoidance and tax evasion. Moreover, a fair appeals process is vital for creating confidence in the tax system. In all my interviews with private sector representatives, complaints about the inherent unfairness of the appeals process was mentioned as a major cost of tax compliance. For current BOI firms, which are mostly exempt from income taxes, worries about entering the tax net centered around efficiency and fairness issues within Inland Revenue.

The Minister of Finance announced in the Budget 2003 speech that one issue with the appeals process—that the first appeal is often heard by the original assessor—would be dealt with. That change has yet to happen, and it is unclear if there is support in Inland Revenue for the change. From the private sector, I received conflicting reports on the severity of corruption in Inland Revenue, some reporting very little and others citing it as a major problem that goes to the highest levels. The opposition to change in the appeals process will vary directly with the degree of corruption, and experiences in other countries

have shown that any corruption issue will have to be dealt with swiftly and severely, with support from the highest levels, if the effort is to be successful.

An independent Appeals Board under the newly created Revenue Authority with a more efficient procedure may be at least a partial solution to this problem. Of course, simplifying tax policy and educating taxpayers and providing effective taxpayer service are also important methods for dealing with the appeals process: the less complicated the system and the more educated the taxpayer the less demand for appeals. Estimating the cost of transforming the appeals process is problematic. However, to do nothing is likely to cost more, in terms of poor compliance, taxpayer ill will and lost investment.

3 Case study: Bhutan

Sonam sighed, almost longing for the “good old days” – back when he was just a department head and not Director of Tax and Customs and back when the government was less concerned with attracting foreign investment. He was preparing to meet with Customs and Tax Administration officials from both the head office in Thimphu and the regional office in Phuntsholing. Yesterday, Sonam met with some upset business representatives, who were claiming they simply could not continue to do business if either sales tax policy or procedures were not changed. Things were much easier before the Government decided to actively recruit foreign investment into Bhutan. So much had changed in the last year or two, it was hard to keep up with it all. But, he had to admit that the sales tax issue was indeed a problem, and something had to be done.

Under the current tax law, purchases of plant and machinery and raw materials used by a manufacturer for production purposes are exempt from Sales Tax at the point of entry or sale (Department of Revenue and Customs 2000a). To receive this exemption, an “Import Duty Exemption Certificate” must be obtained. This certificate is issued if the following conditions are met:

- The importer has a valid license;
- Raw materials is included in the list approved by the Department for a particular industry;
- The importer is a licensed manufacturing industry;
- Raw materials and assembly components cover only those items that are used as direct inputs or form part of the finished product;
- The raw materials or assembly components are not for sale or re-export to any other country;
- Import of such raw materials and components is justifiable in terms of price, technology and availability in local currency including Indian currency or raw materials and assembly components are not available in the country;
- The final product has the value addition of minimum of 40% on ex-factory price;
- Convertible currency earned during a year by the company or business from export of goods covers at least the cost of imported raw materials and components. In the case of existing industries which do not meet this condition, duty would be imposed as applicable from time to time; and

- Manufacturing industries using the exemption facilities shall maintain proper books of account and exempted goods must be accounted for in the stock register and production records. Failure to maintain such records and misuse of the facilities shall result in withdrawal of the exemptions and imposition of fines and penalties as per the penal provisions (Department of Revenue and Customs 2000a: 18).

Aside from complaints about the foreign exchange earnings requirement and the inherent difficulty in keeping those records, the major complaint stems from the necessity to get an exemption certificate for each shipment. These certificates are only issued in the Head Tax Office in Thimphu, and Sonam mused that is required as an effort to prevent abuse, but it was causing problems. Most goods are imported through Phuntsholing, a minimum six hour drive away. Moreover, to obtain the certificate, the importer must have a copy of the shipment invoice. Theoretically, the importer should be able to receive this document before the shipment arrives at the border, but that is not happening. So when an importer learns that a shipment is at the border, he drives to Phuntsholing, gets the invoice, drives back to Thimphu, gets the certificate and drives back to Phuntsholing to present the exemption certificate to the Customs Officer, who then, and only then, will release the shipment without collecting the sales tax.

This system is creating delays of several days, and can cost businesses significant amounts of money, especially if the sales price of the good is only valid for a few days after the original shipping date, which is true of most fuel imports, or the items imported are perishable. Given that most modern firms operate on a “Just in Time” inventory system, these kinds of delays are not conducive to encouraging manufacturing within Bhutan. One major business owner stated that he spent 90% of his time getting clearances and dealing with customs and tax issues. While Sonam felt he was exaggerating, it was obvious that this system is a major problem.

Business owners kept asking why those of them who imported raw materials on a regular basis could not have some sort of blanket exemption certificate that would be valid for several months. Alternatively, they wanted to know why the clearance certificates could not be issued at the border rather than at Thimphu. Sonam was meeting later that day with the officials involved in this process to try and work out a better system. The new Customs data system was not going to help in this matter—in fact, Sonam feared it might be part of the problem. While there was a considerable amount of upgrading of computer systems within customs and tax administration, and they were all rightfully proud of it, there were many wrinkles still to be ironed out. Systems were not compatible with one another, and officers have not been trained on how to deal with problems when they arise. For example, the new customs system software does not recognize all the goods classification codes, and procedures have not been established for dealing with these issues. Importers are kept

from their shipments because of computer problems. The technology, and its associated problems, is driving policy rather than the other way around.

But overall, Sonam had to admit that the meeting with private businesses, arranged through the Chamber of Commerce, had gone well. The purpose of the meeting was to discuss how tax policy and tax administration practices and procedures adversely affect foreign business activity in Bhutan. There were several policy matters raised, specifically the lack of double taxation treaties with other countries and the withholding tax, but overall tax administration was not seen as a major deterrent to investment—at least that is what he discovered when he promised to take care of the exemption issue.

Sonam credited the successful transformation of tax policy and administration in Bhutan to the vision of the current Minister of Finance (the former Deputy Minister) and the former head of the Tax Department and Joint Secretary. Beginning in 1992, they had worked together and created a vision for the role that tax and customs should play in building a self-reliant Bhutan. They searched for funding sources and bi-lateral donors who could assist them in this transformation process. They nurtured a relationship with the Danish government, which provided tremendous technical assistance in the drafting of the tax law and regulations. They also asked for assistance from the IMF and World Bank in developing positive change in tax policy and tax administration.

Sonam believes that the key to their success in realizing change is that they were willing to seek advice from outsiders, and then they were given the resources and freedom by their own officials to adapt those changes to fit into their culture and figure out how to make them work. The leadership in tax policy and tax administration embraced the concept of positive change, and they allowed the staff to take ownership of the process. Realizing that the ad hoc system of rules that formed “tax policy” were insufficient, when the Deputy Minister became Minister in 1998 he spearheaded the effort to create tax law in Bhutan. This effort culminated in the passage of the Sales Tax, Customs and Excise Act of 2000 and the Income Tax Act in 2001. The Income Tax Act included a new Personal Income Tax (PIT), but enactment of the PIT was delayed until March 2003, so that the tax department could properly train the staff how to administer the tax and train the public how to comply with the tax.

Sonam was quite proud of how successfully the PIT had been launched. But as he prepared for his meeting on the Exemption Certificate, he made a note to ask questions that would allow him to determine if his senior officers were really aware of how their processes worked. In a brief conversation with a senior tax official, he had mentioned the certificate problem, but was told that blanket exemptions were given to all regular importers, and it was only occasional importers who ran into this problem. This was disturbing, because the businessman complaining the loudest about this problem is also one of the

country's largest importers. There is obviously a disconnection somewhere between policy and practice, and if it exists in the sales tax, it is likely to exist in other tax areas as well. Sonam made a note to himself to stop these kinds of problems with the PIT before they start.

Summary of tax administration issues for FDI

The case of Sonam in the previous section highlights the tax administration and tax policy issues for FDI in Bhutan. In the last three years, tremendous positive change has taken place in both tax policy and tax administration. In many ways, Bhutan is a case study on how to “get it right.” The approach has been measured and steady. Implementation of new taxes (e.g. PIT) have taken place only after proper training of both staff and taxpayer, and only after laws and regulations were widely available to the public. A very informative web site has been developed, and it is updated continually.

Conversations with the business community revealed few complaints against tax administration, with the exception of the exemption certificate procedure. Most complaints were about tax policy, and even those were relatively minor. In the next section I examine more closely the issues of tax policy and tax administration reform in Bhutan.

Tax policy and tax administration reform

Change in Bhutan has been spurred by recognition of the Royal Government that Bhutan's growing population and increasing rates of urbanization require an expansion of the economic base. The 2002-2003 Budget emphasized “development of the private sector to generate employment, improve economic productivity and strengthen [the] economy” (Ministry of Finance 2002, 1). The Royal Government began liberalizing the private sector in 1996, when customs duties were lowered significantly. In 1997, foreign exchange controls were liberalized somewhat, and there was a concerted effort to make government laws and regulations more transparent. This culminated in enactment of the Bankruptcy Act in 1999; the Movable and Immovable Properties Act of 2000; Sales, Customs and Excise Act of 2000; the Income Tax Act of 2001; the Industrial Property Act of 2001; the Copyright Act of 2001; and the Foreign Direct Investment Policy of 2002.

Tax policy

A major step forward in creating a friendly environment for investment in Bhutan is the passing of tax laws, rules and regulations. Just as important is the fact that these laws are readily available to the taxpayer: paper copies are published by the Department of Revenue and Customs in both Dzongkha and English, and all laws and regulations are available on the official government web site www.mof.gov.bt/drc. Two major policy issues were dealt with in the last year: 1) the limitation on salary deductions was eliminated for

corporations; and 2) an FDI policy was passed, with enactment scheduled for July 2003.

The FDI policy tax provisions include the following: income tax holidays for all newly-established manufacturing firms, IT training and vocational training institutes, and new hotels, schools and auto-mechanical workshops in the interior region; tax exemption of export income earned in hard currency; and a re-investment allowance of 20 percent for corporations (Ministry of Finance 2002).

Assessment

Eliminating the limitation on salary deductions for corporations removes a major tax policy obstacle for investors. A corporate income tax is a tax on net income, which is measured as gross income less all necessary and ordinary expenses incurred in earning that income. When firms are not allowed to deduct all wages and salaries paid, then the effective cost of labor is increased, which may cause distortions in investment patterns. Disallowing legitimate salary expenses incurred in earning income creates an incentive for firms to hire less labor, pay lower wages, and find alternate ways to compensate employees, which in turn makes the personal income tax more difficult to administer. All these factors create distortions in the economy which hinder economic growth.

As a general rule, investment incentives must be used judiciously so that they have the desired effect. (See Appendix D for a discussion of tax investment incentives.) Without careful thought to the implementation and administration of such incentives, the government can be a net loser, with losses in revenues and little or no new investment in the country resulting from the incentives. To increase business investment, it is generally more effective for the government to concentrate on simplifying its enterprise tax law rather than developing various investment incentive plans. A tax law that is broad-based, with low rates and which is administered fairly will provide the greatest incentive to productive investment (OECD 1993). The FDI incentives which will become effective in July of 2003 have been written in such a way as to minimize abuse, which is important and necessary; however, anti-abuse rules necessarily complicate tax administration procedures and make compliance more costly. In fact, the FDI incentives were opposed by the Tax and Customs officials, and were written at the insistence of the Minister of Finance.

Double taxation treaties and tax withholding at source

There are two tax policy areas that need additional attention: 1) negotiation of double taxation treaties with other countries; and 2) adjustments to the rules for withholding income tax at the source. Currently, Bhutan has a 2% withholding tax required on payments made to contractors, leasers of plant, equipment and machinery, etc. The tax withheld is reconciled against the income tax liability of the contractor, etc. This Tax Deducted at Source (TDS)

is a common method used to capture into the tax net business income that is difficult to tax, often because most transactions are handled with cash. By capturing income at the source, the government insures that at least some part of this business income is taxed, while simultaneously providing an incentive for those firms to file a tax return.

Assessment

Double taxation treaties are important because without them (or without tax sparing provisions within the treaties), firms look at the higher of the tax rates between the home and host country to determine the tax implications of an investment. If the host country offers a tax holiday, the important tax laws for determining investments are those of the home country, and the result of the tax holiday is simply a transfer of tax revenue from the host country to the home country. This means that double taxation treaties and tax sparing provisions vital for tax holidays to have the intended effect.

Finally, current source withholding rules in Bhutan do not have provisions for dealing with income tax withholding done on behalf of a firm that earns losses. Given that many start-up firms take several years to become profitable, this may be a deterrent to new investment, as firms with losses have to pay income taxes. This is one problem the tax holiday granted in the FDI law will help alleviate, at least in the short term; however, it would be far more efficient to deal with the problem directly, by making provisions whereby withholding can either be suspended for some firms, or by making provisions for quick rebates. Alternatively, such withholding might be credited toward other taxes due (e.g. a payroll tax) when the firm is earning losses. The issue is to keep the withholding system from creating a liquidity crisis for loss-earning firms.

Tax administration

Reforms in tax administration have focused on improving taxpayer service and education by: 1) making tax laws and regulations easily accessible; 2) creating a public information department within the agency; 3) channeling resources away from headquarters and to the regional departments where work with taxpayers is performed; and 4) improving management techniques and staff training. The first of these issues has already been discussed; therefore I will concentrate discussion on the last three.

Finally, procedures for audit are being reformed. Previously, it was the practice to audit 100% of tax returns, with final assessment made by tax administration. This policy resulted in a large backlog of taxpayers who had not received final assessments. Last year they began moving to voluntary final assessment with selective audit procedures.

Assessment

While creation of a taxpayer service and education department is a necessary condition for effective tax administration, it is not sufficient: the department must be given the necessary monetary and human resources to achieve its mission. The Public Information Department in Revenue and Customs was created in 1996, and while it is small, with only two people, it has been successful because the head of the department was well-chosen and because that person is given the full support of senior officials. When I spoke with the head of the Public Information department, she credited her success to support by upper management, saying that the Joint Director of Tax Administration is always ready to listen to new ideas and enthusiastically supports the department in its work. The Joint Director has a positive attitude, and is always looking for ways to achieve things, rather than explaining why something can not work.

The public information department develops all its brochures, posters, ad campaigns, etc. in-house, utilizing tax staff as models in photographs. The department held 78 workshops to educate taxpayers on the just introduced Personal Income Tax (PIT). They also use paid advertising on radio and television as well as scheduled appearances on talk shows. Print media is used extensively, (there was an ad reminding taxpayers to save receipts on school uniforms running in the local paper while I was there), and the department has developed explanatory brochures on the PIT and withholding taxes. Brochures for the Corporate and Business Income Taxes are in the planning stages, and they are developing a video for internal training on “best assessment techniques.” They also post announcements on the Revenue and Customs Department web site, which is also a product of the Public Information department. This department has been instrumental in creating an appreciation by taxpayers of the services government provides which are funded by taxes. This appreciation, in turn, helps increase voluntary compliance with the tax laws, which decreases compliance costs and allows tax rates to be lower.

The Ministry has committed funds to create good work environments at the regional office level, rather than to create plush offices at headquarters. With only one exception, all regional tax offices either leased a new building or are housed in a building owned by the Ministry. This sends a signal to staff that their work is important, and it sends a message to both the taxpayer and tax officer that tax administration employees are professionals and have a higher standard to attain.

Training of staff is taken seriously in the Revenue and Customs department. Formalized training for staff begins with a one year program at the Institute of Management. This program was begun in 1997, and all staff are currently hired only after graduating from this program, although employment is not guaranteed upon graduation. This creates a competitive pool of trained workers from which the department can choose. The Head Office has also

worked with foreign donors to create specialized short courses to which personnel are sent on a regular basis. Finally, an in-house ongoing training program is being developed, including a dedicated training space for tax administrators. This latter piece is essential for developing and sustaining a professional tax administration.

Improving management techniques has also been crucial for successful change in the Revenue and Customs Department. Senior staff proclaim the Ministry of Finance to be “extremely supportive” of Revenue and Customs. Senior members of the department have been sent to tax administration management training programs abroad, and are encouraged to try new management techniques. The current Joint Director recently instituted an annual tax meeting for all members of the Revenue and Customs Department. At this annual meeting, proposed changes to tax policy, practices and procedures are presented to the group and input is sought by senior management. All opinions are listened to and all are encouraged to speak. The Director has succeeded in creating a safe environment for junior people to speak their minds, and in the process has created a way to allow “buy-in” for change from those who must implement that change. Junior staff cited these annual meetings as an important element in affective positive change within the organization.

Exemption certificate procedure

Business representatives assembled by the Chamber of Commerce explicitly stated that tax administration practices and procedures posed no real barriers to FDI. According to them, other government agencies created far more serious bureaucratic obstacles for FDI. The most serious complaint lodged against tax administration was the Exemption Certificate procedure, which I described at length in the case study narrative. Balancing the desire to protect the fisc and curb abuse by taxpayers and create an investor-friendly tax system is difficult. The process will only get more difficult as the tax system matures and becomes more complex. For example, if a VAT is introduced, the certificate issue will evolve into a VAT refund problem. Creating an effective method for dealing with these types of issues now will serve tax administration well far into the future.

4 Case study: Korea, Taiwan, Mexico and Kenya

Criteria for selection

Tax administration issues are remarkably similar across countries; therefore, I have chosen to examine countries with issues similar to those of Sri Lanka and Bhutan which have chosen different ways of dealing with those problems. While the number of taxpayers and other country specific factors can certainly amplify certain problems (e.g. timely VAT refunds), experience has shown that regardless of these factors, e.g. number of taxpayers, size of country, age of tax administration, etc., certain approaches for dealing with tax administration issues are successful and others are not. In this section, I will discuss some of the methods used in other countries to deal with the issues of VAT refunds (which corresponds to the sales tax clearance certificate issue in Bhutan) and Russia's method of dealing with tax compliance issues.

VAT refunds

Timely issuance of VAT credit refunds is an issue in many countries, and can be a cause of real concern to businesses, especially exporters. Failure to provide timely refunds can create serious cash flow problems for a firm, and can create a prohibitive expense especially for new firms. Failure of the VAT refund system generally arises for two reasons: 1) the auditing function in tax administration is incapable of effectively monitoring the process, resulting in fraudulent claims that overwhelm the system and cause the entire process to stop; and 2) the revenue situation of the government is so dire that the government is reluctant (or unable) to process refunds.

For example, Russia instituted a VAT in 1993, and despite numerous attempts at reform, its credit refund system has never been operational. The best firms carry-over excess credits to future tax periods. The lack of success stems from abuse by taxpayers who file fraudulent refund claims. For many years, the Russian tax administration did not possess the expertise to detect fraudulent claims, and so for several years had a "no refund" policy.

Methods of dealing with the VAT refund issue that have proved successful in other countries have tended to rely on market-based initiatives rather than command and control initiatives. These market-based initiatives include: 1) requiring a bond or special bank deposit to cover the refund request until tax administration has reviewed it or until the company has shown over time that it is trustworthy; 2) accepting only those refund claims certified by chartered accountants; or 3) issuing "tax credit certificates" (instead of money) which firms may use to pay other taxes (Uruguay uses this method.)

Below I briefly describe how several countries have successfully dealt with the VAT refund issue. (These cases are described in Jenkins and Kuo 2000.)

Korea

In the early years of the VAT (instituted in 1977), Korea had many problems with fraudulent tax credit claims. It has relied on auditing techniques to deal with the problem. This effort is facilitated by a sharing of tax declaration information between VAT, customs and income tax departments. Tax administration has also begun encouraging payment of taxes with credit cards, which provides information links with financial institutions and creates additional audit trails.

Taiwan

Taiwan deals indirectly with the VAT refund issue by delaying VAT due on imports until the goods are sold. This has proved to be an effective method for dealing with timely VAT refunds. Fraudulent VAT claims are detected by cross-checking all invoices for correct input and output tax in the data processing center. Taiwan also requested firms claiming refunds to post a bond equal to the amount of the refund until the government could verify the claim. While not completely alleviating the cash flow problem, this system works well when combined with the delay of VAT on imports

Mexico

Mexico requires firms requesting VAT refunds to deposit an equivalent amount in a special bank account. The requirement is made at the discretion of tax officials, so firms with a proven track record, who keep good accounting records, etc. may be exempt from the requirement.

Kenya

For firms engaged in targeted investment activities, e.g. exporting industries, the Kenyan government established a scheme zero-rating the VAT on both imports by and domestic supplies to approved firms. Firms operating in special export processing zones are not required to register for VAT, unless they make sales to the domestic market. To deal with fraudulent claims, tax administration required all tax refund claims to be certified by chartered accountants. After this policy was instituted, VAT refund claims dropped by over 40%. This system has an added advantage of reducing compliance costs because it reduces required interaction between tax officers and firms. With a policy of accepting chartered accountant certified claims, local tax officers' discretion in such matters is removed. This reduces opportunities for corruption and increases transparency of the process.

Tax compliance

Some countries have opted for a command and control option to compliance, through the use of draconian fines or creation of a separate tax enforcing body, e.g. tax or financial police. These efforts have not proven very effective in those countries which have tried them, for two main reasons: 1) such policies create fear and distrust of tax authorities; and 2) there are always problems with overlapping jurisdictions between tax administration and the tax/financial police, resulting in increased monitoring costs for tax administration and increased compliance costs for the taxpayer.

The Russian case is a good example of a command and control policy gone awry. Russia's Tax Police was created in 1993, and an Institute of Tax Police was founded in 1994. In 2000 the Tax Police (formally known as FSNP) were given expanded powers to conduct tax inspections independently of the Russian Federation Tax Service (Agentura.Ru, 2003). By 2003, the organization was employing over 40,000 people, and earlier this year was given sweeping new powers allowing the tax police to give lie detector tests to suspected tax evaders and to contact family members of people suspected of cheating on taxes (ostensibly to ask them to persuade their loved ones to change their ways.) As reported in the March 10, 2003 International Edition of Newsweek, "A suspect would have to agree to take the [lie detector] test, but it's hard to say no to police who are best known for forcing the muzzles of their Kalashnikov rifles into the foreheads of tax offenders" (Newsweek, 2003:6). The FSNP was reportedly rife with corruption, and in the week of March 14 President Putin announced the dissolution of the organization (Smolenskaya, 2003).

The tax police created huge costs for businesses, in terms of additional compliance costs, harassment, bribes, and because of the law suits FSNP files against taxpayers. One newspaper reported that "On average, up to 150-200 tax cases are filed against every large company. And the Tax Police lose most of these cases" (Rusnet.NL March 12, 2003). Dissolution of the tax police in Russia will certainly reduce current barriers to investment in Russia. For years, there has been considerable pressure from international donor agencies, foreign governments, and investors to abolish the tax police. Why Putin decided to act now is unclear, but recent press articles which cast a highly unfavorable light on the organization likely helped speed the process.

5 Conclusions and lessons for reform

As mentioned in the introduction, tax administration barriers to FDI generally arise from four basic areas:

- Inaccessibility of tax laws, regulations, procedures and forms.
- Cumbersome registration procedures and requirements.
- Poor compliance transparency with respect to procedures and regulations, and costly procedural requirements, especially those necessary to qualify for investment incentives, special exemptions and tax refunds.
- Burdensome filing requirements and procedures and poor appeals processes.

For Bhutan, the only tax administration barrier currently of significance is related to the sales tax clearance certificate. It is important for Bhutan to effectively deal with this issue, and in the process develop procedures which can be used in the future when issues like this arise. As Bhutan's economy diversifies and the tax system becomes more complex, there will be problems which tax procedures will create for businesses. Developing a process now for handling these in a way that is responsive to the taxpayer without unnecessarily compromising the fisc is important for the tax administration to meet its goal of effective and efficient tax administration.

With support for creation of a sound tax system emanating from the highest levels of government and because of the vision of leaders within the Ministry of Finance and tax administration, the Bhutanese tax administration has built a solid foundation for future operations. There are tax policy issues that need to be addressed, especially in the corporate tax area, but officials are aware of this and are currently working on several issues, including opening negotiations with other countries on the tax treaty issue.

In Sri Lanka, there is also impetus for change, with support from the Minister of Finance and other high level officials. The relationship between BOI and tax administration is poor, and it is not clear how the issue will be resolved. There is resentment within BOI that its statutory powers are being taken away, and it is unclear whether the government will actually be successful in its effort to strip BOI of these powers. There also political issues involved with the creation of the Revenue Authority that have not been clearly thought out. These issues have the potential to completely de-rail this process: a process which seems vital to making tax and customs departmental operations more efficient and effective.

The case studies presented here highlight several lessons for reducing tax administration barriers to FDI:

- The tax administration climate needs to change from a “police” function to a taxpayer service function, while maintaining control of the fisc. A successful climate change requires commitment and support from all levels of the organization as well as re-training of staff and the taxpayer.
- Taxpayers need easy access to all laws, regulations and forms. A user-friendly web site is an extremely helpful tool for educating the taxpayer as well as creating a more taxpayer friendly environment. Ready access to tax materials reduces uncertainty and creates transparency.
- Taxpayer concerns with burdensome procedural requirements should be listened to, but not necessarily heeded. Taxpayers often do not understand why certain rules are necessary, e.g. anti-abuse rules, and it is easy for a disconnect to develop between taxpayer and tax administration. Providing a forum for taxpayers to air their grievances and making a good faith effort to reduce unnecessary paperwork, etc. is important for building taxpayer confidence and trust.
- An essential piece of a fair and efficient tax system is creating an impartial and speedy appeals process, as well as clearly delineating taxpayer rights and responsibilities. When taxpayers believe they will be harassed and treated unfairly, the tax system creates incentives for evasion and avoidance.

Appendix 1: Overview of country economies and FDI

Sri Lanka

Sri Lanka is an island nation located in the Indian Ocean, south of India. Sri Lanka's population is approximately 19.5 million, with 26% of the population under age 14, and 68% between the ages of 15 and 64. In 1997, the population growth rate was 1.3%, the lowest rate among developing countries (<http://www.statistics.gov.lk/index.html>). Sri Lanka rates well on quality of life indicators, with a purchasing power parity adjusted annual per capita GDP of over \$3400, a life expectancy of 71 years, a literacy rate of 92%, and low infant and child mortality rates (BOI, 2003: 5).

The economy in Sri Lanka is beginning to change gradually from an agrarian based economy. In 1996, the agriculture share of GDP was 22.4%. By 1999, it had fallen to 20.6%. In 1970, 93% of exports from Sri Lanka were plantation crops. By 1996, plantation crops accounted for only 20% of exports, while textiles and garments comprised 63% (CIA 2002).

In 1992, the Greater Colombo Economic Commission, which had been established in 1978 to create and monitor enterprise zones in Colombo, was transformed into the Board of Investment (BOI.) The BOI serves as a "one stop shop" for foreign investors in Sri Lanka. Not only does the BOI promote FDI, but also it is an autonomous statutory body with the power to grant investment incentives, within parameters set out in government regulations. The BOI has the authority to "waive, modify, and exempt Inland Revenue, Customs, Exchange Control and Import Control laws" (BOI, 2003: 1). As of February 2003, there were approximately 1500 companies operating in Sri Lanka under signed agreements with the BOI (BOI, 2003: 1).

According to the Chamber of Commerce, the main impediments to FDI in Sri Lanka are the following, in order of most important to least important:

1. War situation
2. Local law and order (mafia issues) and politicization of the police department
3. High cost of electricity
4. Poor infrastructure
5. Public governance (on a per capita basis, Sri Lanka has one of the largest civil services in the world) and private governance

6. Corruption
7. Legal reforms
8. Labor laws

Bhutan

Bhutan is a small, landlocked country nestled in the Himalayas. Bhutan has sustained a real GDP growth rate of 7% since 1997, although agriculture sustains 90% of the population (CIA, 2002: 5). It has only been in the last fifteen years that Bhutan has begun actively promoting private sector development (Ministry of Trade and Industry 2002). The government's formal policy is now to be a "facilitator" of economic development, rather than a direct provider of goods and services. It is important to note that this policy is being developed under the general economic development policy of the Royal Government of Bhutan, which is based on the concept of maximizing the "Gross National Happiness" of the people of Bhutan (Ministry of Trade and Industry 2002, 2). The government is trying to create balanced development, i.e. economic growth that is both environmentally and culturally friendly. This is a formidable task, as Bhutan is landlocked, has a small population (750,000), and a poor infrastructure due, at least in part, to the rugged terrain.

The Royal Government of Bhutan has only recently begun actively promoting FDI. The Ministry of Trade and Industry is in the process of creating an office—a "one stop shop" to assist foreign companies who want to begin operating in Bhutan. The Ministry is currently concentrating promotional efforts on tourism, energy intensive industries (because of heavily subsidized electricity), and information technology (IT) industries. A new FDI policy was passed and will go into effect in July 2003. The FDI policy tax provisions include the following: income tax holidays for all newly-established manufacturing firms, IT training and vocational training institutes, and new hotels, schools and auto-mechanical workshops in the interior region; tax exemption of export income earned in hard currency; and a re-investment allowance of 20% for corporations (Ministry of Finance 2002).

Appendix 2: Country tax policies and tax administration

Sri Lanka

Tax policy

In 2002, a major tax reform effort was undertaken in Sri Lanka. By abolishing several taxes and rationalizing the goods and services tax into a credit-invoice VAT, the government has developed a simpler tax system that should be easier to administer and increase compliance. (See Table 1A for a summary of tax reforms undertaken in 2002.)

There were also reforms made to tax administration.

Tax revenues in Sri Lanka

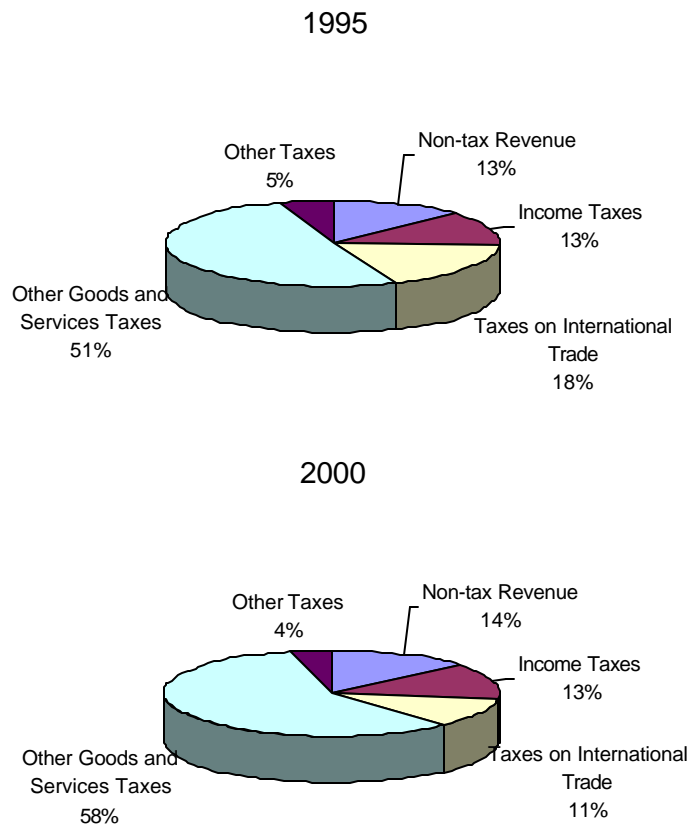
Central government tax revenue as a percent of GDP has fallen steadily, from 16.9% in 1996 to 14.6% in 2001. This is largely a result of a narrowing of the tax base over the period combined with low levels of tax compliance.

As shown in Figure 1A, Sri Lanka has increased its reliance on consumption taxes, as their share of total revenue increased from 51% in 1995 to 58% in 2000. The share of income tax revenue has remained constant.

Table 1A: Summary of tax changes in Sri Lanka, 2002

Tax	Action Taken
Goods and Services Tax (GST)	Abolished
National Security Levy	Abolished
VAT	Instituted to manufacturers and import traders level
Personal Income Tax	Increased exemption threshold, reduced number of rates from 4 to 3
Interest withholding tax	Made final tax on interest, 10% rate
Dividend withholding tax	Made final tax on dividends, 10% rate
Nonresidential rent withholding tax	10% tax on rents above Rs 500,000/year
Corporate income tax	Reduced rate from 35 to 30% (effective 2003)
Stamp duty	Abolished
Debit tax	Established at rate of .1%
Excise tax	Excise rate on beer and liquor were unified, one agency given responsibility for all excises, gasoline and diesel rates changed from ad valorem to specific
Tax exoneration	Established
Resident visa tax	Abolished
Rent on government property	Increased
Administrative fees	Increased by 15%
Sales tax on local garments	Established at Rs 25 per piece
Transfer tax on immovable property owned by non-residents	Abolished

Figure 1A: Sri Lanka, Composition of Revenue, 1995 and 2000



Source: IMF 2002: 13

Overview of tax administration procedures in Sri Lanka

Availability of tax laws, regulations and forms

Sri Lanka has official publications of all tax laws and amendments, in Sinhala, Tamil and English. The publications are available at nominal cost from an office on the first floor of Inland Revenue headquarters in Colombo.

Taxpayer registration

Tax registration can only occur after a company has officially registered as a business and received its Certificate of Incorporation. All firms must come to Inland Revenue headquarters in Colombo to register for tax. The firm must bring its business registration and a copy of the company's memorandum of articles. There is a two-page form to be filled-in that registers the firm for both the CIT and PAYE (employee withholding tax.) The application form is only available at the tax office in Colombo, and often firms send a messenger with relevant documents to retrieve the form. The messenger rarely has the knowledge necessary to complete the registration form and must return it to the company where it is filled in. The completed form must then be taken back to Colombo to complete the process. If there are no computer problems or discrepancies with the application, the registration is completed in about half an hour. With taxpayer identification number (TIN) in hand, the taxpayer, (or messenger) goes down one flight of stairs to register for VAT. This is a one-page form. Again, if the person at the office does not have the necessary information, the form will be carried back to the firm, filled in and then returned to the office in Colombo. Currently, Inland Revenue is in the process of re-designing the business registration form to combine business and VAT registration into one process with a single, two-page form.

Compliance transparency

VAT refunds

VAT returns are due on either a monthly or quarterly basis, depending on the size of turnover, on the last day of the month following the taxable period. VAT payments can be made at any one of 35 branches of the State Bank. If a refund or credit voucher is needed because of VAT overpayment, the return must be submitted to Inland Revenue's main office in Colombo.

Exporters are allowed to import inputs and raw materials without paying VAT if they have posted a bond. The bond is good for 60 days, which means they have to have proof from Inland Revenue for their VAT credit within 60 days of the import or they will lose their bond. Because of this, firms with VAT overpayment will often submit VAT returns before the last day of the month. Otherwise, they would be starting the refund/credit voucher process near the end of the 60-day period.

In the VAT refund office at Inland Revenue, each day's returns are collected and edited, and then turned over to data processing. The information from the return is entered into the computer and when the previous month's customs data is received from Customs and BOI, a payment statement and customs information document is generated. BOI can often take a month to process its import data, which creates bottlenecks in the system. Customs often takes three weeks to get data to Inland Revenue. The Deputy Commissioner of VAT recently met with Customs to discuss this problem. Customs agreed to get

import data to Inland Revenue by the tenth day of the month following importation. [It is not clear if by “Customs” they were including BOI staff that handle imports as well as regular customs.]

Once these reports are generated, they are sent back to the VAT Refund Division and one of their 15 tax officers will physically verify that the customs information and the payment statement information match. If the information is verified, a VAT refund form is filled in and sent back to data processing. The computer will generate a refund request in duplicate, which is then sent back to the VAT Refund Division. The VAT Refund Division then writes a check or issues a VAT credit voucher, which the taxpayer must come to the office in Colombo to collect. If everything goes well, this process takes about three weeks. The fifteen officers in the VAT Refund Division issue, on average, 700 VAT credit vouchers and 1500 VAT refund checks each month.

Additional bottlenecks are created because of amended returns. If BOI or customs modifies import data or if the taxpayer makes a mistake, an amended return must be filed and reconciliation made. Inland Revenue estimates that 15% of all VAT returns have to be amended because of *taxpayer* error.

Filing compliance

Inland Revenue embarked on a campaign to increase filing compliance during 2001, mailing reminders to late payers and levying penalties on non-compliers. They also embarked on a publicity campaign to increase public awareness of tax filing and payment responsibilities. As shown in Table 2A, the results were not encouraging, with only 58% of income tax returns filed within one month of the official filing date and only 73% of returns filed within 13 months (Perera, 2002: 25).

Table 2A: Returns Filing Compliance, 1997-2001

	1997	1998	1999	2000	2001
Income Tax					
1 month after the filing date	52%	52%	59%	50%	58%
13 months after the filing date	93%	81%	86%	82%	73%
Turnover Tax					
3 months after the filing date	77-83%	51-54%	51-55%	78-83%	40-47%
Goods and Services Tax					
15 dates after the filing date	-	-	50-54%	51-55%	65-70%
National Security Levy					
3 months after the filing date	-	-	-	37-54%	51-52%

Source: Commissioner General of Inland Revenue 2002: 25.

Bhutan

Tax policy⁶

Vision :

- To Develop an effective tax system in a phased manner
- To avoid any distortionary effects in the economy
- To provide a major policy tool for both regulatory and fiscal purposes

Mission:

- To ensure that the tax and customs administration has the capacity to collect taxes efficiently and effectively at minimum cost through impartial and consistent enforcement of regulations, and to provide a convenient and honest service to the taxpayers.

⁶ This section is taken directly from the official government web site <http://www.mof.gov.bt/drc/taxation.html>.

Historical Background

Before 1960 :- Taxes were collected in kind and in form of labor contribution. Taxes in kind were gradually phased out to be replaced by nominal monetised tax on :- land, property, business income and consumption of good and services.

First Major Tax Reform in 1989

Purpose : To take stock of various tax measures
To develop a coherent and rational tax system
To establish a system of tax in fair, equitable and efficient manner that minimizes the need for frequent change. To fully document the system in a way that promotes taxpayer awareness

Main features : BIT on net profit replaced 2% turnover tax. Export income exempted. Plant machinery exempted from sales tax and import duty; other nuisance taxes were abolished

Tax Reform in 1992

Purpose : Rationalization and Streamlining/simplification of procedures in line with the development objective enshrined in 7th FYP.

Guiding principles : Rationalization of tax structure
Expansion of tax base
Promotions of savings
and investments Correct
trade imbalances
Ensure equity
Simplify administrative procedures for compliance and transparency

EXISTING TAX STRUCTURE

DIRECT TAX:

Business Income Tax (BIT)/
Corporate Income Tax (CIT) on net Profit30%

Personal Income Tax (PIT)

The following rates are applied on the Net Taxable Income:

First Nu.100,000 (basic exemption) – Nil
Next Nu.150,000 - 10%
Next Nu.250,000 - 15%
Next Nu.500,000 - 20%
Nu.1000,001 & above - 25%

Property Transfer5%

INDIRECT TAX : (BST, CUSTOMS DUTY, EXCISE DUTY)

Bhutan Sales Tax (BST): 0% to 50% depending on the nature of commodities

Customs Duty : 0% to 100% depending on the nature of commodities

Excise Duty : On distillery products and aerated water

Royalties : Royalties on Forestry products, mines, minerals and Tourism industries

Other Taxes:

Tax on export of goods in primary form such as timber

Motor Vehicle

Land and house tax

Tax revenues in Bhutan

Tax revenues as a percent of GDP have fallen from 9% in 2000 to 7% in 2001. Tax revenues declined in 2001 .3% from collections in 2000. The government attributes this decline to arrears issues with excise tax refunds from India. Tax revenues are projected to increase in 2003 As I show in Figure 2A, CIT comprises 45% of all tax revenue in Bhutan, with the sales tax the second largest source of tax revenue.

Figure 2A: Bhutan - Composition of revenue (1995 and 2000)



Overview of tax administration procedures in Bhutan

Availability of tax laws, regulations and forms

Bhutan's tax laws, regulations and all forms are readily available in paper copies as well as via the official government web site. In addition, the Public Information Department published brochures explaining various taxes and procedures (e.g. "Tax Deducted at Source (TDS)" Taxpayer Series 2001/DRC/PIS/TDS/01).

Taxpayer registration

The taxpayer registration process is relatively straightforward, although it requires a firm to first register as a business with the Ministry of Trade and Industry. All businesses must register for taxes at the Thimphu regional tax office. The process generally takes about 20 minutes, but there are occasionally problems with the business registration code issued by the Ministry of Trade and Industry, and that problem must be solved before tax registration can proceed.

Compliance transparency

Accounting standards and auditing practices

There are no legal accounting standards in Bhutan. While tax authorities accept chartered accountants statements of books, the only chartered accountants are Indian firms. Adequate record-keeping by firms is a problem in Bhutan, making adequate business management as well as accurate tax assessment difficult.

Last year, tax administration revised its auditing procedures, shifting final assessment from the tax office to the taxpayer and instituting a system of more selective detailed audits. Each tax office is currently working through its backlog of files that need final assessment (the Thimphu office had 159 backlogged files.)

Appeals

The appeals process in Bhutan is relatively straightforward. Because the tax system is still developing, appeals are not a big issue yet. Last year, there were only 32 appeals made. The current system requires quick decisions at each stage of the appeal—from 30 to 60 days. As both business transactions and tax law become more complicated, these time constraints may need to be relaxed, to allow for thoughtful consideration of the issues. Timely action should, of course, still be a top priority.

Sonam Karma compiled the following summary on the tax appeals process for the regional tax officers at last year's annual general meeting of tax administration. This is an excellent summary of the process, and is a good example of the type of training and continuing education done by tax officials in Bhutan.

Appeals Committee and Procedures⁷

Overview

The objectives of the appeal system at both DRC HQ and RRCO level are as follows:

- To ensure that all decisions taken are fair and consistent.
- To facilitate the timely disposal of tax appeal cases.
- To minimize the inconvenience to the taxpayer.

These objectives should be facilitated by the following appeals system:

Stage 1 Taxpayer appeals against assessment raised by RRCO

Stage 2 Appeal case is reviewed by Tax Appeal Committee at RRCO. This review will have one of the following outcomes:

- Appeal decision is accepted by taxpayer - case is closed.
- Appeal decision is not accepted by taxpayer - taxpayer appeals to DRC HQ.
- The case has policy implications - RRCO refers the case to DRC HQ.

Stage 3 Appeal case is reviewed by Tax Appeal Committee at DRC HQ. This review will have one of the following outcomes:

- Appeal decision is accepted by taxpayer - case is closed.
- Appeal decision is not accepted by taxpayer - taxpayer has further right of appeal to the Appeal Board and ultimately, the Courts.

⁷ Prepared by Sonam Karma, Department of Revenue and Customs, Thimphu, Bhutan.

Appeal Committee and Appeal Board

An Appeal Committee shall be established at the Regional Office of the Department consisting of three officers of the Regional Office and chaired by the Regional Director but excluding the assessing officer.

An Appeal Committee shall be established at the Head Office of the Department consisting of five members.

An Appeal Board shall be established at the Ministry, consisting of four regular members and one ad hoc member as mentioned below:

- Two from the Ministry of Finance;
- One from the Ministry of Trade and Industry;
- One from the Bhutan Chamber of Commerce and Industry; and
- One ad hoc member.

Notwithstanding the Appeal Committee at the Regional and the Head Office, the quorum of the Board shall not be less than three members, one being always from the Bhutan Chamber of Commerce and Industry.

Appeal procedures

Conditions for Appeal

The appeals procedure must not be used to delay payment of assessed taxes. Therefore the taxpayer is normally required to deposit the entire assessed tax due before an appeal can be considered. If the appeal is successful, the taxpayer will then be entitled to a refund of the excess amount paid according to the procedures laid down in section 8.5

A person taxable or business entity may appeal on assessment of tax or any other decision passed by an officer of the Department.

Filing an appeal against an assessment does not postpone the date for payment of taxes.

An appeal shall be admitted only if the undisputed part of the taxes is paid. However, the taxpayer may apply for a postponement of the tax amount under dispute if, within 30 days of the date of dispatch of the demand notice, the taxpayer:

- Applies to the concerned RRCO for a postponement in writing.
- Pays all other tax amounts not under dispute.

- Agrees to pay interest under the late payment rules if the appeal is unsuccessful.
- Has no other outstanding taxes, fees or charges.

Where the order in appeal does not reverse or the appeal is otherwise unsuccessful, the appellant shall be liable for the disputed amount along with a penal interest of 24 per cent per annum from the due date.

Procedures

An Appeal shall be filed before the Appeal Committee within 30 days from the date of the issue of demand notice.

The Appeal Committee at the Regional Office shall pass its decision within 30 days from the date of the receipt of an appeal.

Where an Appeal Committee fails or does not pass decision as specified under Section 47.2, a person or entity may appeal to the Appeal Committee at the Head Office.

The decision of the Appeal Committee of the Regional Office may be appealed to the Appeal Committee at the Head Office within 30 days from the date a decision has been passed.

The Appeal Committee at the Head Office shall pass its decision within 60 days from the date of the receipt of an appeal.

Where an Appeal Committee fails or does not pass a decision as specified under Section 47.5, a person or entity may appeal to the Appeal Board.

The decision of the Appeal Committee of the Head Office may be appealed to the Appeal Board within 60 days from the date a decision has been passed.

The Appeal Board shall pass its decision within 60 days from the date of the receipt of an appeal.

The decision of the Appeal Board may be appealed to the Court of Law within 30 days from the date a decision has been passed.

Where the Appeal Board fails or does not pass a decision as specified under Section 47.8, a person or entity may appeal to the Court of Law.

The decisions passed thereto by the Appeal committee or the Board shall be in writing.

The provision of appeal under this Act shall not bar a person from filing an appeal in the Court of Law.

RRCO Requirements

The Tax Appeal Committee at the RRCO must do one of the following within 1 month of the date of receipt of the appeal:

- Request further clarification from the taxpayer, together with a time limit for submission.
- Review the appeal case in the light of all available information.
- Issue a judgement to the taxpayer, if the appeal is within the power of the RRCO.
- Forward the case to DRC HQ if the appeal has policy implications, or if the taxpayer does not accept the decision of the RRCO. The RRCO must inform the taxpayer that the appeal has been referred.

Where the appeal cannot be settled within 1 month, the RRCO must notify the taxpayer of the reasons for the delay. These reasons may include the following:

- The appeal has policy implications.
- The appeal depends on information from other authorities.
- The delay is caused by the taxpayer.

It is essential that all appeal applications, supporting information and decisions are fully documented so that a full case history can be produced if an appeal reaches either the Tax Appeal Committee at DRC HQ, or the Courts.

DRC HQ Requirements

Appeal cases may be heard by the Tax Appeal Committee at DRC HQ on request from either:

- The taxpayer, following an unsatisfactory appeal decision from the concerned RRCO.
- The concerned RRCO, where the case has policy implications.

Where an appeal cases is referred by the concerned RRCO, it must be accompanied by the following information:

Basic information on the taxpaying unit, plus the recommendations of the Tax Appeal Committee at the RRCO. A standard format is provided as Form IT -16 in Appendix B-I of the Tax Manual.

Copies of the Tax Demand & Assessment Report under appeal:

- Copies of the Tax Return & Final Accounts for the relevant year.
- Taxpayer's appeal letter.
- Any other relevant supporting schedules, information, and working papers.

The Tax Appeal Committee at DRC HQ must do one of the following within 1 month of the date of receipt of the appeal from RRCO:

- Review the appeal case in the light of all available information
- Issue a judgement to the taxpayer, copied to the concerned RRCO.

Where the appeal cannot be settled within 1 month, the DRC HQ must notify both the taxpayer and the concerned RRCO of the reasons for the delay.

If the taxpayer is not satisfied with the decision of DRC HQ, he or she has the further right of appeal to the Appeal Board and thereafter to the Law Courts.

Tax Appeal Reporting Procedures

Detailed Case Reporting

The outcome of all tax appeals considered at the RRCO level must be reported to DRC HQ using the standard format given as Form IT-17 in Appendix B-i. Parts 1 to 8(b) only should be filled out and signed by a representative of the Tax Appeal Committee at the RRCO.

The Tax Appeal Committee at DRC HQ will review this information for the following purposes:

- To ensure that appeal decisions taken at the RRCO level are consistent across all regions.
- To compile a database of appeal decisions which can act as precedents for future decisions, and ensure that these precedents are communicated to all RRCOs for implementation. Over time, this should reduce the number of appeal cases requiring submission to DRC HQ.
- To provide background information where an appeal case is later referred to the DRC HQ Tax Appeal Committee. The remainder of Form IT-17 will then be completed once the appeal case has been finalized.

Monthly Progress Reports

In addition to the detailed case reporting outlined above, each RRCO must make monthly progress reports to DRC HQ concerning the number of appeal cases received, finalized, and still pending in each period, according to the reporting format laid down in volume A, Chapter 3)

Appendix 3: An analysis of investment incentives

Many governments are concerned about low levels of investment in their countries, and in particular foreign direct investment (FDI). Because investment is necessary for economic growth, the concern is not misplaced, and discussion often focuses on ways to encourage new investment. Tax policy has come under close scrutiny, and various proposals have been made to change tax policy so as to promote FDI. These proposals range from creating or extending tax holidays, to exempting imported capital goods from certain taxes, to allowing firms special deductions or allowances.

As a general rule, investment incentives must be used judiciously so that they have the desired effect. Without careful thought to the implementation and administration of such incentives, the government can be a net loser, with losses in revenues and little or no new investment in the country resulting from the incentives. To increase business investment, it is generally more effective for the government to concentrate on simplifying its enterprise tax law rather than developing various investment incentive plans. A tax law that is broad-based, with low rates and which is administered fairly will provide the greatest incentive to productive investment.

In 1993, the OECD reported results from a study indicating that tax incentives already in place and which are directed toward FDI are less important to the investment decision than the tax laws in general. In other words, when making an investment decision, the overall tax law is a more important factor than any special tax incentives, which might be available. According to the report, "In most cases, firms were concerned to have perceived impediments to investment in the law or administration removed, rather than have [additional] incentive measures. Moreover, the concerns of firms often extended beyond the income tax and were centred on other taxes not related to the profits of the firm" (OECD, 1993: 12).

In this appendix, I discuss the investment incentives used most throughout the world. I describe how they work, what types of investment they affect, and discuss problems other countries have encountered in using them. I also describe some of the administrative issues involved with each type of investment incentive.

Why do countries want to attract foreign investment?

Countries often look to attract foreign investment because local firms may have difficulties fulfilling their capital needs. This often occurs when local capital markets are underdeveloped and when access to foreign exchange is limited. Foreign investment is seen as an answer because foreign firms have access to foreign capital markets and they have access to hard currency. Foreign investment is therefore not constrained by the local market limitations and therefore is seen as an easy way to increase capital investment in a country.

FDI is also believed by some to have other "spillover" benefits, besides increasing the capital investment in a country. For example, it is argued that FDI imports technology and other skills (managerial and entrepreneurial, for example) which may be lacking in the local economy. In addition, foreign firms may help open-up the local economy to foreign markets, because they may have well-established markets and distribution centers in their home countries.

How effective FDI is in achieving these goals is questionable, but these are the arguments typically given for encouraging FDI. And creating tax incentives is one of the most often used methods for encouraging FDI. The thought is that by creating a more favorable tax climate for foreign investment, a country can increase the level of FDI and therefore reap the benefits mentioned above.

Costs and benefits of tax incentives

The economic argument for a government to provide tax incentives for foreign investment relies on expected social returns from that investment being greater than the private returns that would be experienced by the firm. These returns are in the form of increased technology and know-how and faster development of a market economy than would occur without the FDI. However, the costs of providing the investment incentives must be weighed against the benefits which will accrue from that investment. Tax incentives may not be the most efficient means of promoting FDI, because the revenue losses from the incentives may exceed the benefits of the additional investment.

Investment incentives cost revenues

Tax incentives are costly for 3 major reasons:

- 1) they often accrue to investment that would have occurred without the incentive;
- 2) taxpayers not intended to receive benefits can plan activities so as to qualify for the tax incentive;

3) once even limited incentives are allowed, the door is opened and those involved in activities not targeted by the investment incentive will lobby to be included.

Many econometric studies have shown that revenue losses from tax incentives are greater than the increased investment. This occurs primarily because the incentives can not be given only to additional investment, but must be given to all new investment. But the purpose of the incentive is to create new investment, not to help investment which would have occurred even with no investment incentive. Unfortunately, it is difficult, if not impossible, to distinguish this "incremental" investment. Investment incentives are therefore given to all new investment, even though much of that investment was planned long before the incentive became effective.

In addition, revenue losses occur because unintended taxpayers take advantage of the benefits, and because there is pressure to increase the scope of the benefits after they have been allowed. Therefore, the investment incentive results in revenue losses rather than the intended increased investment levels.

Investment incentives complicate the tax system

A major problem of tax incentives is that they make the tax system more complicated. Because incentives will create "windows of opportunity" to reduce tax liability, anti-abuse rules must be written to accompany the investment incentive. These anti-abuse rules are often quite complicated.

Writing investment incentives into the tax law creates other complications. For example, the activity eligible for the benefit must be defined. This definition must be precise and thoughtfully formulated so that only the desired activities are affected. It is also important to create rules to deal with special circumstances. For example, decisions must be made on how the activity will be treated in years when a loss is made. If the incentive does not apply in loss years, then it may be ineffective. Many firms experience losses in the first few years of operation, because this start-up period is often a time of heavy capital investment with little productive output.

The complexity introduced into the tax system by investment incentives affects not only the taxpayer, but also the tax administration. Even in countries with highly-developed tax administrations, monitoring and auditing targeted tax incentives is very difficult. For example, many western countries have tried to target investment incentives to promote research and development, and have discovered it almost impossible to judge whether an activity falls within the special category and is therefore eligible for the incentive. These judgements are often subjective, and an inexperienced tax administration (and often an experienced tax administration) will be unable to administer the law.

Types of tax incentives

There are four major categories of tax incentives:

- 1) tax holidays;
- 2) investment allowances or credits (offsets);
- 3) timing differences; and
- 4) free economic zones.

Each of these categories of incentive is described and discussed below.

1. Tax holidays

Tax holidays are usually available only to new firms. They typically take the form of relieving a new firm from taxes for a specified period of time. Sometimes they also include a period of reduced tax rates after the initial no-tax period. While on the surface it appears that a tax holiday greatly reduces a firm's tax liability, in fact there are several factors which affect the amount of tax relief or benefit which a firm is able to realize from a tax holiday. These factors include: 1) the timing of the benefit; 2) the treatment of depreciation; 3) the length of the tax holiday; and 4) tax policies in the foreign firm's "home" country.

The timing of the benefit

A crucial decision is when the tax holiday will begin. It could begin at the time the firm registers, at the time the firm begins operations, the first year in which positive profits are earned, or the first year cumulative profits are positive. Many firms, especially capital intensive firms, will experience losses in the first few years of operation. For these firms, if the tax holiday begins when production begins, the tax holiday may actually increase taxes paid over the life of the project, rather than decreasing taxes paid. This is demonstrated in Example 1 in the appendix to this memo.

When the tax holiday does not allow firms to take advantage of the loss carry forward rules they would otherwise have, then the tax holiday is likely to be a disincentive to investment, rather than an incentive. Because the firm experiences losses which can not be carried forward during the tax holiday period, total taxes paid over the life of the project increase over what they would have been if there had been no tax holiday but losses were carried forward into profitable periods. The same situation arises if the tax holiday begins in the first year when profits are earned, and not the first year when cumulative net profits are positive.

The treatment of depreciation

Sometimes firms are allowed to defer depreciation expenses until the tax holiday has expired. But depreciation should be accounted for when determining profits during the tax holiday period. Allowing the deduction after the tax holiday means that expenses in the post holiday period are too high, and taxes are reduced even further. Allowing a deferral of depreciation deductions effectively extends the tax holiday period.

The length of the tax holiday

To benefit capital intensive projects, which usually earn losses in the first few years of operation, tax holidays need to have a lengthy duration, typically at least 3-5 years. But the longer the duration of the holiday, the greater the revenue loss and the greater the probability that firms can take advantage of tax planning schemes to qualify for the holiday.

A tax holiday of relatively short duration, 1 to 3 years, will benefit those firms which typically make profits early on in the life of the project. These firms tend to be small firms operating in real estate, restaurants, trading, and other service sectors. These firms can benefit from the holiday because they earn profits relatively soon after making the investment. But precisely because they can become profitable so quickly, they are the firms least in need of an investment incentive. Unfortunately, these are the types of investments typically fostered by tax holidays.

Tax policies in the "home" country

If the home country of the foreign investor allows a foreign tax credit for taxes paid to the host country, then the tax effect of a tax holiday (and other types of investment incentives which lower taxes) may simply be to transfer revenues from the host to the home country. This is true for both branches and subsidiaries. While subsidiary income will be generally taxed in the home country only at the time of repatriation, this does not negate the fact that the income when earned was not taxed in the host country. At the time of repatriation, there will be no host country tax to credit against the home country tax, and so revenues are transferred from the host to the home country. If the revenues are never repatriated, but are reinvested in the host country, then they are never subject to home country taxation. The effect of the revenue transfer will therefore depend on the extent and the timing of repatriation.

Some countries (Australia, Canada, France, and Germany for example) exempt repatriated foreign income from tax, to the extent that the host country has a "comparable tax system." When foreign income is exempted, the revenue transfer arising from a tax holiday does not take place; however, a tax holiday may make the tax system non-comparable, and thereby make the exemption unavailable. When the exemption is unavailable, then a credit system is normally used, and the revenue transfer problem arises again.

It is also important to note that if the host country taxation is greater than the home country's taxation, then the firm will only get to credit foreign taxes up to the home country tax liability. Allowing a tax holiday when this is the case will reduce the firm's tax burden, because the tax owed to the home country is less than the tax that would have been paid to the host country. In this case, the tax holiday will decrease the firm's total tax burden, unlike the case discussed in paragraph one of this section. These two cases are illustrated in Example 2. While the total tax burden is decreased, thereby creating some investment incentive, it is still true that tax revenues which are paid will accrue to the home country and not the host country.

Problems with tax holidays

Tax holidays provide firms with many opportunities for avoiding tax. The most often used strategies include the following.

1. Fictitious foreign investment

Many tax holidays are targeted to firms with certain levels of foreign investment or foreign ownership. Domestic firms often "create" foreign investors so that their domestic company can take advantage of a tax holiday. A common vehicle for accomplishing this is to transfer funds from a domestic company to a company incorporated offshore. The "foreign" company then re-invests the funds in the host country as though it were a foreign firm, and the new "foreign" firm qualifies for the tax holiday. This activity is very difficult to police, and is also difficult to detect, even in an audit.

Some countries have tried to limit abuses of tax holidays by requiring minimum foreign investment amounts. These rules are also fairly easy to circumvent, and so do little to curb the abuse. For example, it is difficult to value capital equipment contributions, and by over-valuing these contributions firms can reach the threshold amount, and thereby qualify for the tax holiday.

2. Transfer pricing

When some firms enjoy a tax holiday, the incentive exists to transfer income from operations which do not qualify for the tax holiday to an operation which does. The income can be transferred by manipulating costs between related firms, typically called "transfer pricing." Transfer pricing can be very difficult to detect and police.

3. Rollover of businesses

While tax holidays are typically only for new firms, it can be difficult to determine when a firm is really a new firm. Often, a firm can re-invent itself so as to qualify for a tax holiday. This can easily be done by a new corporation which buys the assets of an existing corporation. The resulting firm is a "new"

firm and qualifies for the tax holiday, even though there may be no new economic activity occurring.

2. Investment allowances and tax credits (offsets)

Investment allowances or tax credits are given for qualifying investment expenditures. An allowance reduces the taxable income of the firm, while a tax credit reduces tax payable. These allowances and credits are given in addition to the regular depreciation allowances given on the investment. Investment allowances are often viewed as better investment incentive devices than tax holidays because they are targeted to capital investment. They are also limited by the amount a firm is willing to invest in capital. Therefore, small firms with little capital investment (which can often take advantage of tax holidays) will not benefit from investment allowances and credits.

The factors which affect the amount of tax relief a firm receives from an investment allowance or tax credit include: 1) the rate chosen; 2) the definition of eligible expenditures; 3) limits set on the allowance or credit available in any one tax year; and 4) the treatment of allowances or credits greater than taxable income or tax payable in a tax year.

The rate chosen, the definition of eligible expenditures, and limits placed on the allowance or credit

Investment allowances are usually stated in terms of a percentage of the qualifying investment. For example, an investment allowance might grant firms the right to deduct 20% of the value of all qualifying investments during the taxable period. This is a deduction over and above any depreciation on those investments. Likewise, a tax credit might state that the firm can credit against tax payable 6% of the value of all qualifying investments made during the taxable period. The higher the rates, the greater the tax benefit.

Likewise, the greater the number of investments which qualify for the allowance or credit the greater the value of the tax incentive for the firm. It can be difficult to define the eligible expenditures so that all the kinds of investment which should be targeted qualify, and at the same time reduce the opportunities for revenue losses.

The government can place a limit on the amount of allowance or credit available in any taxable period. The allowance may be limited to some percentage of taxable income, and the credit limited to some percentage of tax payable. In this way, the firm can not use the allowance or credit to completely offset taxable income or tax payable.

The treatment of allowances and credits in years of low profits or losses

If the firm is not allowed to carry forward allowances or credits, then it will derive no benefit from these investment incentives in years when low or no profits are earned. This situation would typically apply to new firms, which may be the very group the government is hoping to benefit from the incentives. Firms may also develop schemes to allow use of the incentive even when they are earning no profits. This means that productive resources are diverted into tax planning schemes, and unproductive business arrangements may be devised to take advantage of the incentive. For example, a firm may use a leasing arrangement to take advantage of an investment incentive which it would otherwise not be able to qualify for, because it has no taxable profits. This is demonstrated in Example 3.

Investment allowances and credits can be made beneficial to new companies by allowing the value of the incentive to be carried forward into profit making years. In this manner, an investment allowance or credit can reduce taxes for firms in the start-up period, just like a tax holiday; however, the allowance or credit is limited by the amount of capital investment actually undertaken by the firm. For this reason, an investment allowance or credit may be a better investment incentive tool for the government than tax holidays.

A caveat is the revenue losses that may incur with unlimited carryovers of investment allowances and credits. The revenue losses in early years of the investment incentive program are likely to be small, to the extent they are used by new firms. As those firms begin to earn profits, they will then use the allowances and credits from previous periods, and will be able to offset income even though no qualifying investments are occurring in the current taxable period.

Problems with investment allowances and credits

The biggest problems with investment allowances and credits arise from opportunities for abuse. The higher the allowance or credit rate, the greater the incentive to cheat, and the greater the possibilities for avoiding income tax. If the investment allowance or credit plus depreciation allowances for tax purposes are greater than the actual expense, a firm can actually make money by spending money. This case is demonstrated in Example 4.

To keep the same asset from receiving tax benefits more than once, it is important to include anti-abuse rules in the law. A rule stating that the allowance or credit is only allowed for the first use of an asset in a country is one example of such a rule.

3. Timing differences

By changing the timing of deductions or the recognition of income, the tax laws can provide investment incentives. For example, allowing accelerated depreciation changes the timing of a deductible expense, allowing expenses to be written-off faster than usual. This reduces current taxable income.

Accelerated depreciation can be granted by shortening the time an asset is written-off, or by allowing a special deduction in the first year the asset is used.

Accelerated depreciation allows future year deductions to be taken in the current year, and defers tax due now to the future. This, in effect, means that by allowing accelerated depreciation, the government has given the firm a tax-free loan for the period over which the tax is deferred.

This should not be confused with an investment allowance. The special depreciation deduction in the first year reduces the depreciation base. An investment allowance does not reduce the depreciation base. Accelerated depreciation does not allow more than the value of the expenditure to be deducted, as investment allowances do.

Another incentive can be created by allowing firms to recognize certain costs of assets as they accrue, but not recognizing income until the asset is sold. A typical example is allowing a firm to currently deduct interest expenses on an asset which is held for an extended length of time. This case is demonstrated in Example 5. In that example, it is shown how investing in an asset earning a before tax rate of return equal to the rate paid on borrowed funds, can generate a positive after-tax rate of return. This occurs because of the timing differences in the expense deductions and the income.

Problems with timing difference tax incentives

The same sorts of issues arise with timing difference investment incentives as with investment allowances and credits. There are still problems with defining which types of assets and investments qualify for the incentives. Recapture rules need to be written and capital gains taxed to keep more than one firm from claiming the incentive on the same asset. Firms need to be able to carry forward the deductions to receive full benefits from them. The same caveat on revenue losses also applies.

4. Free economic zones

A free economic zone is a specified geographic region where firms which are operating within that region receive special tax treatment. The special treatment can range from easing of registration rules and procedures to the reduction or exemption of certain taxes. Often firms operating in free economic zones are exempt from import duties, given they are producing goods within the free economic zone which are for export. In effect, the area

defined as a free economic zone is treated as outside the jurisdiction of the country's customs. Any of the investment incentives already discussed can be extended to a free economic zone.

An advantage of a free economic zone may arise from confining the incentives to a limited geographic area, which may allow easier monitoring of firms. This does not eliminate any of the abuse potentials already discussed, and does not eliminate the ability of firms to use transfer pricing and other means to allow firms located outside the designated area to benefit from the incentives offered inside the zone.

Problems with free economic zones

Typically free economic zones relieve firms from customs and excise duties and VAT on imports used as inputs. The zones are established to remove barriers for the export industry, and are not particularly used for general investment incentives. Extending other investment incentives to free economic zones may be a way to provide further incentive for export industries, but would not be a way to provide general investment incentives for firms not engaged in export production.

One of the biggest problems with free economic zones is choosing the site for the zone. The choice is likely to be a political decision, and once one free economic zone is established, there will be pressure to establish more. Thus there is great potential for eroding the tax base. Moreover, all the problems with investment incentives which have already been discussed apply to free economic zones.

Anti-abuse measures

There are steps the government can take to reduce the potential for abuse of investment incentives.

Measures which can curb abuse of investment allowances and credits

If the government decides to use "investment-linked" incentives, such as investment allowances, investment tax credits, or accelerated depreciation, there are measures which can be taken to reduce the level of abuse associated with the incentives.

1. The rates of an investment allowance or credit should be moderate.

The higher the rate, the greater the tax value to the firm of increasing expenditures. Keeping the rates low will reduce the incentive to abuse the rules.

2. Clearly define the investments which qualify for the incentive, and make the rules as simple as possible.

When the rules for qualifying for an incentive are vague or if they are too specific (which means they will be complicated), this creates confusion for both the taxpayer and the tax administrator. The taxpayer will only be persuaded to make the additional investment if she knows that the investment will qualify for the incentive. If the law is too vague or too complicated, both the taxpayer and the tax administrator will have difficulty ascertaining which investments qualify. Therefore, the effectiveness of the incentive can be greatly reduced. Vagueness or complexity can also create opportunities for abuse.

3. Clearly establish and uphold the starting and ending periods for the incentives.

The justification for providing the investment incentive is that markets are not developed and help is needed to get the required level of investment. Therefore, as markets develop, the justification for the incentive diminishes. Firms also need to be able to make plans, and knowing that the incentives will expire at a certain time reduces uncertainty.

4. Include recapture and capital gains rules in the tax law.

Without these rules, the same asset can receive an investment allowance or tax credit again and again. One way to restrict the abuse is to have the incentive apply only to new assets. This may bias investment against imported used equipment, which is not otherwise available in the country. This problem can be avoided by allowing the incentive to be applied to an asset only for its first use in the country; however, this means assets have to be traced, and could be difficult to enforce. Tax policy makers must decide how big an issue this is before making a decision to allow the incentive only for new assets.

5. Value transactions between related parties at fair market value.

With investment-based incentives, firms have an incentive to sell assets at inflated values to increase the benefit. Therefore, it is important that the tax officials have the authority to value transactions between related parties at "fair market value." The authorization alone will help curb attempts by firms to abuse the rules in this manner.

6. Target the incentives towards assets for which there is a good secondhand market.

This makes valuation of the assets much easier. It is very difficult to value intangible assets, and they should not be included in the investment incentive.

Measures which can curb the abuse of tax holidays

While I do not recommend tax holidays, if the government believes they are necessary, there are measures which can be taken to reduce the abuse potential of tax holidays.

1. Restrict the holiday to new firms whose assets were not previously employed in the country.

To qualify for the tax holiday, the requirement should be that at least 90% of the firm's assets were not previously employed in the country. The restriction could be relaxed for buildings, as long as the building can be renovated for new use. This restriction keeps existing firms from re-inventing themselves to qualify for the holiday, including firms which are simply being privatized.

2. Deny the holiday to any new company which is related to another company in the country, where the related firms do not all qualify for the holiday.

This keeps firms from selling their assets to an offshore company which then opens a "new" firm qualifying for the holiday. It also helps restrict the holiday to new investment.

Conclusions

The effectiveness of investment incentives is highly questionable, and the revenues lost often exceed additional investment created by the incentives. Tax holidays can create the greatest revenue losses and provide the least amount of benefit to the firms making the kind of capital investment desired by the government. Tax holidays are also subject to the greatest abuse among the investment incentives discussed in this paper.

If the government decides it wants to actively provide incentives for investment, incentives which are linked to the investment are preferable over a general incentive like a tax holiday. A tax holiday is not linked directly to the investment, but instead is directly linked to the creation of a new firm. The amount of benefit received by the firm is also not directly linked to the size of investment made, but to the profitability of the newly created firm. As pointed out earlier, capital-intensive firms often make losses for the first few years of operation, and so a tax holiday provides no incentive for such a firm to be created.

Investment allowances and credits and accelerated depreciation are directly linked to the investment, and therefore are better tools for the government to use if it wants to promote *productive* investment and believes specific investment incentives are required.

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