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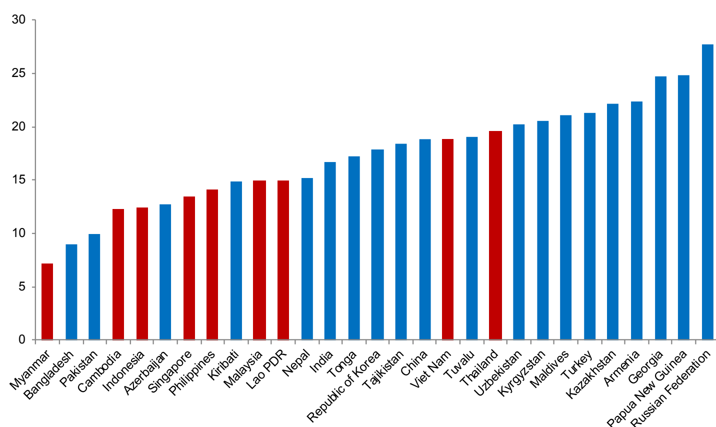
Improving tax policy and administration in South-East Asia

An important function of the government is to collect taxes for the provision of public goods. While a number of South-East Asian economies, such as Indonesia and the Philippines, have relatively low tax revenues as a share of GDP, there is renewed public interest in strengthening tax revenues for better education, healthcare and infrastructure, especially in the context of the recently adopted 2030 Agenda for Sustainable Development. This policy brief discusses how improvements in tax policy and administration could help raise adequate revenues and provides illustrative estimates of 'potential' tax revenues.

Total tax revenues in South-East Asian economies as a share of GDP ranged between 12.4 percent in Indonesia and 19.6 percent in Thailand in 2013 (figure 1).[1] While the 'optimal' tax-GDP ratio would depend on a number of factors – such as a country's preference for public goods, the availability of non-tax revenues, and the structural characteristics of the economy – by all accounts, there seems to be room for increasing tax revenues in a number of countries. For instance, ESCAP (2014) found that Indonesia's 'potential' tax-GDP ratio is approximately 4 to 5 percentage points higher than the actual level.[2]

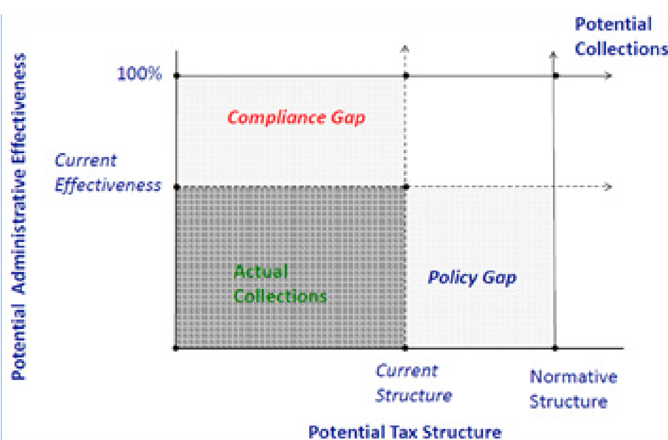
Intuitively, tax revenues can be below 'potential' for two reasons: a tax law which allows for various exemptions and the imperfect implementation of the tax law. For instance, in South-East Asia, the tax base tends to be narrow due to various exemptions and incentives such as tax holidays and investment allowances. At the same time, tax compliance tends to be low due to weak enforcement and inadequate taxpayer services. Taken together, the actual revenue could be below potential, as illustrated in figure 2, where the former is labeled 'policy gap' and the latter 'compliance gap.'[3] These two gaps are discussed below in the context of different income and consumption taxes.

Figure 1. Tax revenues in South-East Asian and other regional economies, % of GDP in 2013



Source: IMF World Revenue Longitudinal Dataset (accessed 20 October 2015).

Figure 2. Visualizing the tax gap



Source: IMF Revenue Administration-Gap Analysis Program (RA-GAP).

The revenue contribution of personal income tax (PIT) is generally low in South-East Asia compared to other parts of the world, despite fast growth of high-income individuals and the need for some redistribution of incomes against rising inequality. Among middle-income economies, PIT revenue as a share of GDP ranged from 0.8 percent in Indonesia to 2.4 percent in Malaysia in 2012. While raising the top marginal rate may be difficult, partly due to the need to align corporate and personal tax rates to some extent[4], there seems to be room to lower the income threshold for the top bracket, particularly in the Philippines, Thailand and Viet Nam, where it is 23 to 30 times higher than the country's per capita income.[5] At the same time, compliance measures can be strengthened, especially for high-income individuals and self-employed professionals that have greater opportunities for tax evasion and avoidance compared to regular employees whose wages are subject to withholding. Some of them may not even be registered. For instance in Indonesia, it is estimated that out of a population of 255 million, at least 44 million should be paying taxes, whereas the reality is that just 27 million are registered, of which only 10 million pay income tax in full every year.[6]

As in many developing economies, the corporate income tax (CIT) has been a major source of government revenue in South-East Asia, contributing between 3.5 percent of GDP in the Philippines and 9 percent of GDP in Malaysia in 2012.

However, it is increasingly coming under pressure due to higher global economic integration, including mobility of capital. While declining CIT rate is a worldwide trend, the problem seems to have been exacerbated in South-East Asia with ASEAN integration. Since the adoption of the ASEAN Economic Community blueprint in 2007, several countries have further reduced their CIT rate and expanded tax incentives and exemptions for investors (table 1).

Table 1. Tax incentives

	Max. tax holiday years	Reduced tax rate	Investment allowance/tax credit	R&D incentives	Super deductions	SEZ
Cambodia	9	x	x			x
Indonesia	20		x			x
Lao PDR	10	x		x		x
Malaysia	10	x	x	x	x	x
Myanmar	5	x	x	x		x
Philippines	6	x		x		x
Singapore	negotiable	x	x	x	x	x
Thailand	11	x	x	x	x	x
Viet Nam	4	x		x		x

Source: World Bank. *East Asia Pacific Economic Update, October 2015: Staying the Course* (Washington, D.C., 2015).

Viet Nam lowered its CIT rate from 25 to 22 percent in 2014, to be lowered to 20 percent in 2016; Indonesia expanded its tax holiday from 10 to 20 years in August 2015; and Thailand's new investment promotion strategy expands provisions for reduced rates. This is in contrast to the trend in OECD countries, where revenue loss from lower rates has been offset by base-broadening measures.[7] Therefore some tax coordination amongst ASEAN member countries seems desirable in order to avoid excessive tax competition. Additionally, tax incentives can potentially erode revenues further by making enforcement more challenging. For instance, investors could use transfer pricing to funnel profits from an existing profitable company through the "tax holiday" company and completely avoid paying taxes.[8]

The value-added tax (VAT) has helped to offset government revenue losses from trade liberalization in recent decades.[9] In South-East Asia, VAT revenues stood between 2.2 percent of GDP in the Philippines and 4.5 percent of GDP in Thailand in 2012. Lately, Malaysia introduced a goods and services tax (GST), a variant of VAT, in April 2015 to broaden its tax base and rely less on oil revenues. Despite its relative success, there seems to be room to expand the VAT base, as there are currently many exemptions and zero-rating on areas such as petroleum products and legal services. The services sector in particular tends to maintain traditional sales taxes and has yet to transit to VAT, which encourages production efficiency and also tax compliance. Another issue is the VAT threshold for small businesses; while they are difficult to manage and have limited revenue potential, bringing them into the tax net has several benefits for both parties, such as enhanced taxpayer morale and record-keeping capacities.[10] At the same time, current VAT rates in South-East Asia are generally lower than in other parts of the world and there seems to be room to raise rates, especially in Malaysia and Thailand (table 2).[11]

Table 2. Statutory tax rates in 2015, %

	PIT	CIT	VAT/sales	SS-EE	SS-ER	WHT
Brunei Darussalam		20		8.5		
Cambodia	20	20	10		0.8	14
Indonesia	30	25	10	2	5.74	20
Lao PDR	25	24	10	5.5	6	10
Malaysia	25	25	6	11	12	
Myanmar	25	25	5	1.5	2.5	
Philippines	32	30	12	3.63	7.37	15
Singapore	20	17	7	20	17	
Thailand	35	20	7	4	5	10
Viet Nam	35	22	10	8	18	

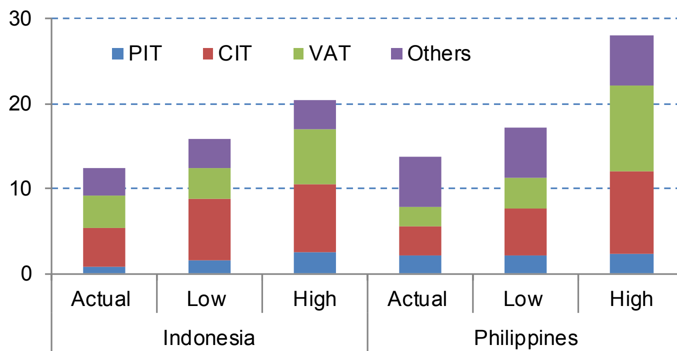
Source: National tax administrations and KPMG.
Note: Top marginal rates for PIT and CIT. Standard rates for VAT/sales. SS= social security contributions by employee (EE) and employer (ER). WHT = withholding tax on dividends. No entry indicates that such taxes are not collected.

Conceptually, the VAT is supposed to facilitate compliance through a built-in incentive structure. However, automatic audits on all VAT refund claims, as practiced in many countries, tend to increase compliance costs for smaller firms while over-looking unreported cash transactions which could be better tackled through risk-based auditing.

Given that many governments are seeking to increase tax revenues, it may be helpful to get a sense of how much is feasible. ESCAP (2014) provides estimates on 'potential' revenue based on a regression of structural characteristics of the economy. Complementary estimates are provided here, based on a simple methodology often employed for estimating VAT efficiency, known as C-efficiency in the literature. The basic idea is that revenue should equal the multiple of the rate, the base, and an efficiency factor – a residual which could be attributed to the policy and compliance gaps illustrated in Figure 2. Compared to back of the envelop calculations, which typically assume the GDP as the tax base, effort is made to capture the tax base more accurately. For instance, for PIT, tax efficiency is defined as tax revenues divided by the multiple of the tax rate and the share of wages in national income. Malaysia marks high on income tax efficiency whereas Thailand performs well on VAT efficiency in a group which also includes Indonesia and the Philippines.[12] These estimates can be used to derive a range of potential revenue increases, as shown in

figure 3.[13] The results suggest that Indonesia, for instance, could increase tax revenues by up to 7.9 percentage points of GDP by enhancing their tax efficiency to the levels of its peers, even without an increase in the statutory tax rate. This could entail tax policy measures such as rationalizing redundant tax incentives and tax compliance measures such as arrears collection. The potential is even greater for the Philippines, especially for VAT, given the large share of consumption in the economy.

Figure 3. Actual versus 'potential' tax revenues, % of GDP



Source: ESCAP based on data from CEIC Data, IMF, KPMG and Penn World Table.
Note: Actual data is from 2012. Group includes Malaysia and Thailand. 'Others' include excises and trade taxes.

Tax reforms can be challenging and the outcomes sometimes disappointing, as they require institutional capacity strengthening and effective governance, which cannot be achieved overnight. Setting medium-term strategies and targets are therefore recommended. Political leadership is critical. To ensure that tax policy and administration are properly aligned, governments could focus more on improving coordination among finance ministry, board of investment and other bodies that grant tax incentives, regional and local governments, and the revenue administration.

To narrow 'policy gaps', a recommendation highly relevant but not limited to the CIT is that governments publish tax expenditures as part of their national budget reporting. This would help enhance transparency and encourage proper cost-benefit analysis of tax exemptions and incentives. Countries could also intensify regional dialogue to curb excessive tax competition. Regarding PIT, given the increasing challenges of implementing a 'global income tax', governments may consider adopting a 'dual income tax' which levies a proportional rate on capital income and a progressive rate on labour income.

Tax compliance related priorities include effectively engaging the taxpayers in the process of registration, collection, audit and appeals while making good use of information technology and modern tools of tax enforcement such as withholding and third-party information sharing. Staff development is critical for all these activities. Better taxpayer services are needed to encourage voluntary compliance. As noted in the case of VAT, risked-based audit rather than automatic audits on all refund claims could help ease administrative pressure and improve compliance.

Additionally, it seems that corrective taxes such as those levied on tobacco or fuel are underutilized in South-East Asia, but they could contribute to revenues and enhance social welfare by addressing health and environmental externalities. Examples include the Philippines' excise on alcohol and tobacco and Viet Nam's environmental protection tax. Wealth related taxes such as on property, inheritance or capital gains are also underutilized, but could be a stable and progressive source of revenue, including for local governments. Thailand plans to introduce an inheritance tax in 2016. While these taxes may not be big revenue-raisers like VAT, the marginal impact could be significant.

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[1] Excluding Brunei Darussalam and Timor-Leste, which derive most of their government revenues from oil and gas sectors, with a fine line between tax and non-tax revenues.

[2] ESCAP (2014), *Economic and Social Survey of Asia and the Pacific 2014*. Bangkok. While estimates of tax potential tend to be sensitive to specification and thus should be regarded as illustrative, other studies also arrive at similar conclusions.

[3] See also Keen, Michael (2013), "The Anatomy of the VAT." IMF Working Paper 13/111. Washington, D.C.: International Monetary Fund.

[4] This is to minimize the incentive for shifting income from the personal to the corporate tax base, for instance, by changing the forms of compensation, activity or asset.

[5] ESCAP (2014), *Economic and Social Survey of Asia and the Pacific 2014*. Bangkok: ESCAP.

[6] Estimates by Indonesia's Ministry of Finance, as cited in "Can Indonesia boost tax revenue by 30%?" *Wall Street Journal*, 14 April 2015.

[7] Countries in South-East Asia typically offer five to eight types of tax incentives to firms, compared to only one or two in many developed economies. The empirical evidence suggests that reduced tax rates and incentives can attract foreign investment, but only where other business conditions are good.

[8] World Bank (2015). *East Asia Pacific Economic Update, October 2015: Staying the Course*. Washington, D.C.: World Bank.

[9] Tax revenues from international trade is set to decline further, including in Cambodia, the Philippines and Viet Nam, which were given a longer adjustment period to reduce tariffs in the ASEAN integration process.

[10] IMF (2011), "Revenue mobilization in developing countries." Washington, D.C.: International Monetary Fund.

[11] Thailand's VAT was lowered from 10 to 7 percent as a temporary measure in response to the global financial crisis, but has not been restored yet due to persistent weak recovery of the economy.

[12] These four middle-income countries are more homogenous in terms of the economic structure and tax system.

[13] Using the efficiency factors of the top performer and the country with a mark just above the concerned country provides the upper and lower bounds, assuming no changes in the tax rate and base.

The MPFD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. This issue is prepared by Daniel Jeongdae Lee. This policy brief benefitted from comments by Hamza Ali Malik and previous study by Oliver Paddison and Steve Loris Gui-Diby. For further information on this issue, please contact Aynul Hasan, Director, Macroeconomic Policy and Financing for Development Division, ESCAP (escap-mpdd@un.org)

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