



## DOMESTIC RESOURCE MOBILIZATION: OPTIONS FOR EXPANDING FISCAL SPACE

# 3

The previous chapters have highlighted some of the domestic challenges that economies in the region are facing, including infrastructure shortages, large budget deficits, inflationary pressure and rising and persistent inequality. With constrained growth prospects, productive and countercyclical government spending is critical in supporting inclusive growth and sustainable development. One of the most pressing issues for any country determined to invest in development is to raise the necessary resources. This chapter therefore explores various options of mobilizing domestic resources, with a particular focus on tax revenues.

Governments that wish to increase the resources available for development have a range of options for unlocking the fiscal space for such spending. They can, for example, increase their borrowing, either domestically or from abroad. They can also create fiscal space by making existing public expenditure more efficient; and they can reprioritize public expenditure to orient it more towards development.

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*Strengthening tax revenues is the primary route for creating fiscal space*

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The focus in this chapter is on strengthening tax revenues as the primary route for creating fiscal space in the Asia-Pacific region. For one, international experience demonstrates that for a country to successfully implement its development and public expenditure strategies, it needs to mobilize its tax revenues. Indeed, it has been argued that a country must be able to collect taxes amounting to between 25% and 35% of its GDP to fulfil one of the key conditions to becoming a developed country.<sup>1</sup> Yet, most developing countries in the region are far from this goal. In 2011, only seven developing economies in the region collected more than 20% of GDP as tax revenues, of which four were resource-rich. In contrast, tax-to-GDP ratios were close to, or in, single-digit levels in several other countries. In developing Asia and the Pacific, tax collection by central government averaged 14.8% of GDP in 2011, even lower than 16.3% of GDP in sub-Saharan Africa.

Indeed, tax revenues have in recent years increased at a higher rate than output in many countries in the region. Nevertheless, in many of the region's developing countries tax collection is neither sufficient nor equitable. Experience across the region has demonstrated numerous opportunities for improving all forms of taxation, direct and indirect, whether of corporations or individuals. Strengthening tax revenues must therefore be considered key to creating fiscal space and delivering more resources for Governments to invest in development. This is particularly the case in those economies that are not

fully utilizing their tax potential, which is equivalent to 5% of GDP or more in some economies. Thus, by embracing their tax potential and closing existing tax gaps, tax revenues could in some cases be increased by over 70%.

It is shown in this chapter how tax revenues may be enhanced through a number of policy measures. Those include, in particular, broadening tax bases and rationalizing tax rates to provide greater incentives for tax compliance. In any case, countries must strive to make tax administrations more effective and transparent to tackle tax evasion and tax fraud. This could be achieved by sequencing reforms of tax policy and of tax administration, including setting up special tax courts to deal with tax fraud.

Strengthening regional tax cooperation would further contribute by stemming tax competition and the illicit transfer of funds. Moreover, countries may wish to consider establishing an Asia-Pacific tax forum under the aegis of ESCAP. This could monitor the tax legislation of member countries and publish a regular review of tax reforms with a view to harmonizing tax regulations and sharing best practices.

In the following sections some of the challenges that the region faces in raising more resources for development are considered. The advantages and disadvantages of various options, including non-tax revenues, for expanding fiscal space are briefly outlined. After this brief outline of the various options available, the level and composition of tax revenues in selected Asia-Pacific countries (where data are available) are examined. The following section contains an estimate of the tax potential in the region. The chapter concludes with an analysis of the main challenges that countries face in raising tax revenues and the policy options that are available to overcome them.

Data for this chapter come from the Government Finance Statistics database, supplemented with data from CEIC, national data sources and several background studies commissioned for this report. More details on the data sources are provided in annex I.

## CREATING FISCAL SPACE

There are a number of ways in which Governments can create fiscal space. For instance, countries with low levels of debt can consider borrowing to invest in development. In Kazakhstan and the Russian Federation, for instance, debt in 2012 was less than 13% of GDP, and in Cambodia, China and Indonesia it was less than 30%. In others, however, debt is significantly higher — more than 60% in India and Pakistan.<sup>2</sup>

Yet even in countries where levels of debt are low, expanding indebtedness can be risky. One problem is that the debt not utilized productively can lead to a drain on resources in the form of its servicing. In India in 2011, for example, net interest payments were equivalent to a quarter of total revenue, and in Pakistan they were one third. In the Philippines, debt in 2011 was equivalent to 36.2% of GDP, and interest payments were equivalent to a fifth of government revenue. In Turkey, debt reached 41.9% of GDP and interest payments were equivalent to one sixth of government revenues.

Other risks from borrowing include rising pressure on interest rates and potential crowding out of the private sector. Together, these developments complicate fiscal and monetary management as authorities struggle to tackle inflation or mitigate the consequences of capital outflows. Borrowings could also entail maturity mismatches — especially, if long-term projects are financed with short-term debt/funding from the financial system, which can cause problems if the short-term debt cannot be rolled over when its maturity expires. In the case of foreign currency borrowings, there will be additional risks including currency risks — as the Asian, Mexican and Russian experiences of the 1990s clearly demonstrated. Higher levels of foreign-denominated debt can also constrain countercyclical macroeconomic policy.<sup>3</sup>

Thus, as highlighted by the Development Committee (2006:14) of the IMF and World Bank, “the most attractive way for countries to create fiscal space is within existing borrowing parameters”. To avert

complications arising from borrowings (hedged or unhedged), Governments have the option to enhance the effectiveness and efficiency of existing resource use.<sup>4</sup> This includes a shift in the composition of public expenditure, whereby funds are reallocated from current expenditure towards capital expenditure. Current expenditure includes spending on the wages and salaries of civil servants, interest payments, subsidies and expenditure on goods and services. Capital expenditure is associated with physical capital formation, including investment in infrastructure. Significant reallocating of expenditure is, however, often not possible as a certain level of current expenditure is always required for proper operation and maintenance in order to deliver quality services. Moreover, capital expenditure often entails current expenditure: greater investment to build schools, for example, will subsequently increase the demand for current expenditure on staff salaries.

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*Governments have the option to enhance the effectiveness and efficiency of existing resource use*

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Another option is to reduce expenditure on non-priority areas. One area to target for cuts would be defence expenditure, which makes little if any contribution to inclusive development. In several countries, including Bangladesh, China, Georgia, India, Pakistan, the Republic of Korea, the Russian Federation and Singapore, defence accounts for more than 10% of total public expenditure. In some countries, defence expenditure exceeds that on health and education combined. Political compulsion and other rigidities, including expenses outside the normal budgetary scrutiny, limit a country's ability to rationalize and streamline the use of funds.

Another option would be to reduce various kind of subsidy — whether to consumers or producers, including public sector enterprises. In Bangladesh, the Islamic Republic of Iran, Pakistan and Thailand, for example, subsidies account for around 7% of total public expenditure, and in the Russian Federation for around 10%. In South-East Asia in 2012, energy

subsidies alone amounted to \$51 billion.<sup>5,6</sup> While removing subsidies can be politically difficult, some interesting reforms have been achieved in certain areas (see box 3.1).

Governments seeking to increase fiscal space can also try to boost non-tax revenues, which primarily comprise royalties from natural resources, grants and revenues from property, and income from public enterprises that sell goods and services. In fact, many countries rely heavily on such revenues: in Afghanistan, Azerbaijan, Bhutan and the Islamic Republic of Iran, for example, non-tax revenues account for more than two thirds of total government revenues. In Cambodia, China, Hong Kong, China, Maldives, Mongolia, Myanmar, the Russian Federation and Turkey, they account for between one third and two thirds of government revenue (see table 3.1).

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*Non-tax revenues can be quite volatile and complicate fiscal planning*

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In many economies, non-tax revenues from natural resources play an important role. In Indonesia, natural resources account for more than 60% of non-tax revenues. In the Russian Federation, oil and gas revenues alone accounted for more than half of all revenues in 2012, and in the Islamic Republic of Iran, oil revenues also account for about one half of total revenues. Natural resources can deliver significant resources that Governments can use to forward development. However, managing such wealth poses additional challenges as Governments are often unable to tackle the institutional and policy challenges that come with natural resources. As a consequence, the human development indicators of many resource-rich countries compare less favourably with those of less-endowed countries.<sup>7</sup>

Between 2000 and 2011, a number of countries have seen significant changes in their non-tax revenues. This was particularly the case in the resource-rich economies of North and Central Asia, where non-tax revenues increased by 55% in the

Russian Federation and by more than 80% and 110% in Uzbekistan and Kazakhstan, respectively. In Azerbaijan, they increased more than fivefold.

On average, however, the increase in non-tax revenues in the region over this period was similar to that of tax revenues. Yet, non-tax revenues are significantly more volatile. This may be due not only to changes in prices of natural resources, but also a reflection of one-off revenues that may result, for instance, from the proceeds of privatizing state-owned enterprises or from other public sales, which can make year-to-year variations in non-tax revenues quite large. In Pakistan, for instance, non-tax revenues increased by more than 50% between fiscal years 2012 and 2013, largely due to central bank profits and an increase in external funds. Similarly, in India, where non-tax revenues have grown at a compound annual rate of more than 7.5% in the 10 years ending the fiscal year 2009/2010, the proceeds of auctions of wireless spectrum have recently contributed significantly to this growth, contrasting to more regular receipts of dividends and profits of state-owned enterprises, which have been rather sluggish.

Governments can increase non-tax revenues in a number of other ways. They can, for example, increase earnings from public enterprises by improving their efficiency and increasing their charges. Also, user fees charged for a variety of public services could be increased. However, there is a limit above which such fees cannot be raised, particularly as they are often more regressive in nature and adversely affect access of low-income groups. As far as natural resources are concerned, Governments can boost revenues by increasing royalty rates. However, these are often tied in with long-term contractual agreements that cannot be changed easily without upsetting investor confidence.

While non-tax revenues contribute significantly to overall revenue, the evidence above suggests that non-tax revenues can be quite volatile as they are influenced by one-off events or by global prices, which can change significantly without warning and

### Box 3.1. Difficulties with removing consumer subsidies

Subsidies on fuel and energy are inefficient and primarily benefit the non-poor. Furthermore, they inherently encourage wastage, and energy subsidies result in fuel-intensive production. Yet, removing or reducing subsidies is politically difficult; in many countries the removal of fuel and energy subsidies has sparked protests.

To address these problems, some 12 countries in Asia and the Pacific are implementing subsidy reforms. To offset the impact of phasing out of subsidies for the poor, Governments may opt to have compensatory policies, such as cash transfers. Indonesia and Malaysia, for example, are reducing fuel and energy subsidies to consumers and industry, and replacing them with targeted safety nets. In the Philippines, there are plans to limit rice and transport subsidies and move instead towards more targeted conditional cash transfer programmes. Timor-Leste also intends to reduce subsidies on rice and electricity. Similarly in Palau, the Government is considering phasing out water and sanitation subsidies, while in Kiribati policy discussions are focused on reforming distortionary subsidies to copra producers and other state-owned enterprises.<sup>a</sup>

Generally, the removal of subsidies helps create fiscal space to provide social protection, either targeted or universal. However, the real value of cash transfers, unless properly adjusted, could be eroded by inflation. Moreover, policies to remove subsidies must avoid one-size-fits-all approaches. Rather, reforms need to take into account their net welfare effect. For instance, if the subsidies that are being removed were benefiting primarily poor households, offering a meagre safety net only for the poorest may prove to be insufficient compensation to the extent that, in net terms, welfare will have declined. Policymakers also need to treat fuel or energy subsidies differently from food subsidies, which generally benefit low-income groups due to self-selection.

While many practitioners want to alleviate hardship with minimal targeted interventions for the poor, countries should aim for more. In particular, universalism is being increasingly espoused. For instance, world leaders, who were gathered at the High-level Plenary Meeting of the General Assembly on the Millennium Development Goals in 2010, declared that "... promoting universal access to social services and providing social protection floors can make an important contribution to consolidating and achieving further development gains".<sup>b</sup> This was reiterated in the outcome document of United Nations Conference on Sustainable Development, which was held in Rio de Janeiro, Brazil, from 20 to 22 June 2013.<sup>c</sup> Similarly, in 2011, 193 Member States of the WHO committed to move towards universal health coverage.<sup>d</sup> This policy is also supported by the World Bank.<sup>e</sup>

The huge savings from the removal of subsidies should allow policymakers to be more ambitious and consider universal social protection systems and other policies that work for all citizens, instead of for a few. For instance, recent estimates of subsidies on fuel alone reached nearly 2% of GDP in the fiscal year 2011/2012 in India; in 2011, energy subsidies exceeded 3% of GDP in Bangladesh, Brunei, Indonesia and Pakistan and exceeded 5% of GDP in Kyrgyzstan, Turkmenistan and Uzbekistan.<sup>f</sup> According to ESCAP estimates, savings from these subsidies would, for example, in India and Bangladesh be sufficient to finance a comprehensive policy package comprising income security for the entire elderly population and all those with disabilities, as well as providing universal access to health and education.<sup>g</sup> In Pakistan and Indonesia, energy subsidies would, in addition, be sufficient to finance employment for everyone for 100 days per year, at a wage equivalent to the national poverty threshold.

<sup>a</sup> See [http://policydialogue.org/publications/working\\_papers/age\\_of\\_austerity](http://policydialogue.org/publications/working_papers/age_of_austerity).

<sup>b</sup> General Assembly resolution 65/1, para. 51.

<sup>c</sup> See General Assembly resolution 66/288, annex, p. 107.

<sup>d</sup> Resolution WHA64.9 (available at [http://apps.who.int/gb/ebwha/pdf\\_files/WHA64/A64\\_R9-en.pdf](http://apps.who.int/gb/ebwha/pdf_files/WHA64/A64_R9-en.pdf)) of the Sixty-fourth World Health Assembly, held in May 2011.

<sup>e</sup> See [www.worldbank.org/en/topic/health/publication/universal-health-coverage-study-series](http://www.worldbank.org/en/topic/health/publication/universal-health-coverage-study-series).

<sup>f</sup> IMF (2013).

<sup>g</sup> ESCAP, *Economic and Social Survey of Asia and the Pacific 2013: Forward-looking Macroeconomic Policies for Inclusive and Sustainable Development*. (United Nations publication, Sales No. E.13.II.F.2). Available from [www.unescap.org/resources/economic-and-social-survey-asia-and-pacific-2013](http://www.unescap.org/resources/economic-and-social-survey-asia-and-pacific-2013).

Table 3.1. Revenue mobilization in selected Asia-Pacific economies, 2000 and 2011

(Percentage of GDP)

	Total revenue		Tax revenue		Non-tax revenue	
	2000	2011	2000	2011	2000	2011
<b>East and North-East Asia</b>						
China <sup>a,b</sup>	26.3	27.6	15.6	18.2	10.7	9.4
Hong Kong, China <sup>c</sup>	14.7	23.5	9.0	14.1	5.7	9.5
Macao, China	19.9	39.9	16.6	37.5	3.3	2.4
Mongolia <sup>d</sup>	32.5	38.4	19.1	24.5	13.4	13.9
Republic of Korea <sup>a</sup>	28.3	29.4	21.8	23.0	6.5	6.4
<b>North and Central Asia</b>						
Armenia <sup>d</sup>	21.7	25.6	14.4	17.7	7.3	7.9
Azerbaijan <sup>e</sup>	17.9	45.5	12.7	12.2	5.2	33.3
Georgia	15.7	28.2	11.8	25.2	3.9	3.0
Kazakhstan	22.6	31.7	20.2	26.6	2.4	5.1
Russian Federation	37.9	45.0	24.3	23.8	13.6	21.2
Uzbekistan	27.9	21.9	26.7	19.7	1.2	2.2
<b>Pacific</b>						
Australia <sup>b</sup>	36.6	32.5	29.6	25.7	7.0	6.8
Fiji	25.4	26.8	19.9	25.7	5.5	1.1
New Zealand <sup>b</sup>	39.7	37.7	33.0	30.5	6.7	7.2
Papua New Guinea	25.8	27.3	24.3	26.1	1.5	1.2
<b>South and South-West Asia</b>						
Bangladesh <sup>f</sup>	10.6	12.3	7.8	10.0	2.8	2.4
Bhutan <sup>g</sup>	43.7	39.8	11.1	10.9	32.6	28.9
India	17.0	20.3	13.6	16.0	3.4	4.2
Iran (Islamic Republic of) <sup>f, g</sup>	24.0	31.2	7.1	10.0	16.9	21.2
Maldives <sup>b</sup>	32.2	34.0	13.8	15.3	18.4	18.7
Pakistan	14.9	12.6	10.1	9.3	4.8	3.3
Sri Lanka	17.2	14.5	14.5	12.4	2.7	2.1
Turkey	n.a.	34.7	18.6	18.5	n.a.	16.1
<b>South-East Asia</b>						
Cambodia <sup>b</sup>	14.1	17.6	8.2	10.4	5.9	7.2
Indonesia	14.8	16.3	8.3	11.8	6.5	4.5
Malaysia	17.4	21.0	13.2	15.3	4.2	5.7
Myanmar <sup>b,h</sup>	5.3	6.5	3.0	3.3	2.3	3.2
Singapore	28.6	17.9	16.6	13.8	12.0	4.1
Thailand	17.6	22.7	14.7	18.8	2.9	3.8

Source: International Monetary Fund, Government Finance Statistics database.

Notes: Data from Armenia, Australia, China, India, the Islamic Republic of Iran, Kazakhstan, Mongolia, New Zealand, the Republic of Korea, the Russian Federation, Thailand and Turkey pertain to general government data; for others, it is central government data.

a Begins 2005.

b Ends 2010.

c Begins 2002.

d Begins 2003.

e Begins 1999.

f Begins 2001.

g Ends 2009.

h Ends 2004.

are all but impossible to predict reliably. This volatility can clearly complicate fiscal planning. Moreover, as non-tax revenue from, for instance, natural resources will decline as resources are exhausted, they should not be considered as the main pillar of resources for long-term development planning. As a recent OECD (2012:23) report observes, “Taxation is key to promoting sustainable growth and poverty reduction. It provides developing countries with a stable and predictable fiscal environment to promote growth and to finance their social and physical infrastructural needs. Combined with economic growth, it reduces long-term reliance on aid and ensures good governance by promoting the accountability of governments to their citizens.”

In sum, while Governments have a range of options for increasing fiscal space, tax revenues bear the most potential as a source for reliable funding, especially when the current tax effort is low. The remainder of this chapter focuses in greater detail on tax revenues and related policy issues.

## BOOSTING TAX REVENUES

In recent years, many economies in the Asia-Pacific region have been transformed. Some have moved from agriculture towards more diversified and industrialized economies. Some have transited from centrally-planned to more market-based economies. Yet, despite this general move up the value chain, overall in Asia and the Pacific, revenue collection is quite weak.

Compared with the developed economies, the developing countries in Asia and the Pacific are less successful in raising government revenue. In 2011, while overall government revenue (tax and non-tax) for the developed economies was 39.7% of GDP, for the developing countries it averaged only 26.1%. There were, however, notable differences between subregions — total revenue as a proportion of GDP was higher in East and North-East Asia at 31.8%, in North and Central Asia at 30.1%, in South and South-West Asia at 26.1% and the

Pacific at 25.5%, but lower in South-East Asia at 16.6%. As indicated in table 3.1, there were also large variations among countries — ranging from 45.5% of GDP in Azerbaijan to 6.5% in Myanmar. Table 3.1 also shows that between 2000 and 2011 some countries, including a number in North and Central Asia, managed to increase their revenues. In contrast, revenues decreased in several countries, including in Australia and Uzbekistan.

There are similar patterns in revenues specifically from tax. Overall Asia and the Pacific is less successful in tax collection than other developing regions — averaging only 14.8% of GDP in developing Asia-Pacific countries in 2011 for central government revenues, compared to an average of 17.1% of GDP in Latin America and the Caribbean, and 16.3% in sub-Saharan Africa.

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*Asia and the Pacific is less successful in tax collection than other developing regions*

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In several countries, general government tax revenues are significantly greater than central government revenues. Taking this into account for the countries mentioned in annex I, developed countries of the region were more successful, generating 24.2% of GDP compared with 16.9% for the developing economies. Again, too, there are marked differences among countries. In Fiji, Kazakhstan and Papua New Guinea, for example, tax revenues were equivalent to more than 25% of GDP, whereas in Afghanistan, Bangladesh, the Islamic Republic of Iran, Myanmar and Pakistan the proportions were close to, or at, single-digit levels. Nevertheless, many countries have been able to strengthen their tax revenues over the past decade — with notable progress in Georgia, for example, and Mongolia.

All Governments need to collect taxes effectively. As mentioned earlier, one of the conditions for becoming a developed country is the ability to collect taxes amounting to between 25% and 35% of GDP.<sup>3</sup> Most developing countries in Asia and the Pacific are far



from this goal: in 2011, only seven, of which four were resource rich, collected tax revenues of more than 20% of GDP, while several had tax-to-GDP ratios in single digits. The IMF has estimated that if low-income and emerging market economies were to raise their tax effort by 10 percentage points, their revenues would increase by 3% of GDP.<sup>9</sup>

Some Governments will find it easier to raise tax revenues than others — depending on their economic structures, their geographical characteristics or their development histories. Much will also depend, for example, on a country's endowment of natural resources. Countries with the highest tax revenues include some with abundant natural resources, including Australia, Kazakhstan, Mongolia, Papua New Guinea and the Russian Federation. Similarly, small island economies, the ports of which are easier to monitor, are typically better able to gather taxes on international trade than landlocked countries, into which goods are easier to smuggle.

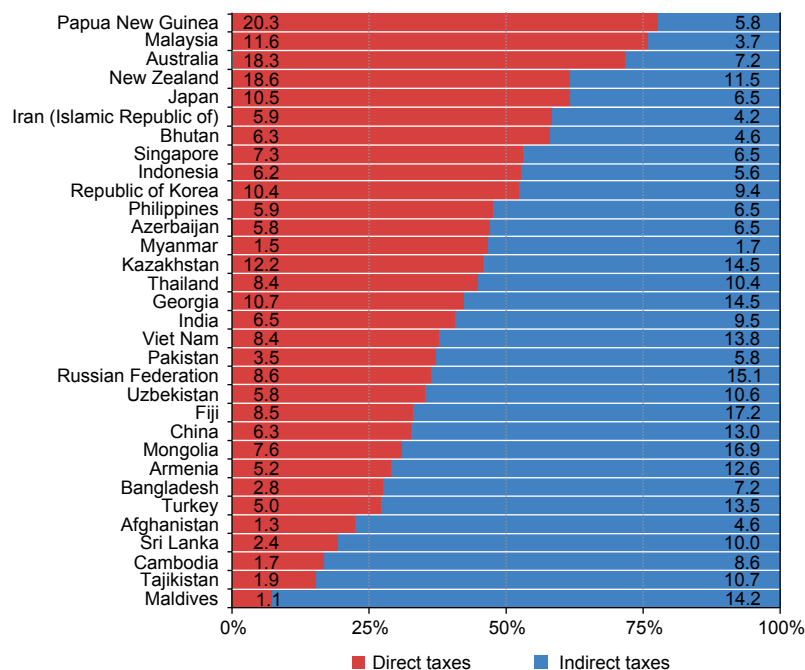
## COMPOSITION OF TAX REVENUES

The two main categories of tax are indirect and direct. Indirect taxes are levied on goods, services and international trade. Direct taxes are levied on income, profits and capital gains for corporations or individuals.

### Indirect taxes

For more than half the countries in the Asia-Pacific region the largest sources of tax revenues are indirect taxes (see figure 3.1). On average, these make up 53% of tax revenue in South-East Asia, 60% in East and North-East Asia, almost 65% in North and Central Asia, 67% in South and South-West Asia, and 45% in the Pacific island developing economies. On the other hand, the proportion is considerably lower in the developed countries — at around 35%. Nevertheless, it should be noted that in recent years the share of indirect taxes in total tax revenue has, in general, been declining.

Figure 3.1. Share of direct and indirect taxes in tax revenue, and tax revenues as a percentage of GDP, 2011



Sources: ESCAP calculations based on data from International Monetary Fund, Government Finance Statistics database, and official data sources.

Notes: The numbers inside the figure denote the size of the respective taxes in terms of percentage of GDP. Data are for 2011 except for: Myanmar and Tajikistan (2004), Afghanistan (2007), Bhutan and the Islamic Republic of Iran (2009), and Maldives, Cambodia and China (2010).

*Taxes on trade* – A substantial component of indirect taxes in the region, particularly in the Pacific, is on international trade. Governments have in the past imposed significant duties on exports and imports — partly to protect domestic producers but also as a way of extracting revenue from primary products. In recent years, in order to encourage trade many Governments have liberalized trade and reduced trade-related taxes significantly. Thus, liberalization has reduced the tax revenues from international trade — which have been declining both as a percentage of GDP and as a proportion of overall indirect taxes. In some countries the declines have been substantial — between 1990 and 2011, they amounted to around 5% of GDP for Azerbaijan, Maldives and Pakistan (panel B, figure 3.2). Tariff reforms may thus have been at the expense of government revenues.

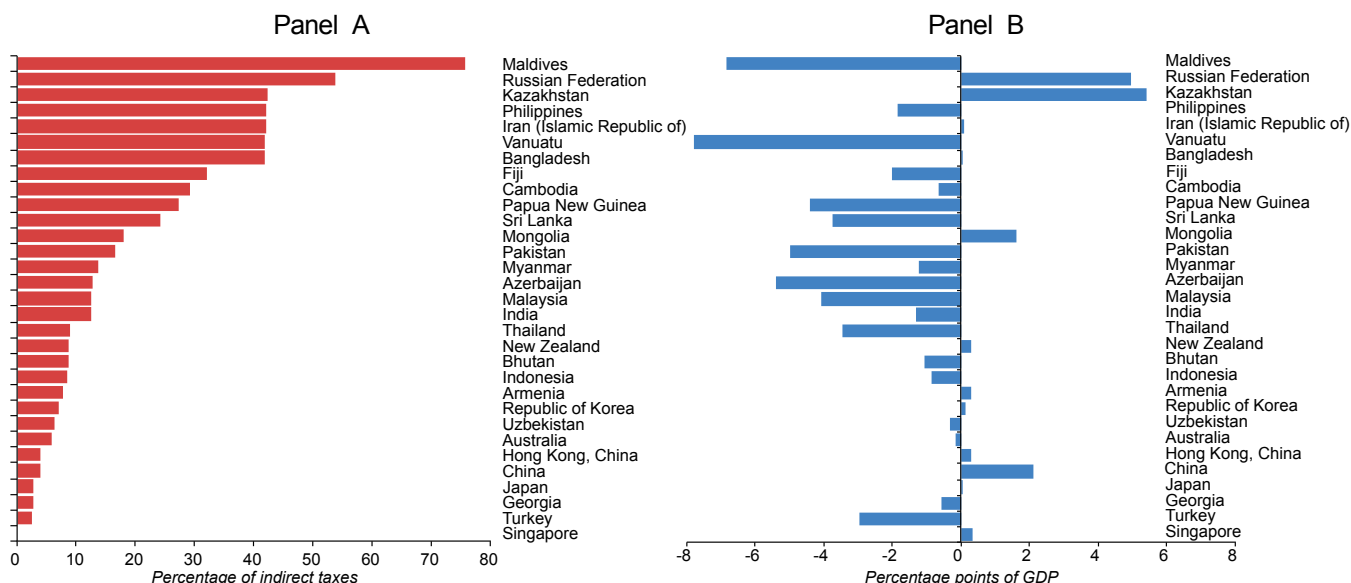
of indirect taxes and in Fiji one third (panel A, figure 3.2). Elsewhere they can be much less significant — in some landlocked economies, such as Armenia, Azerbaijan, Bhutan and Uzbekistan, trade taxes represent only between 6% and 13% of indirect taxes.<sup>10</sup>

*Taxes on goods and services* – To offset a decline in taxes on trade, many countries have been increasing taxes on goods and services, such as through value added tax (VAT) or a general sales tax (GST). The first country in the region to introduce VAT was the Republic of Korea in 1976. Now almost every country in Asia and the Pacific has such taxes. Since 1990, VAT or GST has risen from less than a fifth of indirect taxes to around one half — levied currently at an average rate of 12.5%.<sup>11</sup>

Nevertheless, trade taxes remain important sources of income, particularly for some island economies: in Maldives they make up more than three quarters

One of the most striking changes was in Fiji. In 1992, before the introduction of VAT, indirect tax revenue came entirely from international trade, now

Figure 3.2. Contribution of taxes on trade to indirect taxes, 2011 (panel A) and changes in tax revenue from international trade, 1990-2011 (panel B)



Source: ESCAP calculations based on data from International Monetary Fund, Government Financial Statistics database.

Notes: The starting year differs as follows: Fiji and Uzbekistan from 1992; Azerbaijan from 1995; Australia and India from 1999; Kazakhstan and the Russian Federation from 2000; Bangladesh and the Islamic Republic of Iran from 2001; Cambodia, Hong Kong, China, and Mongolia from 2002; Armenia and Georgia from 2003; Turkey from 2004; and Japan, Republic of Korea and New Zealand from 2005. The end point differs for: Vanuatu until 1999; Indonesia and Myanmar until 2004; Singapore until 2007; Bhutan, India, the Islamic Republic of Iran and Papua New Guinea until 2009; and Cambodia, China and Maldives until 2010.

two thirds comes from VAT. Similarly, in Papua New Guinea, Singapore and Thailand the proportions increased from close to zero to more than 40%. Nevertheless, in many countries such as Malaysia, Pakistan and Vanuatu, the revenue from consumption taxes has not offset the fall in revenues from taxes on trade (see figure 3.3).

## Direct taxes

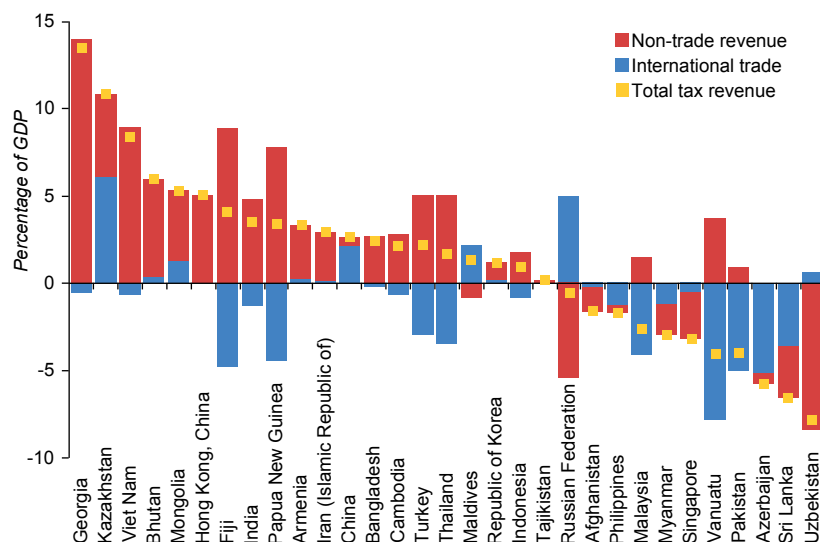
The potential for raising direct taxation from individuals is low in developing countries. For one, due to low incomes, many people would be exempted from tax. Moreover, a high proportion of people work informally or in agriculture, activities from which it is difficult to collect taxes. But even the wealthier individuals in these countries may pay little income tax due to high tax avoidance and non-compliance. As a result, income tax concerns only a small proportion of the population. In Bangladesh, for example, only around 1% of the population pays income tax.<sup>12</sup> In India, the proportion is only 3%.<sup>13</sup>

In Pakistan, less than 1% of the population filed an income tax return in 2011. In Viet Nam, only 0.3% of the total population is estimated to have paid personal income taxes in 2003.<sup>14</sup>

In most countries in Asia and the Pacific, less than half of tax revenues are therefore raised directly — and less than 20% in Cambodia, Tajikistan and Maldives. As the economy grows, however, and more people work in government and the formal sectors, the situation changes.<sup>15</sup> Governments are in a stronger position to levy taxes not just on corporations but also on individual employees who are not only earning more but from whom taxes are also easier to collect.

As countries develop, they are therefore likely to derive more of their tax revenue from direct taxes. This shift to direct taxation is generally desirable as indirect taxes affect prices and thus affect resource reallocation.<sup>16</sup> Direct taxes are also generally more equitable since they can be progressive — with

Figure 3.3. Net change in non-trade tax revenue, trade taxes and overall revenue between 1990 and 2011



Source: ESCAP calculations.

Notes: The yellow square represents the net change in total tax revenue as a result of changes in non-trade tax revenue and tax revenue from international trade. Thus, if it is below the horizontal axis, changes in revenue from international trade have not been offset by changes in non-trade revenue, such that in net terms the country has lost tax revenue over the last two decades.

The starting year differs for: Fiji and Uzbekistan from 1992; Azerbaijan from 1995; Australia and India from 1999; Kazakhstan and the Russian Federation from 2000; Bangladesh and the Islamic Republic of Iran from 2001; Cambodia, Hong Kong, China, and Mongolia from 2002; Armenia and Georgia from 2003; Turkey from 2004; and Japan, Republic of Korea and New Zealand from 2005. The end point differs for: Vanuatu until 1999; Indonesia and Myanmar until 2004; Singapore until 2007; Bhutan, India, the Islamic Republic of Iran and Papua New Guinea until 2009; Cambodia, China and Maldives until 2010.

higher rates at higher levels of income. Yet, this will not happen at a similar pace in each country as the changes will also depend, for example, on natural endowments or on specific social and political factors. Nevertheless, for the region as a whole, this is the predominant trend. Over the last two decades, about two thirds of the countries with available data have seen increases in direct tax revenues. For instance, in Bhutan, India, Malaysia and Pakistan, the share of direct taxation in overall tax revenues has increased by approximately 25 percentage points. Nevertheless, in many cases, the increases have been relatively small, less than 2% of GDP.

Overall, developing countries in the region often collect more tax from corporations than from individuals. In some countries, such as Bhutan, Cambodia, the Islamic Republic of Iran, Kazakhstan, Maldives and Viet Nam, corporate income tax accounts for more than three quarters of direct tax revenues (see figure 3.4).

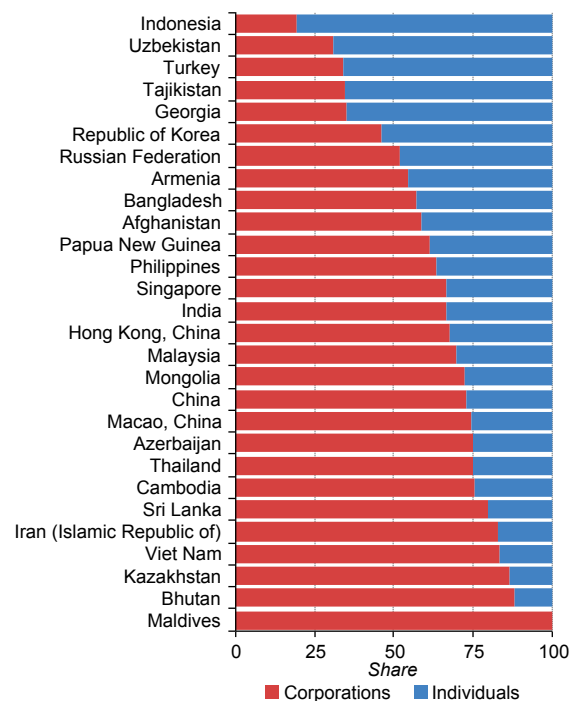
## MONITORING TAX REVENUES

Governments need to be able to monitor their tax systems closely.<sup>17</sup> One measure in this respect is “tax elasticity” — which is the responsiveness of tax revenue to a change in national income or output. If a tax is elastic, a 1% increase in GDP results in a greater than 1% increase in revenue from the tax. However, it can be difficult to measure elasticity accurately. This is because of the need to control for such factors as changes in tax rates or a widening of the tax base. Moreover, few developing countries have long, consistent data series on tax revenues.

### Tax buoyancy

Most studies of tax responsiveness rely instead on a different measure, namely “tax buoyancy”. If the nominal tax revenue rises faster than nominal GDP, the buoyancy coefficient will be greater than unity, resulting in a rising tax-to-GDP ratio. Thus, tax buoyancy is a more “rough and ready” measure, which does not distinguish between discretionary

Figure 3.4. Distribution of corporate income and personal income taxes, 2011 or latest year



Source: ESCAP calculations.

and automatic growth of revenue. Nevertheless, it has the advantage of being easier to calculate using the available data.

Table 3.2 shows buoyancy coefficients for a sample of Asian countries from the 1990s to 2012. Details on the calculations are given in annex II. It is reassuring to note that in the most recent period, 12 of these countries had buoyancy coefficients greater than unity – indicating that, despite the global economic and financial crisis, they had managed to increase their tax-to-GDP ratios.

A number of countries have buoyancy coefficients greater than 1.5 — indeed this is the case in all of the least developed countries with available data, such as in Bangladesh (1.66), Bhutan (2.19), the Lao People’s Democratic Republic (1.58) and Nepal (1.74). Those four countries have low tax-to-GDP ratios — less than 15% — so higher buoyancies augur well for the future, indicating that as their GDPs grow these countries should be able to

Table 3.2. Buoyancy of tax revenue in selected countries

	1990s	2000-2006	2007-2012
Azerbaijan	0.60	1.45	0.37
Bangladesh	1.49	1.67	1.66
Bhutan	1.83	0.81	2.19
China	0.73	1.50	1.27
Georgia	n.a.	2.67	1.52
India	0.78	1.33	0.92
Indonesia	1.01	0.90	1.13
Iran (Islamic Republic of)	1.69	0.73	0.78
Kazakhstan	n.a.	0.99	1.88
Lao People's Democratic Republic	0.65	1.06	1.58
Malaysia	0.74	1.24	1.43
Myanmar	0.40	n.a.	n.a.
Nepal	1.29	1.01	1.74
Pakistan	0.98	0.87	0.87
Papua New Guinea	1.13	1.65	n.a.
Philippines	0.92	1.16	0.71
Republic of Korea	0.99	0.96	0.72
Russian Federation	n.a.	1.12	0.68
Singapore	1.03	0.32	1.29
Sri Lanka	0.70	1.01	0.72
Thailand	0.70	1.65	1.32
Viet Nam	n.a.	1.91	1.06

Source: ESCAP calculations.

Note: For details on the method of calculation, see annex II.

generate more tax revenue. Moreover, in a number of countries buoyancy has increased — as in Bhutan, Kazakhstan, Nepal and Singapore.

Elsewhere, however, tax buoyancies have fallen — as in Georgia, India, Philippines, the Russian Federation and Viet Nam. Between 2007 and 2009, revenues declined by more than 10% in India, Indonesia and the Russian Federation; in Kazakhstan they declined by almost a quarter. In fact, in terms of revenue, the global crisis continues to affect those countries where tax buoyancy has declined; in India, Kazakhstan, the Philippines, the Russian Federation and Viet Nam tax revenues as a percentage of GDP in 2012 were still below their pre-crisis levels.

In some countries, buoyancy may have been affected by tax reductions to provide economic stimuli during the global recession. In mid-2008, Malaysia, for example, granted greater tax deductions to employers that hired retrenched workers in order to reduce

unemployment. Malaysia also widened tax exemptions for retrenchment benefits.<sup>18</sup> Indonesia, too, cut taxes to increase consumption expenditure — entitling some companies to a 5% reduction in the highest rate of corporate income tax.<sup>19</sup> Yet, in these two countries, tax buoyancy was higher in the latter period than during the first years of the millennium.

### Tax potential

A country's ability to raise taxes will depend on many factors — structural, developmental, institutional and socio-economic.<sup>20</sup> One of the most important factors is income: economies with higher per capita incomes are likely to have higher tax revenues. Another significant structural factor is the share of agriculture in GDP; if this is high, then tax income is likely to be lower — partly because agricultural workers tend to have lower incomes but also because wages are paid in cash and not properly recorded. The same applies to the activities in the informal

sector. Moreover, agriculture primarily produces food and basic raw materials, which are often either exempt from tax or subject to relatively low rates.

Another structural factor will be the openness of the economy and the extent of international trade, which can be measured by the combined share of exports and imports in GDP. Countries more open to trade are likely to raise more revenue, since taxes on international trade are relatively easy to collect.

When judging a country's capacity to raise more tax, it is important to allow for such factors. For this report, an econometric analysis has been carried out taking these differences into account.<sup>21</sup> For a selection of countries for which sufficient data are available, this indicates their "tax potential" — the level suggested by a comparison with other countries. The results are reported in table 3.3, which shows that 17 economies in the region are estimated to be currently collecting tax revenues below their potential. The largest gap is in Hong Kong, China,

the current tax-to-GDP ratio of which is 14.2, while its potential ratio is 26.7. The economy's additional tax potential is thus quite sizeable, equivalent to 12.5% of GDP, or almost 90% of its current tax revenue. The gap arises probably because of a low-rate tax regime: there is no sales tax, and the top marginal tax rate on corporate and personal income is relatively low. Moreover, there are tax incentives for foreign firms. At the other end of the scale is Thailand, which has an additional tax potential of only 0.2% of GDP, so the country is already close to its potential. In the case of Pakistan, the tax-to-GDP ratio has declined significantly in recent years, such that the country now faces an additional tax potential of 1.8% of GDP.

If countries could realize their tax potentials, they would be able to finance urgently needed investment. Closing the tax gaps in the 16 developing economies listed in table 3.3 would lead to a total increase in tax revenues of over \$300 billion. For selected countries, the *Economic and Social Survey*

Table 3.3. Estimated tax potential in selected Asian economies

	Year	Tax-to-GDP ratio (percentage of GDP)		Tax gap (percentage of GDP)	Tax gap as a proportion of current tax revenue
		Actual	Potential		
Afghanistan	2011	8.8	15.0	6.2	70.5
Azerbaijan	2012	12.9	15.1	2.1	16.6
Bangladesh	2013	10.5	18.0	7.5	72.1
Bhutan	2009	9.2	16.0	6.7	72.9
Cambodia	2011	10.0	13.0	3.0	30.4
China	2012	19.4	21.2	1.8	9.4
Hong Kong, China	2011	14.2	26.7	12.5	88.1
Indonesia	2012	11.9	16.6	4.7	39.3
Iran (Islamic Republic of)	2013	5.8	13.1	7.2	124.5
Japan	2012	17.0	19.3	2.2	13.1
Malaysia	2012	16.1	17.4	1.3	7.9
Maldives	2010	10.7	16.5	5.8	54.2
Nepal	2013	15.2	16.1	0.9	5.6
Pakistan	2012	10.3	12.1	1.8	17.3
Philippines	2012	12.9	14.3	1.5	11.4
Singapore	2011	13.8	20.7	6.9	50.3
Thailand	2011	18.8	19.0	0.2	0.9

Source: ESCAP calculations.

Notes: The tax gap in column 5 is calculated by taking the difference between the estimated tax potential and the actual tax-to-GDP ratio for a given country in the year with most recent data (listed in column 2). Only countries with a positive tax gap are listed in this table (that is, countries that are raising more revenue than the model outlined in annex III — and would therefore have a negative tax gap — are not listed). This is the case for only a few countries where the negative tax gap is relatively small.

of *Asia and the Pacific 2013: Forward-looking Macroeconomic Policies for Inclusive and Sustainable Development* estimated what would be required for public investment in a package of basic programmes comprising employment guarantees, education, health care, income support for elderly and disable persons and access to modern energy. In seven of these countries, tax collection is significantly below its potential. Table 3.4 compares the investment required with the tax potential. Indonesia, for example, would require 3.4% of GDP for such an investment. Since its additional tax potential is 4.7% of GDP, the country should be more than capable (over 137%) of financing this investment from more effective taxation.

## RATES OF MAJOR TAXES

### Corporate taxes

In Asia and the Pacific, corporate tax rates are somewhat lower than in other global regions (see table 3.5). The average corporate rate in 2013 was 28.2% compared with 32.2% in Latin America and 29.8% in Africa.

Standard corporate tax rates can, however, vary greatly among countries, from 15% in Georgia

to 35% in Pakistan (see table 3.6).<sup>22</sup> Countries having high corporate tax may not necessarily be the ones with higher corporate tax collection, as often the effective tax rates are lower than the nominal rate. Also, in some economies, specific sectors can be subject to higher corporate tax rates. In Bangladesh, for instance, the normal rate is 27.5% but for banks it is 42.5% and for mobile phone operators it is 45%. India has a standard rate of 34% but levies a rate of 40% on foreign companies. In Malaysia, where the standard rate is 25%, petroleum companies pay 38%.

In many countries in the region, corporate tax rates are often low because Asia-Pacific countries have reduced taxes competitively in order to attract foreign direct investment. Generally, those that are small or have more open economies set lower corporate tax rates.<sup>23</sup> Table 3.7 indicates that in a sample of 24 Asian economies, two thirds have brought down their corporate tax rates over the past seven years; the average rate has fallen from 28.5% to 22.5%. Countries that have made large reductions include China, from 33% to 25%; Sri Lanka, from 32.5% to 28%; Fiji from 31% to 20% and Thailand, from 30% to 20%.

Countries engaged in tax competition need to carefully examine the net impacts of lower corporate tax rates

**Table 3.4. Additional requirements for public investments in six policy areas and the additional tax potential of selected economies, 2013**

	Required investment <sup>a</sup> (percentage of GDP)	Additional tax potential <sup>b</sup> (percentage of GDP)	Additional tax potential covering required investment (percentage)
Bangladesh	11.1	7.5	68.2
China	2.6	1.8	71.4
Indonesia	3.4	4.7	137.2
Malaysia	1.9	1.3	65.3
Pakistan	5.4	1.8	33.3
Philippines	5.1	1.5	28.9
Thailand	4.6	0.2	3.7

Source: ESCAP calculations.

<sup>a</sup> As estimated in ESCAP (2013b) for the year 2013.

<sup>b</sup> As estimated in table 3.3.

Table 3.5. Tax rates in developing countries by global region

(Percentage)

	Asia	Latin America	Africa
<b>Corporate income tax rate</b>			
2007	28.5	28.3	30.6
2009	25.7	28.0	28.8
2011	23.1	29.0	28.6
2013	22.5	27.6	28.6
<b>Individual income tax rate (highest rate)</b>			
2007	28.2	31.5	29.5
2009	28.0	31.3	26.9
2011	27.5	32.0	26.9
2013	28.2	32.2	29.8
<b>VAT or sales tax rate</b>			
2007	11.8	14.4	13.9
2009	11.7	14.1	14.1
2011	11.6	12.8	14.1
2013	12.4	12.9	14.4

Source: KPMG International (2013b).

Notes: Regional rates have been calculated as simple averages of cross-country rates for corporate income tax rates and VAT or sales tax rates. For individual income tax rates, the average of the highest marginal tax rate across countries in respective regions has been taken.

Table 3.6. Corporate, personal income and sales tax rates in selected Asian economies

(Percentage)

	Corporate tax rate	Maximum personal income tax rate	Standard sales tax rate
Bangladesh	27.5	25	15.0
China	25.0	45	17.0
Georgia	15.0	20	18.0
Hong Kong, China	16.5	15	0.0
India	34.0	30	12.5
Indonesia	25.0	30	10.0
Kazakhstan	20.0	10	12.0
Malaysia	25.0	26	10.0
Pakistan	35.0	30	16.0
Philippines	30.0	32	12.0
Republic of Korea	24.2	38	10.0
Singapore	17.0	20	7.0
Sri Lanka	28.0	24	12.0
Thailand	20.0	37	7.0
Turkey	20.0	35	18.0
Viet Nam	20.0	15	10.0

Source: KPMG International (2013b).



Table 3.7. Evidence of tax competition in corporate taxation in selected economies

(Percentage)

	Corporate income tax		Trend		Corporate income tax		Trend
	2006	2013			2006	2013	
Afghanistan	20.0	20.0	→	Malaysia	28.0	25.0	↘
Armenia	20.0	20.0	→	New Zealand	33.0	28.0	↘
Australia	30.0	30.0	→	Pakistan	35.0	35.0	→
Bangladesh	30.0	27.5	↘	Papua New Guinea	30.0	30.0	→
Cambodia	20.0	20.0	→	Philippines	35.0	30.0	↘
China	33.0	25.0	↘	Russian Federation	24.0	20.0	↘
Fiji	31.0	20.0	↘	Samoa	29.0	27.0	↘
Hong Kong, China	17.5	16.5	↘	Singapore	20.0	17.0	↘
India	34.0	34.0	→	Sri Lanka	32.5	28.0	↘
Indonesia	30.0	25.0	↘	Thailand	30.0	20.0	↘
Japan	40.7	38.0	↘	Turkey	20.0	20.0	→
Kazakhstan	30.0	20.0	↘	Viet Nam	28.0	25.0	↘

Source: KPMG International (2013b).

on total revenue and investment. In particular, studies do not find a significant correlation between lower corporate tax rates and foreign direct investment.<sup>24</sup> Keen and Simone (2004) found that tax competition harmed developing countries more than developed countries. One recent IMF study of corporate tax developments in emerging and developing economies found mixed results.<sup>25</sup> While reducing the tax rate also reduces tax revenues, the loss is likely to be smaller in the medium to long term, if a low tax rate encourages investment. But in many countries, investment cannot be encouraged through lowering tax rates as any tax-sensitive investment often already takes place under a special regime, so that the standard tax rate is irrelevant.

### Income taxes

Making a tax system more equitable means giving greater weight to income taxes, which can be levied in a progressive fashion — effectively placing more of the tax burden on upper-income households. The degree of “progressivity” will be higher when the maximum rate is higher and when it becomes payable at a relatively high-income level. On this basis, as indicated in table 3.8, income tax is quite progressive in China, Thailand and Viet Nam.

At the other extreme, some countries have introduced “flat-rate taxes”. In 2002, Kazakhstan, for instance,

Table 3.8. Progressivity of personal income tax in selected countries

	Maximum rate (percentage)	Applied at taxable income (times per capita income)		Maximum rate (percentage)	Applied at taxable income (times per capita income)
Bangladesh	25	18	Philippines	32	23
China	45	25	Republic of Korea	38	12
Georgia	20	flat	Singapore	20	5
India	30	10	Sri Lanka	24	8
Indonesia	30	15	Thailand	37	24
Kazakhstan	10	flat	Turkey	35	4
Malaysia	26	3	Viet Nam	15	30
Pakistan	30	50			

Source: KPMG International (2013b).

harmonized all its income tax rates into a single rate of 10%. In 2001, the Russian Federation set a flat rate of 13% for all Russian tax residents. Georgia also has a flat rate, equivalent to 20%.

Flat taxes have advantages. The principal one is that they simplify the system, making it cheaper to administer. Simpler rules might also encourage greater tax compliance. Moreover, lowering the marginal tax burden might create incentives for investment and encourage employment especially of individuals in higher income brackets.<sup>26</sup> However, there is little evidence that these benefits have been realized. In the Russian Federation, for example, revenues from personal income taxation did increase but this was due not to the reform but to improvements in tax administration. Moreover, the rate reduction did not seem to lead to improved compliance or greater work effort.<sup>27</sup> Importantly, flat taxes are highly regressive. Given the widespread increase in income inequality in the region, the progressivity of taxes (or lack of) needs to be looked at very carefully.

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*An appropriate move may be to a dual income tax system that taxes income on labour and capital separately*

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Given that flat taxes are regressive, a more appropriate move may be a dual income tax system that imposes increasing marginal rates on income but also taxes income on labour and capital separately.<sup>28</sup> Capital income is usually taxed at a lower rate than labour income. This encourages savings and investment. Taxation of capital income separately allows flexibility to address global tax competition to attract capital. While the Nordic countries (Denmark, Finland, Norway and Sweden) were the first countries to set up such a dual income tax system, where labour income and capital income are taxed separately, others have followed. Yet, in most developing countries, tax systems do not treat labour and capital income separately. The complexity of dual tax systems raises many challenges, however, including separation of labour

and capital incomes. Further work is needed on the suitability of such a system for developing countries and how to overcome difficulties in its implementation.

### Sales taxes

For sales taxes, a number of Asia-Pacific countries have made the transition to VAT, including Bangladesh, Georgia, Indonesia, Kazakhstan, Pakistan, Sri Lanka, Thailand and Turkey. Other countries are also contemplating this move. Although sales taxes can raise considerable revenues they also have drawbacks. The main concern is equity: as the poor spend a larger percentage of their income on consumption, these taxes have a relatively greater impact on the poor than on the rich.<sup>29</sup> In Bangladesh, for example, it has been found that VAT places a relatively higher burden on people in lower income groups.<sup>30</sup> Another disadvantage is that the informal sector largely escapes the VAT net, discouraging businesses from making the transition to formal activities.<sup>31</sup>

It is possible to offset these effects to some extent by zero-rating or exempting certain goods and services. Indeed most countries also have exemptions and lower rates for certain items such as food (see table 3.9). However, the benefits of doing so must be weighed against increases in administrative costs.

The effectiveness of VAT and GST can be assessed through “collection efficiency”, which is the actual rate of taxation of value added in goods and services as a percentage of the standard rate. As indicated in table 3.10, collection efficiency is relatively high in Thailand, Turkey and some North and Central Asian countries, but much lower in Bangladesh, China, India and Pakistan, indicating tax exemptions and difficulties in implementation of the tax.

### Taxation of imports

In the early stages of industrialization, countries generally levy high import tariffs — both to raise

Table 3.9. Items exempt or taxed at lower rates in selected Asia-Pacific countries, 2013

	Type of tax	Standard rate	Special rates
<b>East and North-East Asia</b>			
China	VAT consumption tax	17%	<ul style="list-style-type: none"> <li>• Reduced rate on transportation services (11%) and “modern services”, such as ICT and consulting services (5%)</li> <li>• Reduced rates on goods for export (0%) and utility services (13%). Refunds for zero-rated exports are often only partial</li> <li>• Small business pay VAT on turnover (3%)</li> </ul>
<b>North and Central Asia</b>			
Armenia	VAT	20%	<ul style="list-style-type: none"> <li>• Exemptions: sales of books, scientific research, financial services and insurance</li> </ul>
Georgia	VAT	18%	<ul style="list-style-type: none"> <li>• Zero-rating provisions</li> </ul>
Kazakhstan	VAT	12%	<ul style="list-style-type: none"> <li>• Exemptions: exports, and financial, medical and insurance services</li> </ul>
Russian Federation	VAT	18%	<ul style="list-style-type: none"> <li>• Exemptions: medical, financial and educational services, rents, etc.</li> </ul>
<b>Pacific</b>			
New Zealand	GST	15%	<ul style="list-style-type: none"> <li>• Exemptions: exports, financial services and rents</li> <li>• GST reverse charge for imported services</li> </ul>
Papua New Guinea	VAT	10%	<ul style="list-style-type: none"> <li>• Exemptions: exports and medical supplies (zero-rating)</li> <li>• Exemptions: medical and educational services, road transport and books</li> </ul>
Samoa	VAT	15%	<ul style="list-style-type: none"> <li>• Zero-rating of exports and medical services</li> <li>• Exemptions: food, financial services, electricity and transport</li> </ul>
Vanuatu	VAT	12.5%	<ul style="list-style-type: none"> <li>• Zero-rating: exports, education, rents, etc.</li> </ul>
<b>South and South-West Asia</b>			
Bangladesh	VAT	15%	<ul style="list-style-type: none"> <li>• Railways (10%), construction companies (5.5%), garments (5%), English-medium schools (4.5%), ICT services (4.5%), dental clinics (2.25%), land developers/apartments (1.5%)</li> <li>• VAT exemptions on social welfare, training, etc.</li> </ul>
India	Sales tax with some VAT features	12.5%	<ul style="list-style-type: none"> <li>• ICT products, capital goods, fertilizers, cotton, drugs and medicines, iron and steel, tractors (4.5%), gold, jewellery, etc. (1%)</li> <li>• Exemptions: books, electrical energy, food items</li> <li>• Exports are zero rated</li> </ul>
Pakistan	VAT partial	Goods 17% Services 16%	<ul style="list-style-type: none"> <li>• Local supplies of export goods (5%)</li> <li>• Exemptions: food, construction materials, computer software, etc.</li> </ul>
Turkey	VAT	18%	<ul style="list-style-type: none"> <li>• Reduced rate on textiles, education services and hotels (8%)</li> <li>• Food and books (1%)</li> </ul>
<b>South-East Asia</b>			
Indonesia	VAT	10%	<ul style="list-style-type: none"> <li>• Exemptions: food, banking and insurance, finance and leasing, hotels and restaurants, employment and manpower services, various social services, and the supply of electric power</li> </ul>
Malaysia	Sales tax/ service tax	10%	<ul style="list-style-type: none"> <li>• Reduced rate on food stuffs, alcoholic beverages and tobacco (5%)</li> <li>• Service tax (6%)</li> </ul>
Singapore	GST	7%	<ul style="list-style-type: none"> <li>• Reduced rate on the export of goods and on financial services (0%)</li> </ul>

Source: KPMG International (2013b).

Table 3.10. Collection efficiency of sales tax/VAT, latest available data

(Percentage)

	Actual tax revenue on goods and services as a percentage of value added	Standard rate of sales tax/VAT	Collection efficiency
Bangladesh	4.8	15.0	32.2
China	8.0	17.0	46.8
Georgia	18.0	18.0	99.3
India	3.7	12.5	29.7
Indonesia	5.6	10.0	56.1
Kazakhstan	7.8	12.0	65.3
Malaysia	36.1	10.0	36.1
Pakistan	6.4	16.0	40.0
Philippines	4.3	12.0	35.9
Sri Lanka	7.1	12.0	59.0
Thailand	9.6	7.0	136.8
Turkey	16.3	18.0	90.8

Source: World Bank, World Development Indicators.

revenue and protect domestic industry. The countries of South Asia, in particular, followed strategies of import substitution. Since the 1990s, however, most countries have embarked on trade liberalization, which has meant scaling down customs duties.

Currently, the lowest tariffs in the region are in the wealthier countries. Average tariffs in Australia and New Zealand are below 3%, and in Singapore imports are duty free. Rates are also relatively low in South-East Asia, in East and North-East Asia, and in Central Asia — on average below 10%. In

contrast, import tariffs remain relatively high in South Asia — average rates are 14.4% in Bangladesh, 13.5% in Pakistan, 13.7% in India and 9.9% in Sri Lanka (see table 3.11).

Most countries impose the highest duties on beverages and tobacco, with lower tariffs on machinery, cotton, petroleum products and textiles. They also impose higher tariffs on agricultural imports. In India, for example, the average customs duty on non-agricultural items is 10.4% while on agricultural goods it is 33.5%. Figure 3.5 shows a stylized pattern of import tariffs.

Figure 3.5. Stylized pattern of import duties

Level of import duty

High



Low

Goods

- Beverages and tobacco
- Transport equipment
- Agricultural food items
- Textiles
- Other manufactured consumer goods
- Agricultural raw materials
- Minerals
- Industrial raw materials and intermediate goods
- Machinery

Source: World Trade Organization, International Trade Centre and United Nations Conference on Trade and Development (2013).

Table 3.11. Import-tariff structure in selected Asia-Pacific countries

(Percentage)

	Year	Average most-favoured-nation tariff			Binding coverage
		Agriculture	Non-agriculture	Total	
<b>East and North-East Asia</b>					
China	2011	15.6	8.7	9.6	100.0
Mongolia	2012	5.1	5.0	5.0	100.0
<b>North and Central Asia</b>					
Azerbaijan	2012	13.4	8.3	9.1	n.a.
Georgia	2012	6.7	0.6	1.5	100.0
Kazakhstan	2012	13.4	8.8	9.5	n.a.
<b>Pacific</b>					
Australia	2012	1.2	2.9	2.7	97.1
Fiji	2012	20.6	16.3	16.9	51.3
New Zealand	2012	1.4	2.2	2.0	100.0
Papua New Guinea	2010	14.8	3.6	2.1	100.0
<b>South and South-West Asia</b>					
Bangladesh	2011	17.2	14.0	14.4	15.5
India	2012	33.5	10.4	13.7	73.8
Pakistan	2012	15.5	13.2	13.5	98.7
Sri Lanka	2012	25.8	7.5	9.9	38.1
Turkey	2011	41.2	4.8	9.6	50.3
<b>South-East Asia</b>					
Cambodia	2012	15.2	10.3	10.9	100.0
Indonesia	2012	7.9	6.9	7.0	96.6
Malaysia	2012	11.2	5.8	6.5	84.3
Philippines	2012	9.8	5.7	6.2	67.0
Singapore	2012	1.4	0.0	0.2	69.7
Thailand	2011	21.8	8.0	9.8	75.0
Viet Nam	2012	16.1	8.4	9.5	100.0

Sources: World Trade Organization, International Trade Centre and United Nations Conference on Trade and Development (2013).

Notes: Most-favoured-nation (MFN) tariffs are the standard rates charged on imports from all World Trade Organization members, excluding preferential rates, or lower rates charged within quotas. "Binding coverage" refers to the percentage of products (or "tariff lines") in a member's list of commitments (or "tariff schedule") that are legally committed (or "bound") in the World Trade Organization.

## EXEMPTIONS AND CONCESSIONS

Currently, most countries in the region aim to attract foreign direct investment by offering special tax exemptions and allowances. These can take the form of tax holidays, reduced corporate income tax rates, investment tax allowances and partial profit exemptions to reduce the cost of capital. These policies have in the past been pursued extensively in South-East Asia, for example, where countries have used tax policies to encourage investment, and promote exports, R&D and skill training.

Indonesia, Pakistan, the Republic of Korea, Sri Lanka and Thailand, for example, currently tax small

companies at substantially lower than standard rates. Some countries offer preferential tax treatment for a whole sector — as in Sri Lanka for tourism and construction, in India for insurance, and in Pakistan where power-generating companies are permanently exempted.

Certain types of individuals also enjoy special treatment. Senior citizens and working women, for example, generally face lower tax rates. And in most countries, all taxpayers can take advantage of tax deductions and credits for contributions to provident funds, pensions, investments in approved securities, and interest payments on consumer loans, especially those for housing.

**Table 3.12. Tax expenditure as a percentage of GDP in selected countries, latest available data**

	In customs duty	In corporate income tax
Bangladesh	0.1	n.a.
China	8.1	0.1
Georgia	0.3	0.5
India	0.5	0.0
Indonesia	0.6	0.2
Malaysia	0.8	0.2
Nepal	n.a.	0.2
Pakistan	1.2	n.a.
Philippines	1.5	0.6
Sri Lanka	n.a.	0.3
Tajikistan	n.a.	0.6
Turkey	0.6	0.3

Source: ESCAP calculations.

Notes: Tax expenditures in customs duties are computed by calculating the tariff loss that arises if the actual applied tariff is less than the average-weighted MFN tariff for each country. The tax expenditure on corporate income taxes is computed by comparing the actual corporate income tax rate with the statutory rate.

The revenues foregone as a result of these deductions and allowances are referred to as “tax expenditures”. In some countries, these can be significant, reaching 0.5% of GDP or more in Georgia, the Philippines and Tajikistan. In several countries, tax expenditures are also significant in customs duties, reaching more than 1% of GDP in Pakistan and the Philippines and more than 8% of GDP in China (see table 3.12).

Table 3.13 identifies the types of “tax expenditure” most commonly observed in Asia and the Pacific. The table also indicates where revenues foregone are likely to be relatively large.

Some concessions are useful. Corporate tax concessions can be worthwhile if they lead to higher investment, especially in employment-intensive sectors. If that happens, the losses due to the concessions can be offset by more rapid economic

**Table 3.13. Major types of tax expenditure in Asia-Pacific countries**

	Likely magnitude of revenue foregone
<b>Corporate income tax</b>	
• Accelerated depreciation allowance	High
• Lower tax rates for small corporate entities	Medium
• Tax exemption of profits from special economic zones	Medium
• Lower rates on capital gains	Medium
• Charitable contributions	Small
• Tax holidays or lower tax rates for special industries and regions	Small
• Lower tax rates for publicly quoted companies	Small
• Tax exemptions for trusts and non-profit organizations	Small
<b>Personal income tax</b>	
• Tax credit/allowance for investments in securities	Medium
• Lower tax rates for senior citizens or women	Small
• Exemption of interest on investment in long-term bonds	Small
<b>Indirect taxes (domestic)</b>	
• Exemption of food items	High
• Exemption of services like education and health	Medium
• Exemption of financial services	Medium
• Zero-rating of exports	Medium
• Threshold level of exemption for small units	Medium
• Area-based exemptions	Small
<b>Customs duties</b>	
• Lower rates <sup>a</sup> for manufactured goods	High
• Lower rates <sup>a</sup> for special regions and export processing zones	High
• Lower rates <sup>a</sup> for special sector inputs (for example, textiles and pharmaceuticals)	Medium
• Lower rates <sup>a</sup> for public sector imports	Small

Source: ESCAP calculations.

<sup>a</sup> In comparison with statutory import duties.

growth. It can also be worthwhile to extend tax privileges to certain groups of individuals to address inequalities and offer incentives to increase the share of vulnerable or socially disadvantaged groups in employment.

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*Offering investment incentives can be costly and counterproductive*

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However, in many cases these concessions are unproductive.<sup>32</sup> The IMF recently compared the cost of tax concessions in terms of revenues forgone with the benefits in terms of increased foreign direct investment. It found that the “costs are very large, while the benefits appear to be marginal at best. Forgone tax revenues range between 9.5% and 16% of GDP per year, whereas total foreign direct investment does not appear to depend on concessions”. Thus, it urged “rethinking of the use of concessions”.<sup>33</sup> Several OECD studies have also concluded that offering investment incentives can be costly and counterproductive if the fundamentals of the potential investment fail to meet the requirements of serious investors.<sup>34</sup>

If foreign investors can offer something extra compared with domestic investors, it may be useful to offer them special incentives.<sup>35</sup> If they do not, preferential tax treatment only distorts competition and puts local companies at a disadvantage. Industrial policy in developing countries should instead aim to attract foreign investors by offering more extensive modern infrastructure and a more highly skilled workforce.

## POLICY OPTIONS TO ENHANCE TAX REVENUE

Countries with untapped tax potential can enhance tax revenues in a number of ways. Box 3.2 provides a few examples of innovative tax reforms in Asia and the Pacific. However, there are a number of priorities for most countries in the region. These include the need to broaden the tax base and rationalizing rates; tackling tax evasion and tax fraud;

improving tax administration and sequencing reforms appropriately; and promoting regional cooperation.

## Broadening the tax base and rationalizing rates

Governments can take a number of measures to rationalize and extend their tax systems. One objective is to avoid very high rates, which lead to disproportionate welfare losses and increase the incentive for tax evasion. There are also disadvantages of high import tariffs. By providing high levels of protection to domestic industry, they reduce competition and the incentive for achieving higher levels of efficiency. They also encourage smuggling, illicit trade and under-invoicing of imports.

Overall the objectives should be to have large tax bases with relatively low and consistent tax rates such that they do not create distortions in the allocation of resources. Potential measures include:

- (a) Reducing “tax expenditure” — Frequently, tax expenditure reflects rent-seeking behaviour by powerful, vested interests, so reducing it would make the tax system more equitable. Countries could review their tax system and retain only those exemptions or concessions that are achieving their stated objectives;
- (b) Increasing collection efficiency — Electronic tax returns and pay-as-you-earn systems can enhance collection efficiency. Countries can also think of setting up “one stop” tax collection centres at convenient locations during the annual tax return period. This has been found quite successful in Bangladesh. In the case of GST and VAT, countries could aim for simpler, more consistent systems;
- (c) Extending VAT/GST — VAT/GST frequently apply only to goods and the manufacturing sector. There is therefore substantial scope for extending VAT to services, which are often provided by large corporate entities, especially in banking and insurance, telecommunications, business-related services, information technologies, various

### Box 3.2. Recent innovative tax reforms in the Asia-Pacific region<sup>a</sup>

A number of countries in the Asia-Pacific region have implemented innovative tax reforms. In Fiji, a number of new taxes have been introduced to mobilize more domestic resources and offset a recent reduction in individual and company tax revenue. For instance, a 2% levy on all credit card purchases and payments, inclusive of interest and other bank charges, has been introduced. Fiji and India have also introduced additional taxes on high-income individuals: in Fiji, a “social responsibility tax” is levied once chargeable income goes beyond about \$142,000, in addition to the normal income tax; in India a “super tax” is levied on individuals whose income exceeds about \$170,000. Meanwhile, the Ministry of Finance of Pakistan recently published a tax directory of all taxpayers, in the hope that non-taxpayers — whose names do not appear on the list, but who are known to have significant incomes — would be shamed into compliance.

Taxes can be earmarked for high-priority expenditure. India, for example, has introduced a 3% education levy (“cess”) on income tax, corporation tax, excise and customs duties and service tax; the funds are used to provide universal access to quality basic education. Meanwhile, countries such as Bangladesh and Turkey have extended GST/VAT to private education and health providers, albeit at lower rates; whereas in India and the Philippines, a “reverse charge mechanism” on imported services has been expanded, whereby the recipient (rather than the provider) of an imported service is expected to pay the sales tax.

A number of countries have taken measures to increase corporate tax revenues. For instance, to stop avoidance of capital gains tax, in 2004 India introduced a securities transaction tax. To ensure that taxpayers refrain from incurring excessive debt levels to claim higher tax deductions, Fiji links the tax deductibility of financial charges to a maximum debt-equity ratio. In Bangladesh, an “excess profits tax” is levied on commercial banks if their profits exceed 50% of capital and reserves. In Sri Lanka, a deemed dividend tax is designed to encourage boards of companies to increase their dividends to a reasonable level; thus, tax is levied at 15% (compared to the usual dividend tax of 10% for resident companies) unless 10% or more of the distributable profits of the prior tax year are distributed by 30 September following the end of a tax year.

“Green taxes” have been used to raise revenue and to change business and consumer behaviour. In a recent report on 21 economies, the Republic of Korea, China and India ranked 2nd, 3rd and 4th in the use of tax incentives to influence corporate activity. Available tools include, for example, tax rebates for investment in renewable energy and energy conservation, and the levy of “green taxes” on polluting industries.

<sup>a</sup> This box draws upon various country studies, and the KPMG Green Tax Index 2013. Available at [www.kpmg.com/greentax](http://www.kpmg.com/greentax).

types of consultancy services, and private security. Another challenge is to extend the tax to wholesale and retail transactions, especially bringing into the tax net entities such as shopping malls, supermarkets and departmental stores in large cities. This is unlikely to worsen progressivity as low-income individuals normally do not shop there;

(d) Taxing imports of services — As countries develop, the share of trade in services increases significantly. There is therefore a case for expanding the base for customs duties to the

import of services, as it has already been done in some countries;

(e) Taxing capital gains — Capital gains are seldom taxed effectively. That may arise from the difficulty in valuing capital gains, but is more likely due to the potential negative impact on competitiveness vis-à-vis countries that do not have such a tax. However, mechanisms for taxing capital gains in securities or property have been developed by some countries and should be more widely implemented. For instance, investment income is



taxed at a flat withholding rate of 20% in China. As advocated above, the introduction of a dual income tax system in the region may be appropriate and could address the taxation of capital gains. Such a proposal should be examined more closely;

- (f) Taxing foreign operations — As countries develop business interests abroad through outward foreign direct investment, it is necessary to develop mechanisms for proper apportionment of costs between their domestic and foreign operations, so that there is no loss of tax revenues, especially in the presence of treaties for avoidance of double taxation. It is essentially through such transfer pricing that many multinational corporations are reducing their tax liabilities;
- (g) Harmonizing income tax rates — Ideally, the rate should be the same for companies and for high-income individuals. This is necessary not only to preserve the progressivity of the tax system but also to prevent distortions in the organizational form of economic activities and to prevent income shifting to reduce tax liabilities.

### Tackling tax evasion and tax fraud

Significant financial resources flow out of developing countries illicitly.<sup>36</sup> Some estimates for the losses range up to \$5.9 trillion for developing countries as a whole for the period between 2001 and 2010.<sup>37</sup> The Asia-Pacific region is considered the major source of these outflows, accounting for more than 60% of all illicit outflows from the developing world; 6 of the 10 countries with the largest illicit capital flows are in the Asia-Pacific region. Of all least developed countries, illicit outflows from Bangladesh are the largest, reaching \$35 billion between 1990 and 2008.<sup>38</sup>

One mechanism for this is trade mispricing, that is overstating the value of imports or understating the value of exports, which has the effect of transferring profits from one country to another, generally from high- to low-tax regimes. Estimates of foregone tax revenues due to bilateral trade mispricing into the

European Union and the United States between 2005 and 2007 include \$577 million for Pakistan, \$350 million for Bangladesh and \$475 million for Viet Nam.<sup>39</sup>

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### *Significant financial resources flow out of developing countries illicitly*

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Countries have adopted different mechanisms to reduce tax evasion and fraud. The most popular way is to deduct the tax at source, through withholding or advance taxes, an approach which has been applied most extensively to combat evasion of personal income tax. Table 3.14 shows the different types of deductions at source, including those on earned or unearned income, on asset transactions, on particular types of expenditure and on economic activities or sectors.

There are two potential problems with such methods. First, there can be some loss of equity, especially where the burden of the tax deduction is shifted forward. Second, there is the likelihood of high levels of refunds. In some cases, this has been avoided by converting the withholding tax into a fixed or presumptive tax. Nevertheless, the contribution of withholding taxes can be large. For example, in Pakistan and Bangladesh they account for more than half of revenue from direct taxes. Moreover, given the difficulties in collecting sales taxes from wholesalers and retailers, some countries have introduced a withholding tax at the time of sale by manufacturers to traders. Alternatively, the tax paid by the manufacturer is not on the ex-factory price but on the retail price.

Another popular instrument for tackling tax evasion is the introduction of minimum taxes on companies and associations of persons. Tax is levied either on turnover or on booked gross profits. At the same time, some South Asian countries have incorporated a provision in their income tax laws whereby certain types of persons are required compulsorily to file returns of income and wealth. Penalties are prescribed in the event of non-filing. Table 3.15

Table 3.14. Types of withholding or presumptive taxes

Withholding or presumptive taxes	
<b>On earned income</b>	<b>On consumption expenditure</b>
• Salaries	• Education fees (above a minimum level)
• Technical fees	• Electricity bills
• Commissions	• Telephone — prepaid cards
• Non-residents	• Air tickets
<b>On unearned capital income</b>	<b>On particular economic activities/sectors</b>
• Dividends	• Imports
• Bank interest and securities	• Exports
• Payment of royalties	• Services
• Return on savings schemes	• Petrol stations
<b>On asset transactions</b>	• Shipping
• Income from property	• Exploration
• Cash withdrawals from banks	• Aircraft
• Registration of cars	• Power projects
• Purchase/sale of shares on the stock exchange	• Cigarette manufacturers
	• Brick manufacturers
	• Marriage halls

Source: ESCAP, based on the tax laws of different countries.

indicates the types of persons who are covered under this provision. This approach has met with varied success.

Non-compliance with and evasion of VAT payments remain important issues in several countries. In Indonesia, for instance, estimates of VAT “gaps” have been put at between 50% and 60%.<sup>40</sup> Improving VAT compliance requires measures to strengthen the incentives for doing so voluntarily, in addition to stricter controls in the case of suspected non-compliance. Voluntary compliance could be enhanced by simplifying a number of procedures,

including not requiring an original invoice for every single transaction, faster processing of refund claims and a reduction in the number of VAT audits. At present, VAT refunds often automatically trigger a tax audit, as in Indonesia for example, making participation in the VAT system onerous and putting a heavy burden on the limited resources of the tax administration.

While tax evasion and tax fraud will always remain a problem, special tax courts could be set up to deal with this. For instance, as long ago as 1960, it was argued — in the *Economic Survey of Asia*

Table 3.15. Types of persons for compulsory filing of tax returns

- If income exceeds a certain minimum level
- If owner of property above a certain minimum size of plot in urban locations
- If telephone subscriber
- If operating a bank account and a trade license
- If registered in any professional association
- If member of any trade association
- If in possession of a taxpayer identification number
- If NGO, non-profit organization or welfare organization
- If owner of a motor vehicle (above a certain minimum size)
- If a subscriber to an industrial or commercial electricity connection

Source: ESCAP, based on the tax laws of different countries.

*and the Far East 1960* — that “Special tax courts, instead of the ordinary legal machinery for civil suits, may be instituted and the legal processes tailored to deal expeditiously with the specific problems of tax evasion. A stricter supervision of the lucrative profession of company accountants and tax advisers or consultants might also bring to light the deficiencies of tax legislation and its practical application and administration.”<sup>41</sup>

### Improving tax administration

A tax system that is both equitable and efficient will require a high-quality and effective tax administration — and one that is free from corruption, political interference and pressure from vested interests. One way to move in this direction is to give the revenue agencies a degree of institutional autonomy. Pakistan, for example, has recently established state-level autonomous revenue collection agencies.

Efficient tax administration requires adequate flows of information. Traditionally, different taxes have been collected by multiple agencies, which has made it difficult to collate information on individual taxpayers. In response, some countries have reorganized their systems along functional lines so that agencies dealing with issues such as intelligence, surveys, audits, legal issues and human resources provide inputs across all taxes.

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*Tax administrations should support taxpayers, lessen transaction costs and reduce the potential for corruption*

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One of the primary tasks for tax offices is to detect new or evading taxpayers. A wealth of information can be derived from an information system on payment of withholding tax. Cross-checking against returns filed provides the basis for determining the extent of under-filing. Also, the national statistical agency should periodically undertake censuses of establishments.

Most modern tax systems rely on the filing of returns by taxpayers on the basis of self-assessment. Ideally, all taxpayers should be able to file their returns electronically. To deter evasion this has to be backed up by an effective audit system for examining a certain proportion of returns. This should be risk based, focusing on the taxpayers who are more likely to evade. A system of rewards that is linked to the amount of tax evasion identified could be established for tax officials.

Countries also have to decide on the extent of the powers of tax officials. India, for example, allows officials to raid premises. Pakistan has recently passed legislation allowing the tax agency to access bank accounts on a selective basis — though this has been vociferously resisted by taxpayers as an invasion of privacy, and banks are also reluctant to divulge this information. Any granting of powers to tax officials must not become a source of harassment or corruption. Moreover, it is essential that taxpayers have access to a fair and judicious appeals process. Some countries have tribunals run by tax officials. A better option is to have specialized tax courts, as mentioned earlier, under the judiciary. Delays in judgements will have to be avoided by specifying a maximum time limit for a decision.

The process of documentation can be facilitated by a system of taxpayer identification numbers. The numbers can be recorded in certain specified transactions. An electronic “data warehouse” of transactions can then provide evidence for the tax liability of an individual with a taxpayer identification number.

To boost revenues some countries have periodically granted tax amnesties. For example, Pakistan has recently announced immunity from audit to taxpayers who declare 25% higher income or make a fixed payment against previous non-filing of returns. The problem with amnesty schemes is that they erode the integrity of the tax system and create a disincentive for honest taxpayers.

The overall approach of tax administrations should be to support taxpayers, lessen transaction costs and reduce the potential for corruption. The World Bank collects information on performance indicators of tax administrations. These are given in table 3.16 for a sample of Asian countries. Two conclusions emerge. First, some countries have too many taxes; countries could improve their collection efficiency by focusing on the more lucrative sources of revenue or rationalizing their tax systems. Second, the time required for filing returns can be very long; this can be reduced by simplifying returns and making them more taxpayer friendly. Electronic filing of returns will also minimize contact with tax officials and reduce the incidence of bribes. Taxpayer facilitation and guidance centres should be established.

Transparency in the formulation of tax policies and administrations could be greatly enhanced by publishing an annual tax directory, and issuing a statement of tax expenditures as part of the budget presentation. To stem corruption among tax officials, a list of their total assets should be published at regular intervals. Corruption within the tax administration could also be addressed by special tax courts.

## Sequencing tax reforms

Countries should sequence their tax reforms carefully. In hindsight it is clear, for example, that before reducing customs duties and other trade taxes, some countries should have made greater efforts to build up their income tax and VAT systems. Several countries, including India and Pakistan, failed to do so and experienced significant reductions in their tax-to-GDP ratios. Reforms should be sequenced for both tax administration and tax policy:

- (a) In the first phase of reform of the tax administration, efforts must be made to expand human capacity and to organize the administration along functional lines. At the same time, computer systems should be integrated, especially with a view to electronic filing of tax returns. This would facilitate objective, risk-based auditing;
- (b) A second phase of reforms should aim at broadening the tax base by detecting new taxpayers and improving the refunds and appeals processes. This would give taxpayers greater incentives to comply;

Table 3.16. Indicators of the quality of tax administrations in selected Asian countries

	Number of tax payments	Average number of meetings with tax officials	Percentage of firms expected to give gifts to tax officials	Time to prepare and pay taxes (hours)
Bangladesh	20	1.3	54.4	302
China	7	1.2	10.9	318
Georgia	5	0.6	8.4	280
India	33	2.6	52.3	243
Indonesia	52	0.2	14.0	259
Kazakhstan	7	2.6	25.1	188
Malaysia	13	2.1	n.a.	133
Pakistan	47	1.5	58.8	577
Philippines	36	1.5	21.8	193
Singapore	5	n.a.	n.a.	82
Sri Lanka	58	1.3	7.7	210
Turkey	11	1.3	4.0	226
Viet Nam	32	0.9	33.7	872

Source: World Bank, World Development Indicators.

Notes: Number of tax payments refers to the total number of taxes paid by businesses, including electronic filing; a tax is counted as paid once a year even if payments are more frequent. Average number of meetings with tax officials provides information on how often management meet with tax officials. Time to prepare and pay taxes is the time, in hours per year, it takes to prepare, file and pay (or withhold) three major types of taxes: corporate income tax, value added or sales tax, and labour taxes, including payroll taxes and social security contributions.

(c) A third phase would involve second-generation reforms in which tax assessments would be based on collateral evidence collected across government departments. Compliance could be strengthened further by reducing the multiplicity of taxes.

Governments will also need to sequence their reforms of tax policy.

- (a) A first phase should aim at broadening the tax base by, for instance, expanding withholding and advance tax regimes, by expanding VAT to cover both goods and services, and in particular by reducing exemptions and concessions;
- (b) A second reform phase would rationalize tax rates to reduce distortions and remove any existing tax anomalies;
- (c) Finally, a third phase could tackle second-generation reforms by, for instance, strengthening laws to regulate transfer pricing and to determine global incomes liable for taxation. These reforms should also move from a withholding and presumptive tax regime to one based on self-assessment through filing of returns.

### Promoting regional cooperation

Regional cooperation can play an important role in mobilizing domestic resources. Greater cooperation between countries would not only enable them to harmonize taxes and avoid tax competition, but would also help avoid double taxation, while tackling transfer pricing by multinational corporations. Regional cooperation can also be a useful tool to deal with tax havens. A regional tax forum of tax experts and officials could share best practices in tax policies, tax administration and tax reforms.

*Harmonizing tax rates* — Competition for foreign direct investment is leading to a “race to the bottom” in terms of taxation of profits. Countries belonging to regional associations, such as the South Asian Association for Regional Cooperation or the Association of Southeast Asian Nations,

may therefore wish to consider some degree of harmonization of taxation of profits of multinational companies.

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*Greater cooperation between countries  
would enable them to harmonize taxes  
and avoid tax competition*

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*Harmonizing import duties for transit trade* — Another area for tax harmonization is for transit trade. There is, for example, significant transit trade via Pakistan to Afghanistan, of which a high proportion is smuggling. This happens because of the non-payment of taxes on goods meant for Afghanistan at Karachi port. The two countries could harmonize their import duties on smuggling-prone items in their customs tariff schedules. Revenues on transit cargo could be collected at the port of entry in Pakistan and reverted to Afghanistan, once certification is provided of the entry of goods into Afghan territory.

*Combating transfer pricing* — Multinational corporations often price transactions between subsidiaries so as to divert more profits to low-tax countries. Regional cooperation can address such transfer pricing more forcefully. Around 20 Asian countries have already adopted transfer-pricing rules in their tax laws, mostly based on OECD lines. For instance, Indian legislation prescribes five methods to compute the “arm’s length price”. Tax officials must use the most appropriate method. The Income Tax Department of India ensures that most multinational corporations are audited for transfer pricing. This issue also highlights the case for greater harmonization of corporate tax rates.

*Combating tax havens and illicit transfers* — Regional cooperation will also be important to address the issue of tax havens and of illicit transfers of resources. Most of the options for addressing individual evasion involve better information reporting and additional enforcement. But there are also options that would involve fundamental changes in the law, such as shifting from a residence to a source basis for “passive income”, which comprises,

for instance, rental income, interest earnings and dividends. An option that appears likely to recover significant revenues is the European Union Savings Directive (Council Directive 2003/48/EC), which requires member States to exchange information about interest earned on savings accounts held by non-residents. If the beneficial owner cannot be identified, a withholding tax could be imposed — a refund would be allowed if evidence of reporting to the home country could be shown. This directive has since been extended to cover all relevant income from both EU and non-EU investment funds (Council Directive 2014/48/EU).

There are also proposals for bilateral information treaties to provide for regular and automatic exchanges of information. This would relate to both civil and criminal issues. It would not require suspicion of a crime other than tax evasion, and would override bank secrecy laws in tax havens.

*Agreements on double taxation* — A further important aspect of regional cooperation will be to broaden double tax avoidance agreements (DTAAs). These bilateral agreements aim to avoid taxing enterprises twice for the same activity. This gives corporations greater confidence and encourages investment. India, for example, has comprehensive DTAAs with 88 countries. Under the Income Tax Act 1961, sections 90 and 91 provide specific relief to taxpayers to save them from double taxation. Similarly, Pakistan has DTAAs with 63 countries. ESCAP could prepare a generic DTAA and encourage member countries to sign bilateral agreements. It can work closely with the Committee of Experts on International Cooperation in Tax Matters, which is a subsidiary body of the Economic and Social Council. The Committee is responsible for keeping under review and updating, as necessary, the United Nations Model Double Taxation Convention between Developed and Developing Countries<sup>42</sup> and the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*.<sup>43</sup>

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### *There is a strong case for establishing an Asia-Pacific tax forum*

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*An Asia-Pacific tax forum* — Finally, there is a strong case for establishing an Asia-Pacific tax forum, possibly under the aegis of ESCAP. This forum could monitor the tax legislation of member countries and publish a regular review of tax reforms. It could also hold seminars on emerging tax issues with the participation of tax officials, experts and the private sector with a view to sharing best practices. The forum could also provide training and capacity development.

## CONCLUSION

Countries across the Asia-Pacific region have significant potential for enhancing tax revenues. They can improve the quality of tax administration, rationalize tax rates, scale down tax expenditures and introduce mechanisms for curbing tax evasion.

While taxation is primarily a domestic policy issue, there are also many regional dimensions. Greater regional cooperation can strengthen domestic resource mobilization — particularly by enabling countries to avoid tax competition and to harmonize tax rates. Such cooperation could also involve exchanging information on cross-border capital flows into tax havens, tackling illicit transfers of funds, and signing agreements on double taxation.

The United Nations could play a useful role in developing conventions for the exchange of information among Asia-Pacific countries and between regions. ESCAP could set up an Asia-Pacific tax forum, which could act as a repository of tax laws, conduct periodic tax reviews of countries and hold seminars on emerging tax-related issues.

## Annex I. Data used in this chapter

Data on tax revenue in this chapter have been sourced from the Government Finance Statistics database of the IMF and augmented by data from CEIC, national data sources and several background country studies that were commissioned for this chapter.

In principle, data are available for 34 developing countries, including: Afghanistan; Armenia; Azerbaijan; Bangladesh; Bhutan; Cambodia; China; Fiji; Georgia; Hong Kong, China; India; Indonesia; Iran (Islamic Republic of); Kazakhstan; Kyrgyzstan; Macao, China; Malaysia; Maldives; Mongolia; Myanmar; Nepal; Pakistan; Papua New Guinea; Philippines; Republic of Korea; Russian Federation; Singapore; Sri Lanka; Tajikistan; Thailand; Turkey; Uzbekistan; Vanuatu and Viet Nam. Data were also available for the three developed countries in the region: Australia, Japan and New Zealand.

The data cover the period from 1990 to 2011, unless otherwise noted. However, gaps exist for individual countries at different points in time. Also, unless otherwise noted, the data refer to central government data for all countries except for China, India, the Islamic Republic of Iran, Kazakhstan, Malaysia, the Russian Federation and Thailand. For these countries, data refer to general government data (unless otherwise noted) due to the significant difference (defined here as equivalent to more than 1 percentage point of GDP) between revenues collected at the central and at the general government level.

## Annex II. Computation of tax buoyancy

There are a number of ways to calculate tax buoyancies (see Haughton, 1998). Due to the limitations of data availability, tax buoyancies in this chapter were estimated by calculating the ratio between the growth rate of nominal tax revenue and the growth rate of nominal GDP between two points in time. One advantage of this method helps to overcome short-term exceptional deviations and provides a broad picture of the reactivity of the fiscal system of a country.

Specifically, buoyancies were computed by using the following formula for two periods,  $t$  and  $t+k$ :

$$b_{t+k,t} = \frac{\Delta TAX_t / TAX_t}{\Delta GDP_t / GDP_t}$$

where  $\Delta TAX$  represents the change in nominal tax revenues received by the Government during the period  $[t; t+k]$  and  $\Delta GDP$  represents the change in nominal GDP during the period  $[t; t+k]$ .

## Annex III. Estimation of tax potential and tax gap

Tax potential represents the potential level of tax revenues as a percentage of GDP which corresponds to the structure of the economy. To capture the structure of economies, three commonly used variables were included in the estimation: the valued added of the agricultural sector, expressed as a percentage of GDP (*AGRI*); GDP per capita (*GDPPC*); and the degree of trade openness in a country (*TRADE*), calculated as the sum of exports and imports as a percentage of nominal GDP. Thus, the following equation was estimated over the period between 1990 and 2012 for a total of 144 countries:

$$tax_{it} = \beta_1 \cdot AGRI_{it} + \beta_2 \cdot GDPPC_{it} + \beta_3 \cdot TRADE_{it} + C + D + \varepsilon_{it}$$

$i$  and  $t$  correspond respectively to cross-section identifiers and to time and  $C$  denotes the intercept.

Regional dummies ( $D$ ) were introduced to consider regional differences for Asia and the Pacific (*AP*), Europe (*EU*), sub-Saharan Africa (*SS*), Latin America and the Caribbean (*LAC*), and the Middle East (*ME*).

The estimation of coefficients was based on a generalized-least-squares approach with panel data. Potential heteroskedasticity of residuals was overcome by applying cross-section weights. The results of the estimation, with relevant test statistics showing a relatively good fit, are reported in table A1 below.

Table A1. Estimation results

Variable	Coefficient	Standard error	t-statistic
TRADE	0.01	0.00	7.98
AGRI	-0.24	0.01	-34.36
GDPPC	0.34	0.04	8.32
LAC	4.15	0.40	10.36
ME	5.62	0.49	11.39
SS	10.36	0.41	25.23
AP	6.28	0.40	15.72
EU	8.46	0.37	22.72
Constant C	12.24	0.39	31.42
R <sup>2</sup>	0.75	S.E. of regression	6.58
Adjusted R <sup>2</sup>	0.75	Sum-squared residuals	81 264.54
F-statistic	694.01	Prob (F-statistic)	0.0

Source: ESCAP calculations.

On the basis of estimated coefficients, predicted values of tax revenues (as percentages of GDP) were computed as follows:

$$\widehat{tax}_{it} = \widehat{\beta}_1 \cdot AGRI_{it} + \widehat{\beta}_2 \cdot GDPPC_{it} + \widehat{\beta}_3 \cdot TRADE_{it} + \widehat{Cte} + \widehat{D}$$

For each country, the ratio between the actual tax-to-GDP ratio and the predicted ratio was computed:

$r_{it} = \frac{tax_{it}}{\widehat{tax}_{it}}$ ; where  $tax_{it}$  represents the observed value of the tax revenue. The tax potential was determined as follows:

$$tax\ potential_{it} = \frac{tax^*_{it}}{\frac{1}{n} \sum r_{it}}$$

where  $n$  represents the number of observations for a country  $i$  and  $tax^*_{it}$  represents the most recent value of the tax revenue (which may not have been considered in the regression).

For each country, the tax gap is equal to the difference between the tax potential and the most recent tax revenue received by the Government. If the difference is positive, countries are currently collecting fewer taxes than the structure, as captured by their level of income per capita, the size of their agricultural sector, and the openness of their economies, would suggest.

## Endnotes

- 1 Kaldor (1963) points out that “whereas the ‘developed’ countries collect 25% to 30% of their GNP in taxation, the underdeveloped countries typically collect only 8% to 15%”. He further argued that, if a country wishes to become “developed”, it needs to collect in taxes an amount greater than the 8% to 15% found in many developing countries. He highlighted that the “developed” countries collected 25% to 30% of their GNP in taxation. Martin and Lewis (1956) held that “... the government of an under-developed country needs to be able to raise revenue of about 17% to 19% of GNP in order to give a not better than average standard of service”.
- 2 However, levels of public indebtedness still compare favourably considering an average level of more than 90% of GDP in the eurozone and 116% of GDP in the developed G20 economies.
- 3 For instance, with foreign denominated debt, any currency depreciation in a recession would increase the debt ratio as the domestic currency value of debt increases. That could trigger a debt crisis as the Government would have to pursue countercyclical fiscal policy to respond to recession.
- 4 The IMF (2013:27) also points this out, stating that “[a] reorientation of public spending (for example, through the reduction of subsidies and containment of wage spending, complemented with targeted measures to protect the poor) could facilitate faster consolidation while supporting growth and social conditions.”
- 5 IEA (2013).



- <sup>6</sup> Subsidizing some critical sectors of an economy may be needed for building productive capacity and acquiring competitive advantage. But there is always the risk of perpetuating infant industries unless subsidies are given with a very clear objective, for example, to be able to export a certain proportion of the product subsidized by a targeted year. Likewise, while consumption subsidies are important for the poor, they are also an inefficient way to reach policy objectives as they may not be well targeted.
- <sup>7</sup> See IMF (2010).
- <sup>8</sup> See endnote 1.
- <sup>9</sup> As highlighted by the IMF (2013:29).
- <sup>10</sup> In two other landlocked countries, Mongolia and Kazakhstan, taxes on international trade remain relatively important, accounting for between 20% and 40% of indirect taxes. However, these two countries may represent outliers, benefitting from their abundant natural resources.
- <sup>11</sup> KPMG International (2013a).
- <sup>12</sup> Karim and Alauddin (2012).
- <sup>13</sup> India, Ministry of Finance (2012).
- <sup>14</sup> Shukla and others (2011).
- <sup>15</sup> Musgrave (1969).
- <sup>16</sup> Atkinson and Stiglitz (1976) consider the interaction of direct and indirect taxes in the attainment of efficiency and equity goals and show that when individuals differ only in their earning ability, Government can impose a general income tax and where the utility function is separable between labour and all commodities, there is no need to employ indirect taxation in the optimum tax design.
- <sup>17</sup> As noted in ESCAP (1983:107), “the calculation of such measures can be a useful preliminary exercise in national tax policy self-assessment and can activate policy makers in efforts towards improved resource mobilization performance”.
- <sup>18</sup> Doraisami (2011).
- <sup>19</sup> Deloitte (2009).
- <sup>20</sup> Musgrave and Musgrave (1989).
- <sup>21</sup> Details of the econometric analysis and method of calculation of the tax gap and the tax potential are provided in annex III.
- <sup>22</sup> However, in Pakistan small companies may be taxed at 25% subject to specific conditions.
- <sup>23</sup> Chen, Huang and Regis (2013).
- <sup>24</sup> See, for example, Myers (2011).
- <sup>25</sup> Abbas and Klemm (2012).
- <sup>26</sup> Saavedra (2007).
- <sup>27</sup> Ivanova, Keen and Klemm (2005).
- <sup>28</sup> Bird and Zolt (2011).
- <sup>29</sup> Bernardi, Gandullia and Fumagalli (2005).
- <sup>30</sup> Faridy and Sarker (2011).
- <sup>31</sup> Emran and Stiglitz (2005).
- <sup>32</sup> Bernardi, Gandullia and Fumagalli (2005).
- <sup>33</sup> Chai and Goyal (2008).
- <sup>34</sup> Oman (2000) and OECD (2001).
- <sup>35</sup> Blomström, Kokko and Mucchielli (2003).
- <sup>36</sup> The term “tax avoidance” refers to transactions that take place by individuals and corporations that fall within the scope of national and international laws, such as by moving revenues to lower-tax jurisdictions to reduce tax liabilities. “Tax evasion” and “tax fraud” refer to transactions that take place to conceal resources and remove them illicitly from any taxation. Examples of tax evasion and tax fraud include, for instance, under-reporting taxable income or transferring it illicitly outside of relevant tax jurisdictions.
- <sup>37</sup> Kar and Freitas (2012).
- <sup>38</sup> Kar (2011).
- <sup>39</sup> Christian Aid (2009).
- <sup>40</sup> Silvani and others (2008).
- <sup>41</sup> Economic Commission for Asia and the Far East (1961).
- <sup>42</sup> United Nations (2011b).
- <sup>43</sup> United Nations (2003).