

TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA:  
OVERVIEW OF THE TAX SYSTEMS AND MAIN TAX POLICY  
ISSUES

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# TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA: OVERVIEW OF THE TAX SYSTEMS AND MAIN TAX POLICY ISSUES



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## **Abstract**

This paper is part of a wider research on South and East Asian countries' taxation, carried out in this Department, under the direction of L. Bernardi, A. Frascini and P. Shome, and under the supervision of V. Tanzi. South and East Asia are a particularly fast developing world economic areas, and are becoming increasingly more economically integrated. These countries, however, are not homogenous, and are lacking in any supra - national Authority. The total fiscal pressure of South and East Asian countries looks somewhat low when compared to that of countries with a similar per-capita income, pertaining to other economic world areas. However, a smooth Wagner law is confirmed by the data so that fiscal pressure is destined somewhat to increase as growth continues. With regards to similar experiences of developing and transition countries, indirect taxes prevail over direct ones. Low tax wedges on labor improve efficiency, by inducing both the supply and demand of labor. The heavy burden on consumption lessens equity and increases welfare losses. Any further uniform analysis of South and East Asian countries' tax policy issues would be however quite fruitless. It is far better to consider tax policies issues which rise inside the whole area separately to those more specific to each cluster made up by similar countries. Intra-regional economic integration poses severe challenges to the tax structure in the Asian area. Three tax policy issues seem most problematic: the building of intra-countries' agreements on reducing trade tariffs; the sequential revenue consequences of reduction in foreign trade taxes; the increasing tax competition for FDI. Intra-countries clusters' tax policy issues differ from each other. In Japan and in South Korea different choices have been made regarding the comprehensiveness of the PIT's basis, whose burden as a consequence ends up being more fairly distributed in South Korea. The two countries are facing the common problem of an ageing population and consequentially, social contributions, and eventually VAT are being raised. Malaysia's direct taxes look higher than Thailand's, but this is only because of the taxation of oil companies. Thailand has adopted VAT, while Malaysia has not changed its traditional sales tax. Both the countries are engaged in the recovery of revenue by improving tax administration. Both in China and in India income tax is small and poorly redistributing. Also, India has just moved from a schedular to a comprehensive tax basis. VAT is well established in China, while it is just arriving in India, as a consequence of a long waited but challenging reform, especially regarding the tax relationships among levels of government. Taxing power is now more centralized in China, but this needs to be corrected in order to avoid a lack of accountability on the part of the provinces.

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## **1. Introduction, contents and main conclusions**

When compared with other areas of the world's economy, the case of South and East Asia is somewhat particular. The region is not just fast growing, but also highly integrated, as in North America or in Western Europe, for instance. The participant countries are, however, barely homogeneous, like in South America or, at a lesser degree, in Eastern Europe. There is a lack of a supra-national authority able to provide coordinating policies for single countries and to harmonize their institutions. This particular feature is fraught with consequences for most tax policy issues.

The total fiscal pressure of South and East Asian countries looks somewhat low when compared to that of countries with a similar per-capita income, pertaining to other economic world areas. The main explaining factors can essentially be found, firstly, in the absence, or in a very small level, of social contributions, and, secondly, in a still widespread infant stage of the personal income tax. However, a smooth Wagner law is confirmed by the data, so that fiscal pressure is destined somewhat to increase as growth continues. According to a common experience of developing and transition countries, indirect taxes prevail over direct ones. The exceptions are, of course, Japan (but not South Korea) and, more surprisingly, Malaysia. Corporation tax's revenue usually stays higher than personal income tax, despite the flood of incentives allowed for corporations. On the contrary, PIT is still in its primary stages everywhere except in Japan. VAT is well established in China, Japan, and South Korea, where it prevails on excise duties, and has just been introduced in April 2005 in India. Custom duties, entirely on imports, are still present in India, China, and Thailand. A relevant consequence of such a prevailing tax structure is the particular ranking of the implicit tax rates. It is only in Japan and Korea that labor income is more heavily taxed than capital and consumption, while the opposite happens in Malaysia and Thailand. The same may be said for China and India. A low tax wedge on labor (due to the limited role played by PIT and the absence or the irrelevance of social contributions) improves the efficiency, by inducing both supply and demand of labor. Generally speaking, the heavy burden on consumption lessens the equity, as the taxes affect the prices in a regressive way. In terms of welfare (consumer's surplus) the excess burden increases.

The previous data and information make it clear that any uniform analysis of the South and East Asian countries' tax policy issues would be quite fruitless. It is far better to consider the following tax policies' issues separately: firstly, those which arise inside the whole area and secondly those more specific to each country. The latter may be organized according to the clusters of some countries which emerge in their economic and social characteristics, and also in their tax systems (India and China; Malaysia and Thailand; Japan and South Korea).

Intra-regional economic integration poses severe challenges to the tax structure in the Asian area. As trade barriers come down and capital mobility increases, the challenges for South and East Asian countries become particularly acute, because of their tax administration capabilities and their dependence on foreign trade taxes that are relatively more limited. Three tax policy areas seem more problematic: the building of intra-countries' agreements on reducing trade tariffs; the revenue consequences of trade reform with reduction in foreign trade taxes, and the increasing tax competition for direct foreign investment.

Around the world there has been a substantial growth in common markets, customs union and free trade areas. Also in the Asian area there are two blocs of countries where the economic cooperation and integration has been strengthened during the past few years. The first bloc is represented by the Association of Southeast Asian Nations (ASEAN) that recently implemented the ASEAN Free Trade Area (AFTA), making significant progresses in trade and investment liberalization by the lowering of tariffs in intra-regional trade. At present a second bloc is represented by the South Asian Free Trade Area (SAFTA), comprised of India and six other countries, where tariffs on internal trade are going to be eliminated. SAFTA was agreed to between the seven South Asian countries that form the South Asian Association for Regional Cooperation (SAARC). SAFTA will come into effect in 2006.

As is well-known, developing countries and emerging markets still rely on trade taxes. For different reasons, trade taxes on imports have been often introduced to protect domestic production and those on exports reflect in part the export of primary products over which the country has some monopolistic power. Standard economic theory suggests that taxes on international trade have a major distorting effect and that efficiency gains deriving from their reduction far outweigh the loss of such revenue

sources. The reduction of taxes on import trade often runs into serious political opposition, due to the pressure of domestic producers. Moreover, one of the most important constraints to trade reform in such countries is the conflict between tariff reforms and macro-stabilization goals. The adverse revenue impact of tariff reductions could be addressed in the short run by reducing existing exemptions, by removing highly restrictive non-tariff barriers and by relying on the expected import volume growth. But in the long run it will require the implementation of compensatory revenue measures

It is in the area of tax competition where the growing economic integration and capital movements between Asian countries pose relevant challenges to the existing national tax structures. As non-tax barriers decline, investment decisions and location of investment become more tax sensitive. Within free trade areas firms can supply different national markets from a single location. The relevant issue here is the temptation for such countries to broaden the scope of tax incentives to attract and compete for foreign direct investment (FDI). The main argument in favor of these national policies is that FDI can contribute to increase the productivity of the domestic economy, but the effectiveness of tax incentives is highly questionable. Almost all South and East Asian countries have made and still make extensive use of tax (but also non-tax) incentives to compete for promoting domestic investment and especially to attract FDI. However, in the next years the use of tax incentives for the promotion of FDI will require a coordinated multilateral approach, at least on a regional basis. Agreements on a regional basis - for instance between the member countries of the ACFTA and those belonging to SAFTA - could create different kinds and varying degrees of cooperation. Countries for instance could agree on a limited set of tax incentives, conditioned to certain criteria.

With regards to intra-countries clusters' tax policy issues, it is primarily necessary to note that in Japan and South Korea, a striking differences emerges in terms of their PIT structure. Looking at the features of PIT, we can point out an important dissimilarity that attests the existence of two alternative theoretical visions in addressing the problem of personal taxation. The original (1940s) structure of the first Japanese personal income tax system was based on an idea of comprehensive taxation, but this was soon transformed into a system founded on a notion of expenditure income. On the

contrary, South Korea still maintains a “global” income taxation that aggregates most personal income, (inclusive of many forms of capital revenues) taxing it at progressive rates. Therefore, in the debate between the two aspects of equality, Japan and South Korea have taken opposite directions. Whereas the reforms implemented in South Korea in the 1990s put increasing effort in extending the tax base, Japan sets up a complex set of allowances that made the base smaller and smaller.

A second issue that has to be discussed when comparing South Korea and Japan is the way in which the two countries are handling the problem of a troublesome raise of the expense needed for pensions. The growing imbalance due to an aging population constitutes a worrying threat for the pension system. Both Japan and South Korea opted for a sharp increase in the share of social security contributions, but, whereas in Japan the population structure shows the typical features of a developed country (inverted pyramid type), in South Korea the demographical transition is still at an earlier stage so that the pensions’ system imbalance looks less pressing. It is clear however, that a VAT increase could be recommended in both countries, provided that VAT hits in a non distortionary way especially the aged, whose pensions in these countries are exempt from income tax.

As to the cluster made up by Malaysia and Thailand, at first glance Malaysia presents direct taxes that seem far higher than in Thailand and near in line with OECD standards. In fact the value of corporate income taxation accounts for a comparatively high value. Nevertheless, this value is inappropriate for evaluating the real impact of the average fiscal pressure on corporations in Malaysia, since it also includes a peculiar tax levied on petroleum companies whose tax rate is much higher than the “standard” one.

In both the two countries PIT has a narrow weight. It relies on a progressive schedule with many brackets and a widely spread set of tax rates. However, the scarce pervasiveness of the tax, along with the massive use of personal relieves and personal tax rebates makes the pursuit of horizontal equity almost infeasible. With regards to indirect taxation a peculiar feature in Malaysia is, firstly, the complete absence of any kind of value added tax. In fact the most important heading of indirect tax is an ad valorem single stage tax, imposed at the import and manufacturing levels. The main problem that arises is the existence of cascading non neutral price effects. An attention

to low income earners in the shaping of consumption taxes can be found in both countries.

After the Asian financial crisis, Malaysia and Thailand also had to find a way to recover their revenues. The main field in which both countries are increasing their efforts is in the strengthening of revenue collection. In order to achieve this goal, one of the fundamental pillars in the agenda of the two governments is the rationalization of administrative procedures and the improvement of the efficiency of tax administration.

Finally, we must consider China and India. Let us first look at direct taxation. In India, personal income tax is imposed by the Union Government. It may look supply friendly: the tax brackets are few and rates' graduation is not steep. Taxable income is very similar to global income according to Haig-Simons definition. However, many personal exemptions narrow the tax base, so limiting the effects of the aggregation of incomes. The Chinese system of personal income taxation presents opposite features. The Chinese PIT has a "pure" schedular structure with many different types of income taxed at different rates, no aggregation of alternative sources of earnings and no personal deductions. As a consequence, in China like in India, albeit due to different factors, there is both a loss on the ground of progressivity, and a fall in the total tax burden. With regards to corporate taxation, the main field for tax planning in China is the tax environment created by some special incentives granted to foreign enterprises, in particular, a generous tax holiday which adds to an investment-encouraging tax regime of amortization. While useful to attract foreign investors, tax holidays in time may be harmful because some "race to the bottom phenomena" can be ensued, as well as a raise in the relative tax burden on home taxpayers.

In the field of indirect taxation the two countries feature important differences. In China the main indirect tax is the value added tax, which recently has been widely updated. In India until 2004 VAT was absent. From 1 April 2005 VAT has been finally introduced. This reform is expected to be welfare improving, since VAT will substitute for a huge, complex and distortionary amount of sales tax and excise duties. In practice, however, such a large reform will have to get over some difficult challenges, as the taxation of services, the adequacy of the tax administration and concerning the complex structure of intergovernmental tax-relationships. The system of public finance is now, after the reforms of the 1990s, more centralized in China, and most taxes are charged by

the central government which transfers part of the revenue to the inferior layers. The system can be powerful to per-equate fiscal capacities among provinces, while weakening their fiscal responsibility. Hence now it is under reform, to avoid harmful fiscal imbalances of the lower layers and in order to increase their budget transparency and fiscal effort.

## **2. How much are South and East Asia economies and tax systems uniform?**

### **2.1 Like, unlike or clusters' economies?**

To begin with, look at the top rows of Table 1. Our selected sample of South and East Asian countries seems to be made up of dissimilar countries, in terms of their geo-demographical features. China is 9,572 thousand Km<sup>2</sup> large, Malaysia just 48. India 3,278, South Korea not more than 99. China and India are populated by more than 1 billion people; Malaysia, South Korea and Thailand stay under 40 million. Therefore population on area ratio looks casually uneven. A historical and cultural perspective confirms this first glance. China and Japan have their roots in long lasting unitary empires, although they reached their present state in very different ways. India was a British dominion until 1947. South Korea was dominated by Japan from 1919 until 1945. At that time an independent Republic took place on the whole South Korean peninsula. However South Korea emerged as separate and western liking state just in 1953 after the war with the communist North region. Thailand has been an independent kingdom since 1932; Malaysia only ceased to be a part of the British Empire in 1957. Races, religions, languages, social aptitudes and institutions are fairly different.

Notwithstanding all this, especially during recent decades, albeit beginning at different starting times, these countries shared a common way of fast catching up growth that was quite sustainable in terms of inflationary pressures and (with just Japan's and Malaysia's exceptions) budget balance. The employment record is near that of other countries (look at the central rows, still Table 1).

*Table 1* Some economic and social indicators in selected South and East Asia countries - Year 2003

	<i>China</i>	<i>India</i>	<i>Japan</i>	<i>Malaysia</i>	<i>South Korea</i>	<i>Thailand</i>
Area 000 Km <sup>2</sup>	9,572	3,287	372	329	99	513
Population million	1,284	1,058	127.6	25	48	60
Pop./area km <sup>2</sup>	134	322	342	76	481	125
GDP US\$ billion	1,372	556.2	4,190.7	101.0	515.3	130.7
Per-capita GDP US\$	1,062	520	32,859	4,042	10,641	2,037
Per-capita GDP US\$ PPP corrected	5,000	2,900	28,000	9,000	17,700	7,400
Yearly rate of growth %	9.1	5.6	2.0	4.2	2.5	5.0
Yearly rate of inflation %	1.2	4.0	-0.3	1.7	3.3	1.4
Central government deficit/GDP %	-2.7	-6.2	-9.2	-5.2	2.8	0.8
Unemployment %	4.3	4.3	5.3	3.8	3.4	2.0
Index of human poverty %	14.2	33.1	11.1	10.9	11.0	12.9
Ranking of human development	94	127	9	59	28	76

Notes: some data may differ from that given by the countries' chapters because of different sources and/or reference year.  
Sources: United Nations, IMF, FACT-CIA for per capita income PPP corrected and countries' chapters.

Current trends in industrial production, inflation, real rates of exchanges are broadly speaking very similar. The evolving economic environment unavoidably raised huge changes in production structures and social aptitudes. A process like this strengthened both the economic and the financial integration of the whole area (REF 2004) and created strong domino effects along cyclical moves. Intra-area commercial exchanges of total exports' shares reach from 33 percent (China towards Japan and other Asian countries) up to more than 47 percent (Japan towards China and other Asian countries). All the region shares a common financial conflicting position inside world rates of the exchange arena, especially with respect to the US\$. Rates of exchange re-evaluations, as requested by EU, US and other commercial & competitive countries, would have the twin effect of losing competitiveness but increasing internal financial wealth and vice-versa. Now go back again, to Table 1, but instead, look at the central and bottom rows. Some countries are still in the first stages of development with a very low level of per capita income, not over US\$ 520 yearly in India. Some other are very mature and rich. In Japan per capita income reaches near US\$ 33,000 yearly. The other countries stay in between, but not in sparse order. China is near India. South Korea stays well over the other countries. The two "tigers" Malaysia and Thailand have their place between the two poor and the two rich. A lot of indicators confirm this ranking: per capita income PPP corrected (albeit with some peculiarities); the index of human poverty; the degree of human development (see again Table 1, central and bottom rows).

To sum up, the final picture shows a structure of clusters. Two fast developing yet still poor countries (China and India); two transition countries (Malaysia and Thailand); and finally, two more or less mature industrialized countries (Japan and South Korea). When compared with other areas of the world's economy, the case of South and East Asia therefore is somewhat particular. The region is highly integrated, from an economic viewpoint, as happens, for example, in North America or Western Europe. However, the participant countries are not entirely homogeneous, like in South America or, at a lesser degree, as in Eastern Europe. There is not any supra-national authority which serves to coordinate single countries' policies and to harmonize their institutions. Subsequently, we see the relevance for tax policy issues of the topics with which we briefly dealt with before.

## **2.2 A general overview of countries' tax systems and their development since the early 1990s**

The total fiscal pressure of South and East Asian countries looks somewhat low when compared with that of countries with a similar per-capita income (Table 3), pertaining to other economic world areas. This is more or less true for India and China as developing countries which stay only just below some Latin American or Central Asian low fiscal pressure countries. However, they are very far from CIS or Eastern Europe countries. About the same may be said for the two transition countries, Malaysia and Thailand. By considering now the pair of industrialized countries, we may notice that South Korea's fiscal pressure stays below the figure of Western European countries by an average of about GDP eight points. Japan is far under Western European standard, while it is very near to the United States.

The main explaining factors of the South and East Asian countries' low fiscal pressure essentially can be found, first in the absence, or in a very small level, of social contributions, and, second, in a still widespread infant stage of personal income tax. We go back to these features subsequently. Before doing this, we notice, from Table 2 (as to its time series evidence), and from Table 3 (along a cross-countries path) that the Wagner's law might not be confirmed. From the early 1990s to a decade after, a significant increase in total fiscal pressure may be observed just for China and South Korea. The remaining countries stayed in the same position, also as consequence of the policies adopted to recover economic growth after the 1997-8 slowdowns (Malaysia and Thailand) or to overcome the long lasting after bubble stagnation (Japan). Furthermore, as the per capita income doubles or grows (from India to China, to Thailand, to Malaysia, to South Korea and to Japan), fiscal pressure's increase is far smoother. A more formal test seems hence interesting. According to a standard literature (e.g. Musgrave 1969; Burgess and Stern 1993; Tanzi 1994), the test to be performed assumes as its maintained hypothesis the dependence of total fiscal pressure (*TFP*) from real per capita income (*RPCI*), the share of agriculture (usually untaxed or taxed very slightly) on GDP (*AGR*), the openness of the economy (*OPE*: being imports a still relevant tax handle, see the following sections), and the debt/GDP ratio (*DEBT*), as a measure of push on taxes to fulfill the long running sustainability of the country's public finance.

Table 2 Structure and development of fiscal revenue in selected South and East Asia countries, 1992-2002 (% of GDP)

	<i>About 1992</i>						<i>About 2002</i>					
	<i>China</i>	<i>India</i>	<i>Japan</i>	<i>Malaysia</i>	<i>South Korea</i>	<i>Thailand</i>	<i>China</i>	<i>India</i>	<i>Japan</i>	<i>Malaysia</i>	<i>South Korea</i>	<i>Thailand</i>
<i>Direct taxes, of which:</i>	3.0	2.4	14.6	9.8	6.2	5.6	4.2	3.2	9.0	11.8	7.3	5.5
personal income	0.0	1.1	8.1	n.a.	3.5	1.8	1.0	1.4	5.5	2.9	3.7	1.9
corporation income	2.7	1.2	6.5	n.a.	2.7	2.9	2.9	1.8	3.5	7.3	3.6	2.9
<i>Indirect Taxes, of which</i>	8.5	12.3	4.0	9.8	9.2	11.2	11.3	10.7	5.2	5.0	10.9	10.5
VAT-general consumption	2.6	-	1.3	n.a.	3.9	3.9	5.9	-	2.4	2.7	4.9	3.0
specific excises & sales taxes	2.6	8.8	2.2	n.a.	5.1	3.9	0.9	8.8	2.1	1.2	5.2	4.4
custom duties	0.8	3.3	-	-	-	3.0	2.3	1.8	-	1.0	-	1.8
<i>Other taxes</i>	0.9	0.6	2.7	0.7	2.7	-	1.3	0.7	2.8	1.1	4.2	-
<i>Total taxes revenue</i>	12.4	15.3	21.3	20.3	18.1	16.8	16.8	14.6	17.0	17.9	22.4	16.0
<i>Social contributions</i>	-	-	8.7	-	1.0	0.2	-	-	10.3	-	5.0	0.6
employers	-	-	4.5	-	0.7	0.1	-	-	5.1	-	2.8	0.3
employees	-	-	3.3	-	0.3	0.1	-	-	4.1	-	2.2	0.3
self-employed	-	-	1.0	-	-	-	-	-	1.2	-	-	-
<i>Total fiscal revenue</i>	12.4	15.3	30.0	20.3	19.1	17.2	16.8	14.6	27.3	17.9	27.4	16.6
<i>Administrative levels</i>												
Central government	3.2	7.4	13.1	n.a.	13.5	15.9	10.1	6.3	10.1	n.a.	16.4	13.9
Local government	9.2	7.9	7.8	n.a.	2.6	1.1	6.7	8.3	6.9	n.a.	5.5	2.1
Social Security	-	-	9.1	-	3.0	0.2	-	-	10.3	-	5.5	0.6

Source: Own elaborations on IMF, OECD, World Bank and national data. See countries' chapters for details.

Table 3 US\$ per capita incomes and taxes/GDP % in selected South and East Asia and other countries. Early 2000s.

	<i>Per capita income</i>	<i>Taxes/GDP</i>
India	520	14.6
Costarica	384	17.5
Ukraine	640	34.2
China	1,062	16.8
Kazhakistan	1,230	19.6
Belarus	860	44.3
Thailand	2,037	16.6
Russia	1,730	37.0
Colombia	2,290	16.2
Malaysia	4,042	17.8
Poland	4,100	40.4
Chile	4,630	19.3
South Korea	10,641	27.4
Greece	12,127	35.9
Portugal	12,103	33.9
Japan	32,859	27.3
Finland	25,299	45.9
United States	35,676	26.4

Source: Bernardi (2005) and related sources; OECD 2004; Datastream on IMF data.

According to the data of our countries' panels, the regressions' results are depicted in Table 4. The unconstrained (log) specification shows that total covariance performs well and all coefficient but the *DEBT*'s one are fairly significant. By dropping down *DEBT*, results on the remaining variables and the overall statistical performance of the whole estimated equation hardly change at all. The sign of *AGR* is however the opposite to that expected. This uncomfortable result may be explained as a consequence of a decreasing and/or flat fiscal pressure in more than one of our countries during the 1990s, when the share of agriculture went down almost everywhere. Finally, by constraining the model to just *RPCI* and *OPE* as explaining variables, the latter still perform well, as does the overall equation. Two observations deserve, however, some further attention. Firstly, the figure of roughly 0.3 of the elasticity of *TFP* to *RPCI* is not very high and seems more determined by the cross countries' than by the time-series shares of the panel.

Table 4 Regressions' results as to total fiscal pressure (TFP) growth. Selected countries, 1991-2002

<i>Variables</i>	<i>Values</i>	<i>T-stat</i>	<i>Variables</i>	<i>Values</i>	<i>T-stat</i>	<i>Variables</i>	<i>Values</i>	<i>T-stat</i>
RPCI	0.1989	16.92	RPCI	0.2035	18.98	RPCI	0.3112	19.80
AGR	0.3115	6.61	AGR	0.3498	14.35	OPE	0.1112	3.00
OPE	0.1157	5.58	OPE	0.1219	6.2			
DEBT	0.0425	0.95						
R-squared	0.64		R-squared	0.63		R-squared	0.57	
Log likelihood	23.12		Log likelihood	22.65		Log likelihood	25.26	

Secondly, *OPE* does not seem, as has been maintained, to represent the tax handle for custom duties but instead the “quality” of economic development. Not surprisingly therefore, it seems to be correlated with *RPCI*, as it might be suggested by the high value of the standard error of the estimated coefficient. To conclude, a smooth Wagner’s law seems rooted in the data and is able to predict a certain but smooth increase of countries’ *TFP* as economic growth continues.

According to a common experience of developing (Burgess and Stern 1993) and transition (Bernardi 2005) countries, indirect taxes prevail (Table 2) over direct ones also in our sample of South and East Asian countries. The exception is, of course, Japan (but not South Korea) and, more surprisingly, Malaysia,<sup>1</sup> where direct taxes dominate, as occurs more often in industrialized countries. Corporation tax revenue usually stays higher than personal income tax, despite the flood of incentives allowed to corporations, especially to attract FDI. On this topic we have to underline the effects for Asian countries (except Japan and South Korea) to be free from OECD surveillance from harmful tax competition. These countries are then particularly attractive for FDI. China is an extreme case. A specific and “ring fenced” corporation tax regime is established just for foreign companies and a generous tax holidays is allowed just to them, but not to the national ones. The control of transfer prices both for internal and international transactions is, however, increasingly performed but just by national tax administrations. Hence the institution of a World Tax Organization, as repeatedly and authoritatively suggested by V. Tanzi (e.g. 1999), seems called for.

The other great personal tax, i.e. PIT, on the contrary, is still at an infant stage almost everywhere but in Japan and has not significantly augmented up from the early 1990s. A relevant consequence of such prevailing tax structure is the ranking of implicit tax rates (Table 5), which looks quite different from that which characterizes industrialized countries, especially Western Europe (Bernardi 2004).

<sup>1</sup> The case of Malaysia depends on the heavy taxation which hits native petroleum companies. See below in this paper.

It is important to note that while in Japan and in South Korea labor income is more heavily taxed than capital and consumption, as in almost all industrialized country, the reverse happens in Malaysia and Thailand. Herein consumption is taxed two or three fold labor income. The same should happen in China and India, albeit we lack the data needed for fine ITR estimations.

*Table 5* Implicit tax rates in selected South and East Asia countries. About year 2000

	<i>China</i>	<i>India</i>	<i>Japan</i>	<i>Malaysia</i>	<i>South Korea</i>	<i>Thailand</i>
Labor income	n.a.	n.a.	28.3	6.3	27.3	6.2
Consumption	n.a.	n.a.	6.0	11.1	13.8	16.6
Capital	n.a.	n.a.	n.a.	24.1	n.a.	7.1

Notes: Capital means National Accounts gross operating surplus.

Source: OECD for Japan and South Korea, own calculations for the other countries.

One unavoidable conclusion arises. A low tax wedge on labor (due to the early stage of PIT and the absence or mild relevance of social contributions) improves efficiency, by enhancing both labor's supply and demand. The heavy burden on consumption, however, lessens equity, as taxes are passed on prices and result in being regressive. In terms of welfare (i.e. consumer surplus) (e.g. Steve 1976) excess burden is raised.

### **2.3 Only a question of countries' clusters or also one of tax systems' clusters?**

The previous discussion makes it clear that any further uniform analysis of South and East Asian countries' tax policy issues would be quite futile. It is far better to consider separately the tax policies' issues which arise inside the whole area and those more specific of each countries' cluster. But do the countries' clusters that we discovered on economic and social characteristics (India and China; Malaysia and Thailand; Japan and South Korea) correspond also to tax systems' clusters? The answer seems to be affirmative, albeit with some exceptions, as follows (see Table 2).

*i. Total fiscal pressure.* China and India share the lower figures among the whole set of selected countries, although China is very near to Thailand. South Korea and Japan have a very similar value, about ten points over the remaining countries. Malaysia and Thailand do not differ by more than about one GDP point.

*ii. Broad tax headings.* China and India have the lower and similar ratio between direct and indirect taxes. Social contributions are fully lacking. Japan and South Korea share a similar figure

for direct taxes, while however Japan stays in a higher position for social contributions and South Korea (where social contributions are anyway present and growing) for indirect taxes. Also in Malaysia and in Thailand there is an opposing ratio between direct and indirect taxes. This depends on the tax handle opened to Malaysia by the profits of the petroleum companies. Social contributions do not exist in Malaysia, but in Thailand they are very light.

*iii. Single taxes.* In China and in India corporation tax remains higher than personal income tax. At a lesser degree, this is also true for both Malaysia and Thailand, but not for South Korea and Japan. In China VAT prevails on excise duties, which in India have commonly allowed for deduction on taxes paid on intermediate and capital goods bought. This feature is shared also by South Korea and Japan and by Malaysia too, while a different pattern is observed only in Thailand. Custom duties that reach a higher level in India and in China, are on the whole lower in Malaysia and in Thailand, and are totally absent in South Korea and Japan.

### **3. Intra zone tax policy issues**

Intra-regional economic integration raises severe challenges to the tax structure in the Asian area. As trade barriers come down and capital mobility increases, the challenges for South and East Asian countries become particularly acute, because of their relatively poor tax administration capabilities and their high dependence on foreign trade taxes. Three tax policy areas seem more problematic: firstly, the building of intra-countries' agreements on reducing trade tariffs; secondly, the revenue consequences of trade reform because of reduction in foreign trade taxes and thirdly, the increasing tax competition for foreign direct investment.

Around the world there has been a substantial growth in common markets, customs' unions and free trade areas. Also, in the Asian area there are two blocs of countries where the economic cooperation and integration has been strengthened over recent years. The first bloc is represented by the Association of Southeast Asian Nations (ASEAN) that recently implemented the ASEAN Free Trade Area (AFTA), making significant progress in trade and investment liberalization by the lowering of tariffs in intra-regional trade. ASEAN is developing enhanced cooperation with other countries in the area, namely with China, South Korea and Japan (so-called "ASEAN plus Three cooperation"). The intention is to create a larger East Asia Free Trade Area (EAFTA). Between China and southeast Asian countries in particular, a new free trade agreement has been recently reached. This is likely to encourage competition among countries and improve economic efficiency in the region (Cordenillo 2005). The agreement recently put into practice creates the largest free

trade area (ACFTA). Tariffs on almost all inter ASEAN-China trade in goods will be gradually eliminated.

The new free trade area between ASEAN and China has caused a domino effect, with Japan, South Korea and even India moving faster to sign similar agreements with southeast countries. At present a second bloc is represented by the South Asian Free Trade Area (SAFTA), comprised of India and another six countries, where tariffs on internal trade are going to be eliminated (Choon 2002). SAFTA was decided upon amongst the seven South Asian countries that form the South Asian Association for Regional Cooperation (SAARC). SAFTA will come into effect in 2006, by reducing tariffs for intra-regional trade and replacing the earlier South Asia Preferential Trade Agreement (SAPTA). It may lead to a fully-fledged South Asia Economic Union. The new free trade area provides for free movement of goods in the region through the elimination of tariffs, other duties that include border charges and fees, and non-tariff restrictions on the movement of goods. On the one hand these new free trade areas produce economic benefits to the countries involved in terms of increased bilateral trade, greater economic efficiency and increased bilateral FDI. On the other hand progresses in economic integrations pose new challenges: intensified competition in domestic markets, loss of tariff revenues, and the possibility of temporary unemployment.

Commonly understood as a difference (Heady 2002) from developed countries, developing countries and emerging markets still rely on custom duties and less on internal sources. The difference in revenue patterns is mainly explained in terms of administrative convenience, as for a developing country it's relatively easy to observe and value goods as they cross international frontiers. For different reasons, trade taxes on imports have been often introduced to protect domestic production and those on exports reflect in part the export of primary products over which the country has some monopolistic power. Standard economic theory suggests that taxes on international trade have a major distortionary effect and that efficiency gains deriving from their reduction far outweigh the loss of such revenue sources. As a general principle, it is well-known that it is optimal for a small open economy to raise any revenue it needs by setting all tariffs to zero and relying entirely on destination-based taxes on consumption (Dixit 1985). Keen and Ligthart (2002) formally show that any tariff reduction that increases production efficiency, coupled with a consumption tax reform which leaves consumer prices unchanged, increases both welfare and public revenue. This provides a rationale for those strategies (often recommended by the World Bank and the IMF) of sequential tariff reforms with strengthening of domestic consumption taxation, often in the form of a value added tax.

The reduction of taxes on import trade often runs into serious political opposition, due to the pressure of domestic producers. Moreover, one of the most important constraints to trade reform in such countries is the conflict between tariff reforms and macro-stabilization goals (Mitra 1992). Concerns on the revenue losses may be exacerbated by the short-term expenditure pressures that can arise, due to increases in social outlays for displaced workers (for instance, IMF 2005). A review of revenue statistics confirms that the decline in tariff revenue in developing countries and emerging markets around the world is underway. According to Zee (2004) tariff revenue in non-OECD countries accounted for 22 percent of total tax revenue in the first half of 1990s and for 17.4 percent in the second half. The comparison with the OECD countries' figures (respectively 1.9 percent and 1.4 percent) suggests that the process will continue in the future. The challenges vary with the degree of economic development. In the selected South and East Asian countries, excluding Japan and South Korea (where as in the other OECD countries trade taxes are so small that the OECD Revenue Statistics does not compute them on average fiscal pressure), the role of trade taxes is almost stable, accounting for about 2 percent of GDP on average and for 10-14 percent of the total tax revenue in countries like China and Thailand. In the transition economies of Southeast Asia (Cambodia, Lao, Myanmar and Vietnam) the role of indirect taxes and particularly of trade taxes is predominant; last years' custom duties accounted for figures between 11 percent and 35 percent of the total tax revenue; it has been estimated that the participation in the new free trade area will cause revenue losses ranging from 14 percent to 60 percent of the total customs revenue (Tongzon *et al.* 2004).

For a number of countries the adverse revenue impact of tariffs' reductions could be redressed in the short run by reducing existing exemptions, by removing highly restrictive non-tariff barriers and by relying on the expected import volume growth. But in the long run it will require the implementation of compensatory revenue measures, like (Tanzi and Zee 2000): a broadening of tax bases, a review of existing exemptions and preferential regimes in the field of indirect taxation (turnover taxes, VAT, import duties) in order to verify their justification and effectiveness, as well as compensating for tariffs' reductions on excisable imports by an increase in their excise rates and increasing the rates of the general consumption taxes (VAT, sales taxes, turnover taxes). More generally, as noted by Zee (2004), this process will induce policymakers in developing countries and emerging markets to fundamentally reform and modernize their tax systems by virtue of necessity rather than choice. As a general principle, attempts to reform the structure of protection trade taxes cannot ignore the role of the domestic indirect tax structure since the latter can - and in many countries does - affect protection (Mitra 1992). In many cases the World Bank (Rajaram 1992) made reference to the need to "harmonize" the domestic tax treatment of imports and

domestic production, given that an asymmetric treatment of domestic and imported goods under the domestic indirect tax system implies that domestic indirect taxes may add to the protective effect of trade taxes.

A central issue in tax policy design is whether - as recommended by the World Bank - such countries should be encouraged to move away from trade-based taxes and existing commodity taxes towards more broad consumption taxes. There are conceptual merits in using domestic consumption taxes - mainly general sales taxes like VAT, but also excises on particular goods - to offset any revenue loss from tariff reduction (IMF 2005). A strategy of matching a reduction in the tariff rate on some final consumption good with an increase in the corresponding domestic tax on consumption on that same good will leave, for a small open economy, the price faced by consumers unchanged. However, the government's total tax revenue will increase, since these revenues are now collected on all consumption, domestically-produced as well as imported goods. There are also practical merits in this strategy. Like trade taxes, also a considerable part of excise and VAT revenues are collected at the border (many developing countries collect more than half of their VAT revenues from imports) using the same administrative organization. Anyway the revenue consequences of trade reform and tariff reduction pose serious challenges. In a recent work based on a panel of 125 countries over 20 years, Baungsaard and Keen (2005) find that low-income countries are typically able to recover only a small percentage of lost trade tax revenue, even over a longer-term. The presence of a VAT does not, in itself, appear to enhance the ability to recover revenue. Excises also play an important role in the transition from trade taxes to domestic consumption taxes, since excisable goods are often a large part of the import base. In those countries with high recovery, there has also been a strengthening of income tax revenues, suggesting that the burden of adjustment has not been borne solely by shifting to taxes on consumption.

The arguments in favor of using VAT rather than trade taxes and other commodity taxes are well-known (Heady 2002). Because the tax base is much larger, (it also includes services), tax rates can be lower and as a consequence, the distortion effects are lower; through the destination principle it does not distort relative prices in international trade. Finally, the self-enforcing mechanism means that compliance is generally higher. There is, however, an important structural feature of a developing country that acts against the desirability of VAT: the existence of a large informal sector that escapes VAT. While a radial (across the board) uniform reduction in trade taxes reduces distortions in production, a revenue-neutral radial increase in VAT increases the inter-sectoral distortions between formal and informal sectors. As a result, such a reform can reduce welfare (Emran and Stiglitz 2005). Also Hines (2004) concludes that increasing consumption taxes

definitely fosters the expansion of the hidden economy. Currently, the large majority of South and East Asian countries apply a VAT, with standard tax rates ranging from 5 percent in Singapore and Japan to 17 percent in China (ITD 2005). On average the standard VAT rate is lower in Asian countries than elsewhere (ITD 2005).<sup>2</sup>

Asian countries have had mixed success with their VAT systems (Adhikari 2002); in some cases the implementation of the VAT led to an increase in indirect tax revenues compared with previous turnover taxes; in other instances the success of the new tax has been lower. Generally, Asian countries - like other transition or developing countries - face difficulties in the VAT's administration due to its complexity. On the one hand the adoption of the VAT is often seen as an opportunity for the overall modernization of tax administration (ITD 2005). On the other hand the administration of the VAT is more difficult in these countries where underground or shadow economies are considerably larger in comparison to developed countries (Bird 2005). The risk is that an increase in tax may foster the expansion of the underground economy, especially when the labor-intensity of production in the informal sector is greater than in the formal sector (Hines 2004). The VAT performance in such countries is still much below its potential, mainly as a consequence of the existing exemptions and of the large informal sector. The VAT systems are often limited to a small number of economic sectors or goods and services. Exemptions and preferential tax treatment should be minimized as they create distortions and difficulties in the administration and compliance of the tax.<sup>3</sup>

A third general tax policy area, where the growing economic integration and capital movements between Asian countries poses relevant challenges to the existing national tax structures, is in the area of tax competition. As non-tax barriers decline, investment decisions and location of investment become more tax sensitive. Within free trade areas firms can supply different national markets from a single location. The relevant issue here is the temptation for such countries to broaden the scope of tax incentives to attract and compete for foreign direct investment (FDI). The main argument in of these national policies is that FDI can contribute to increase the productivity of

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2 Many countries in the area apply a single rate (Bangladesh, Cambodia, Japan, Korea, Nepal, Philippines, Singapore, Thailand). Multi-rate VATs are present in China, Indonesia, Pakistan and Sri Lanka (ITD 2005). The choice depends mainly on balancing tax administration arguments - favoring a single rate structure - against the availability of other instruments better targeted to achieve distributional objectives - the absence of which tends to favor multi-rate structures.

3 The main challenge that the existing VAT systems face is in the context of trade liberalization in the area. As commonly understood with respect to international trade, the standard approach is to levy the tax on domestic consumption through the destination principle, which assures production efficiency even in the presence of differentials in national tax rates. Around the world recent trends toward regional integration, the development of the Internet, the growth in trade involving services and intangibles and the trend toward the reduction of traditional custom formalities complicate the implementation of the destination principle. In the less developed Asian countries further difficulties arise when the zero-rating has to be applied to exports which requires the appropriate refunding of excess VAT input credits to exporters (Adhikari 2002; Choon 2002). As trade barriers come down, methods to address this situations will be increasingly critical.

the domestic economy, but the effectiveness of tax incentives is highly questionable. Moreover, as noted by Tanzi and Zee (2000), a tax system that is riddled with such incentives will inevitably provide fertile grounds for rent-seeking activities. Recent evidence (OECD 2001) suggests that tax incentives can have effects on the location of investment, especially between locations that are similar in other respects. However it is also recognized that neighboring countries within a region could compete against each others in offering tax incentives in a way that provides benefits to the investor without increasing the total amount of FDI allocated to the region.

Almost all South and East Asian countries have made, and still make, extensive use of tax (but also non-tax) incentives to promote domestic investment and especially to attract FDI in forms such as tax holidays, accelerated depreciation or investment tax credits (Easson and Zolt 2003). As reported by Asher and Rajan (1999) there is evidence of tax competition between certain Asian countries for FDI from EU countries, US and Japan. There is also evidence that some South East Asian countries have emulated or responded to the tax incentives provided by the leading country in the region, that is Singapore. Similar patters of tax competition between neighboring transitional or developing countries are very frequent; for instance they can be found between some New EU Member states, with Poland and the Czech Republic responding to the investment incentives provided by Hungary (see Gandullia 2005).

The 1997 East Asian crisis put additional pressure on these countries in order to attract foreign investment (Adhikari 2002); recently Thailand has expanded the scope of its tax (and non-tax) incentives for FDI and Indonesia has reintroduced the income tax incentives after having repealed them in the 1983 tax reform. At present international agreements between Asian and Western countries are unlikely to be successful in this area. While there has been a trend towards transparency in tax structures, preferential treatments in Asian countries are often negotiated on a case-by-case basis and agreements are not made public. Hence, enforcement of any type of international rule becomes very difficult (Asher and Rajan 1999). However, in the coming years, the use of tax incentives for the promotion of FDI will require a coordinated multilateral approach, at least on a regional basis. Agreements on a regional basis - for instance between countries members of the ACFTA and countries members of the SAFTA - could create a different kind and intensity of cooperation. Countries, for instance, could agree on a limited set of tax incentives, conditioned to certain criteria (Easson and Zolt 2003).

#### **4. Intra-clusters' tax policy issues**

## 4.1 Japan and South Korea

Among the countries in the area, Japan and South Korea are those that have reached the highest level of development. In spite of the aforementioned degree of homogeneity in their economic and productive structure, the forces that shape their tax systems are broadly speaking similar but also somewhat different. A simple comparison of the composition of their tax burden shows some differences in the tax mix. In fact, while in Japan the primary source of revenues is direct taxation (although the relative share of direct taxation on income is well below the level of other OECD countries), in South Korea the main role is still played by indirect taxes, in particular specific excises, sales and general consumption taxes. Custom duties are totally absent in both countries because these countries have been participating for a long time in free international trade.

Looking at the features of PIT we can point out an important dissimilarity that attests to the existence of two alternative theoretical visions in addressing the problem of personal taxation. The first Japanese personal income tax system, designed in the late 1940s, was based on an idea of comprehensive taxation, but this original structure was soon transformed into a system founded on a notion of expenditure income in which saving was practically exempt. According to this view (the “schedular view,” following a definition by Musgrave (1969)), incomes from different sources are taxed at separate rates so that the ratio of the total individual fiscal burden to the total personal income depends on the income composition. On the contrary, South Korea adopted a “global” (again, Musgrave 1969) income taxation that aggregates most personal income (inclusive of many forms of capital revenues) by taxing it at progressive rates. The choice in favor of a comprehensive income was due to the well known aim to pursue horizontal and vertical equity, by taxing individuals taking into account not just wages or expenditure, but all the possible incomes they get so that to broaden as much as possible the tax base.

Also in their policies of the last decade concerning tax equity, Japan and South Korea have taken opposite directions. Whereas the reforms implemented in South Korea in the 1990s put increasing effort in extending the tax base, Japan has set up a complex set of allowances that have made the base smaller and smaller. In principle, such deductions could have made a more equitable system by adopting a multidimensional concept of ability to pay<sup>4</sup> and by also taking into consideration extra economic variables. In practice, empirical analysis have shown (e.g. Dalsgaard and Kawagoe 2000) that the allowances have favored only the very low and the very high income earners without giving any relief to those in between. Leaving aside the distorsionary effects in the

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4 This could explain, for example, employment income deductions.

tax payers' behavior caused by a complex ensemble of deductions, let us take a little glance at the main consequences that these measures had in terms of fairness. Since, with a progressive tax schedule, the tax values of deductions increases as long as the tax rate rises, higher income groups receive a larger tax relief due to these kind of allowances. It follows that a disproportionate use of exemptions could have a regressive consequence instead of being a helpful instrument to pursue vertical equity.

A simple way to cope with the problems concerning equity while broadening the tax base could be that of strengthening the effective taxation of the self employed. In fact, in Japan the self employed are allowed to deduct the necessary expenses (including private consumption) from the taxable income and to split their personal business income by paying salaries to family members. When introduced, the relief on employment income had the precise goal of filling the gap between the self employed and wage earners, by also permitting the latter to subtract part of their income from taxation. For example, we can find that the theoretical roots for the spouse deduction exist in terms of giving comparable opportunities for income splitting to all tax payers. Although complex, this is just one aspect of the question. From a revenue raising perspective, the main difficulty that threatens Japan is a sharp decline in the tax base. This is due to two different factors. The broad scope for tax planning permitted for the self employed on the one hand encourages both evasion and avoidance, on the other hand it points out the necessity to lower the effective tax rate for the wage earners to avoid horizontal inequities.

We have just shown how an extensive system of tax exemptions limits the equalizing power of Japanese taxation by removing a big share of the taxpayers' income from the tax roll. So, why does the Japanese government not opt for a more comprehensive taxation? The first reason regards labor supply elasticities. Although the narrowing of the tax base for PIT does not permit the government to lower tax rates (thus limiting the tax wedge on salaries), the tax induced distortions to the Japanese labor market are likely to be low, at least for primary earners (see Tachibanaki 1997 and Tyrväinen 1995). The second reason deals with the way in which Japanese salaries are determined. A growing literature defines the Japanese labor market as an "organizational-oriented system" instead of a "market-oriented" one. This means that salaries are established at a firm level<sup>5</sup> and present a high degree of heterogeneity. Hence, is not surprising that, in such an individualistic environment, taxation tries to preserve net wages' specificity by rejecting the idea of a comprehensive PIT. The recent development of South Korean PIT shows a fairly different pattern. The aim of improving the redistributing consequences of personal taxation without strengthening

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<sup>5</sup> The Japanese system is based on the so called "keyretsu:" sort of "families" of firms that define the wage patterns autonomously. As a consequence, wages are a result of a complex set of personal variables that are only partially related with the bargaining contracts.

the progressivity of the tax schedule led the South Korean government to broaden the tax base while keeping the tax rates at very low levels. This strategy allowed a partial counterbalance in the regressive outcomes of indirect taxation that is still the South Korean main source of tax revenue.

A second issue that has to be discussed when comparing South Korea and Japan is the way in which the two countries are handling the problem of a troublesome raise of the expense on pensions. The growing imbalance due to an aging population constitutes a worrying threat for the pension system. Both Japan and South Korea opted for a sharp increase in the share of social security contributions. Looking once more at Table 2 we can observe that from about 1992 to about 2002 social contributions rose in Japan from 8.7 percent to 10.3 percent of the GDP, while in South Korea throughout the same decade they reached a percentage of about 5 percent from a starting point of 1 percent. The striking gap of the starting level explains the large spread between the two increases, but not at all. In fact, whereas in South Korea the development of the pension system was strongly supported by policymakers as an important source of investment capital for financing developing-oriented projects (the South Korean pension system is basically fully funded), in Japan, the government seems lenient in proposing an increase in contribution rates or a cut in retirement benefits.<sup>6</sup> An increase in Japanese social contributions would raise problems in terms of intergenerational equity, since it would be hitting the young generation, without affecting (or even favoring) the elderly population. Nor could it help to alleviate the intergenerational unfairness by removing the tax allowances for private pension earnings (that are nowadays exempt), since the cost would be borne principally by the youngest cohorts.<sup>7</sup>

In general, it is important to bear in mind that in Japan lump sum payment to employees at the point of retirement and pension incomes<sup>8</sup> receive a preferential treatment compared with wage incomes. Would it be fair to abolish these privileges? Is the strengthening of taxation on pension benefits a possible way to fill the intergenerational financial gap? A recent proposal (Dalsgaard and Kawagoe 2000) suggests to use the VAT to collect the missing revenues. The main argument is that such a tax, besides being neutral with respect to saving behavior, could be an adequate instrument to restore a kind of intergenerational equity. VAT is a consumption tax so it could be considered as a tax whose burden especially hits individuals with a low saving rate. Hence, in a lifetime perspective, this could be the case for elderly people given that old age is typically the age of consumption<sup>9</sup> and the VAT would be *in effect a proportional tax on lifetime income or*

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6 It is useful to note here that the Japanese pension system is financed essentially by the pay-as-you-go system.

7 However, taxing this form of saving could be acceptable to pursue the neutrality among different type of capital investment subject to taxation (albeit the tax rates for capital income are low).

8 The situation in South Korea is not far from the Japanese one. Although most capital income is added to wage income and taxed at progressive rates, income and timber income are taxed separately at low tax rates.

9 Take care that available data do not seem to confirm this theoretical hypothesis.

*intergenerational income*. Furthermore the scope of Japanese PIT is weakened by the aforementioned disproportionate set of exemptions, on the contrary, the Japanese value added tax is more effective since it is broadly based and extremely difficult to avoid.

Table 6 shows the effectiveness of VAT systems in some selected worldwide countries. Looking at the data we gain an idea of the coverage of this kind of taxation in terms of the effective tax base. It is easy to grasp the efficacy of the value added tax in the countries that are considered here. In both Japan and South Korea the effective VAT rate (calculated as a percentage of the standard rate) is very close to the standard “legal” rate thus demonstrating that this tax could be a useful instrument in the fight against avoidance.<sup>10</sup>

Our analysis has shown how different theoretical visions have shaped Japanese and South Korean fiscal systems in peculiar directions. These latter are still reflected by the pillars of the reforms that are being implemented in the two countries. South Korea is continuing in the process of broadening its tax base while increasing the share of direct taxation on the total fiscal revenues.<sup>11</sup> In Japan, the main result of the reforms that were implemented during the 1990s was that of a dramatic compression of the tax base. This raises both a problem in collecting revenues and a concern over inequality, since the redistributive impact of Japanese tax system has recently been lost. The reforms should also take into account what is stated by Musgrave (1969) i.e. that the ‘non global approach which involves progressive rates is an incongruity.’ The simplest option to improve equity while increasing revenues would be to reduce personal allowances in personal income taxation. This requires either an effort towards a more comprehensive system, or a consolidation of a separate taxation of labor and capital income. Without any doubt, the Japanese government has chosen the second way. Inside such a dichotomist scheme the main concern regards the need to ensure tax neutrality between alternative forms of investment. Accordingly, the latest Japanese tax reform committed itself towards a general alignment in the tax rate on different types of capital<sup>12</sup> and on alternative forms of savings. Some people agree that this harmonization should completely involve every kind of pension earning and retirement benefit.

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10 In particular in Korea, where the VAT share, with regards to the total amount of indirect taxation, is less than the share of specific excise and sales taxes, a substitution of some consumption taxes with a less distortive value added tax could be a welfare improving measure.

11 In fact, the effort in pursuing the full concept of the ability to pay at the PIT level is counterbalanced (and strongly weakened) by the huge share of indirect taxation which holds a more distortive and less equitable source of revenue.

12 The tax treatment of interest capital gains from stock and dividends on listed stocks have been unified at the rate of 20 percent .

Table 6 Effectiveness of value added tax: selected countries and 1997 data

	<i>Value added tax revenues % of GDP</i>	<i>Standard rate %</i>	<i>Effective VAT rate, %</i>	<i>Effective VAT rate % of standard rate</i>
Japan	1.8	5.0	3.1	89
Germany	6.6	16.0	11.5	77
France	7.9	20.6	14.7	71
Italy	5.7	20.0	9.8	52
United Kingdom	6.9	17.5	10.8	62
Czech Republic	7.1	22.0	12.6	57
Denmark	9.8	25.0	22.2	89
Finland	8.2	22.0	18.1	82
Greece	7.5	18.0	11.6	64
Hungary	7.9	25.0	14.4	58
South Korea	4.3	10.0	8.5	85
Mexico	3.1	15.0	4.7	32
Netherlands	7.0	17.5	13.2	75
Norway	8.8	23.0	21.7	94
Spain	5.8	16.0	9.9	62
Turkey	6.5	15.0	9.9	66
OECD average	6.7	17.7	12.5	73

Source: OECD

## 4.2 Malaysia and Thailand

Malaysia and Thailand have experienced an economic escalation before the sharp fall in the late 1990s and finally a sustained growth in the more recent past. Despite such a dynamic performance the “catching up” phase is not yet concluded and the two countries are still to cope with the difficulties of the transition towards a full development. In comparing the Malayan and Thai fiscal burden, it may be interesting to draw a rough link with Musgrave’s (1969) theory of tax structure development. In fact, both countries show some typical features of the so-called “early period,” but Malaysia presents a use of fiscal direct levy that seems to be more in line with that of the OECD countries.<sup>13</sup> However, if we look at disaggregated data while taking into account the institutional context, we can notice that the picture is somewhat more complex.

The initial information that we can get from the Table 2 is the share of revenues from CIT which is fairly large in the case of Malaysia. In fact, the value of corporate income taxation accounts for much more than an half of the yield that come from direct taxation. Nevertheless, these data are just a proxy (upward biased) for evaluating the real impact of average fiscal pressure on all

<sup>13</sup> In the area that we are analyzing only Japan shows a bigger share of tax revenues from direct taxation.

corporations, since they also include a specific tax levied on petroleum companies whose rate is much higher than “standard” one (38 percent instead of 28 percent). Hence, interpreting the CIT share in Malaysian tax revenue as a proof of the existence of a more developed fiscal system could lead to methodological misunderstandings and to inaccurate interpretations. The petroleum tax can be interpreted as a tax on non-competitive profits that in developing countries is a much used revenue raising tool since it has a well given tax base and is harder to evade.<sup>14</sup> However such a tax presents some ambiguities given that it does not hit the firm according to its ability to pay, but determines its tax liability by conforming to the specific role that the corporation plays in the market. In its turn, also in Thailand a distinction is made among corporations. It is based on their dimension, since the smaller firms (but just the national ones) are taxed at lower rates by means of a progressive schedule.<sup>15</sup> With regards to personal income taxation there are several analogies between the two countries. The first observation concerns the importance of PIT whose weight is consistently narrow and rather stable. Then, there are important similarities in the structure of personal taxation which counts on a progressive schedule with many brackets and a widely spread set of tax rates.<sup>16</sup> In principle, such a configuration could be powerful in a per-equating perspective, but the scarce pervasiveness of this kind of taxation, along with the massive use of personal relieves and personal tax rebates makes the pursuit of horizontal equity a goal that is far from being attained.

In spite of the likeness between the two, Malaysia differs from Thailand in the sense that it applies a specific tax rate (equal to the highest rate for resident taxpayers) on the chargeable income of foreign taxpayers. In addition, Malaysian citizens who do not reside in Malaysia are not entitled to any form of personal exemption. This is not a common feature in personal taxation where, beside the principle of residence, the specific characteristics that are relevant for defining the personal tax liability do not refer to the country of residence of the tax payer, but relate to her ability to pay. In this vein it could be seen as relevant to bring up a proposal of Mahatir (the Malaysian Prime Minister) who suggested to put a tax on rich countries into practice, in order to support the poorer countries. In effect the reforms that have been implemented in Malaysia in the last decades are rooted in a peculiar mix of nationalism and openness to the international capital market that has, as a consequence, a corporate taxation that is only apparently onerous and a personal taxation whose scope is highly limited.

By analyzing the composition of indirect taxation, a peculiar feature particular to Malaysia is that of the complete absence of any kind of value added tax. In fact the most important form of

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<sup>14</sup> It is a widely accepted fiscal instrument since it allows the government to finance public expenditure while limiting the creation of monopolistic power in the market.

<sup>15</sup> Although the ordinary tax rate for CIT is 30 percent, smaller companies are taxed at lower rate (20 percent or 30 percent).

<sup>16</sup> From 2 to 29 percent in Malaysia and from 5 to 37 percent in Thailand.

indirect tax is an ad valorem single stage tax, imposed at import and manufacturing levels. The main problem that arises due to the lack of a “well behaved” VAT is the existence of cascading non neutral price effects.<sup>17</sup> Secondly, there is the old and widespread (albeit debatable) consensus on the role played by a value added tax in creating a useful information externality that can have a compliance-enhancing outcome on other taxes.<sup>18</sup> The nature of indirect taxation is quite important for a country like Malaysia. In fact, in countries that are yet to be fully developed, which have an economic and productive structure that is still rooted on traditional and informal sectors, personal taxation has a fairly limited coverage. In addition, the lack of adequate administrative skills does not allow direct taxation to be completely effective, thus weakening real progressivity. On the contrary, the greater ease in the collection of consumption taxes makes this kind of fiscal instrument a useful tool both in a revenue raising perspective and (sometimes) also in the fight against avoidance. Since, in the case of sales taxes, underreporting is more difficult, there are several incentives for taxpayers towards a correct declaration of their status given that poorer individuals are associated with a smaller tax burden from indirect taxation.

There is some proof that in both countries, low income earners have been considered in the shaping of consumption taxes. In Malaysia a uniform tax rate (10 percent) is applied to most products, but some goods such as primary commodities, basic foodstuff and basic building materials are completely exempt while in Thailand, the operators earning less than bath 600,000 per year do not have to pay VAT at all. Strictly speaking, this personal exemption is not completely in line with a restrict definition of indirect taxation. Musgrave (1969) reminds us that amongst the characteristics that attempt to draw a separation line between direct and indirect taxation a very used criterion states that ‘(indirect taxes) are assessed on objects rather than on individuals and therefore not adaptable to the individuals’ special position and his taxable capacity.’ In fact, the prevailing literature about taxation considers indirect tax as a useful but regressive instrument for collecting revenue, given that the demand for basic commodities presents a very low elasticity to prices and can not be shifted towards alternative tax-free goods. However, we have shown that, where fiscal systems are still embryonic and direct taxation has a limited scope, indirect taxation may help governments to achieve some objectives on the ground of equity.<sup>19</sup> However, an excessive reliance on indirect taxation could lead to a big loss in terms of efficiency; the more the indirect

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17 In Malaysia indirect taxes are production taxes that can induce distorting changes in relative prices.

18 In Malaysia, an alternative spill-over of information comes from the obligation for manufactures to be licensed under the Sales Act 1972. This requirement has the further effect of allowing a lesser taxation on the smaller (and poorer) manufactures which are permitted to buy tax-free inputs.

19 See Musgrave (1969); on the contrary Sah (1983) states that the extent of the redistribution possible through this kind of fiscal instruments is quite limited.

taxation adopts a progressive schedule, the more it differs from an “optimal taxation structure” whose goal is the minimization of the “excess burden.”<sup>20</sup>

After the Asian financial crisis which strongly hit both countries (although with several important difference in the depth and in the timing of the crash), Malaysia and Thailand had to find a way to build the roots for a quick recovery. With regards to taxation, the main field in which both are putting increasing efforts is the strengthening of revenue collection. In fact, a crucial issue in order to keep the situation of public finance under control is to increase taxpayers’ compliance so that it could be possible to finance public expenditure without creating distorsive consequences on economy. In order to achieve this goal one of the fundamental pillars in the agenda of the two governments is the rationalization of administrative procedures and the improvement in the efficiency of tax administration. For Thailand, this objective means, first of all, the creation of a more effective collaboration among local and central governments to reach a better coordination and take advantage of an increasing fiscal decentralization. For Malaysia it implies a simplification in the complex set of incentives that have been introduced both for economic and for political reasons.

### **4.3 China and India**

Let us now look first at direct taxation. In India, personal income taxation is completely levied at the level of Union Government (see Table 7). In principle, Indian income taxation shows some important features which the supply-siders’ views on taxation (for a discussion: Stiglitz 2000) looks on favorably. In fact, Indian personal income taxation has few tax brackets with a low degree of progression. In addition, the notion of taxable income that has been adopted in the Indian fiscal system is very similar to Haig-Simons definition. This is, however, not entirely problem-free. An important difficulty concerns the presence of many personal exemptions that narrow the tax base, so limiting the effects of income agglomeration. The point is analogous to what has been already discussed in the case of Japan thus it is not necessary to repeat the whole debate. Anyway, it could be interesting to reiterate that the dimension of India, together with its greater administrative weakness, makes the problem even worse and the role of income taxation even more limited. Chinese personal income taxation presents opposite features. The Chinese PIT has a “pure”

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<sup>20</sup> As it is well known, in order to limit the deadweight losses optimal taxation calls for a tax rate to vary inversely with the compensates elasticity of demand. It easy to understand that such a structure differs from a progressive one.

schedular structure with many different types of income taxed at different tax rates,<sup>21</sup> no aggregation of alternative sources of earnings and no personal deductions. As a consequence, there is both a loss on the ground of progressivity, and a fall in the total tax burden, since taxpayers can choose to transform activities that are heavily hit by taxation into others that are less taxed or even tax free.<sup>22</sup>

But the main field for tax planning in China is the tax environment created by some special incentives that have been recently granted to foreign enterprises. In China, specific systems of corporate income taxation are in force for foreign corporations, recently updated. The CIT imposed on Chinese enterprises has a fairly simple structure that applies a 33 percent tax rate<sup>23</sup> on the gross income after eventually having subtracted allowable deductions. To foreign companies a generous system of tax holidays apply is allowed. In fact, for companies that meet some requirements (such as firms operating in some designated industries) the possibility of enjoying a very favorable fiscal treatment throughout long periods of time exists. For example, a ten year tax holiday entails a whole exemption from taxation for the first five years and a big tax cut (50 percent of reduction) for the following five years. These fiscal stimuli add to an already investment-encouraging tax regime that provides for the depreciation and the amortization of tangible assets. While useful in the short run since it has the consequence of attracting foreign investors, the use of tax holidays may be harmful in the long run because some “race to the bottom phenomena” can ensue, thus creating a continuous reduction in tax revenues. A parallel trend that emerges from several empirical studies is that of a raise in the relative tax burden on home taxpayers. This fact could have bad consequences both with regards to horizontal equity and with regards to the growth of Chinese domestic industry.

Indirect taxation is perhaps the most interesting analytical field because on these grounds, many reforms have been recently elaborated. In this respect the two countries feature some important differences in the composition of their fiscal revenues. While in China the main indirect tax is the value added tax that is charged on a broad set of goods including power, heating, gas and services, in India until 2004 VAT was absent. From 1 April 2005 VAT has been finally introduced in India. Obviously, there are still not enough data to evaluate the effect of the reform on the fiscal system as a whole. However, some comments will be made at the end of this section. It is generally agreed that an introduction in India of a value-added type taxation should be a welfare improving reform. In fact, in India, a huge share of fiscal revenues<sup>24</sup> comes from sales tax and excise duties that, as we have already noted in the previous pages, have distorsionary effects on relative prices. These kind

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21 Whether to apply a progressive schedule or a proportional one depends on the single source of income.

22 Actually this possibility is opened also to Indian taxpayers due to the just discussed existence of many exemptions.

23 The tax rate applied to foreign enterprises is substantially similar (30 percent plus a local surcharge of 3 percent).

24 The 8.8 percent of GDP, well above the share of the whole income taxation.

of distortions could be partially eliminated by a uniform tax on consumption (like VAT). According to somewhat forced view of Jha (2001) and Jha and Mittal (1990),<sup>25</sup> taxing consumption at a uniform rate could have specific positive effects in the case in which consumer utility functions are weekly separable between consumption and leisure,<sup>26</sup> so that this tax ‘would approximate a lump sum tax’ (Jha 2001).

Actually, the principle could be valid for India only in the case of a properly harmonized state and central VAT capable of substituting the complex set of sales taxes that are nowadays levied by states’ governments. So far, so good. But what could be the result of such a reform in terms of revenue sharing among national and sub national governments? Before answering the question we will briefly present some basic data about intergovernmental fiscal relations.

*Table 7* Central government percentage share on general government main tax revenues. Selected federal countries

<i>Country</i>	<i>Period</i>	<i>Domestic indirect taxes</i>	<i>Income taxes</i>
Argentina	1975-98	81.72	74.58
Australia	1975-02	64.49	100.00
Austria	1975-02	70.99	63.44
Belgium	1975-02	80.72	82.03
Brazil	1977-97	47.15	97.64
Canada	1975-02	32.25	64.84
Germany	1975-02	63.71	40.63
India	1975-97	50.71	100.00
Mexico	1975-02	99.00	100.00
Switzerland	1975-02	72.83	22.62
United States	1975-02	14.52	82.24

Notes: the time periods stop at the last available data.

Source: Own elaboration on IMF and OECD data.

Table 7 shows the national government tax collection share by type of levy for a number of selected federal countries. The picture drawn by Indian data is quite clear. Although all direct taxation is collected by the central government in line with the redistributive function of income taxation, the share of revenues from indirect taxation that is collected by the center falls dramatically.<sup>27</sup> Among the central government’s revenues, however, are all the production excise taxes that naturally pertain to that level because they have to be uniform across all the country. We can infer from this datum that nearly all the states’ percentage is composed by the whole set of

25 Such a view assumes a Walrasian equilibrium theoretical framework that can not be easily applied to a country like India.

26 This requirement implies that taxation on goods does not have any implication in the labor-leisure choice and hence does not affect the supply of labor.

27 The share of indirect taxes levied by the central government is about 50 percent.

internal sales taxes. It follows that the new VAT system must be implemented on a dual layers' level in order to substitute sales taxes as a main source of local financing.

On the contrary, after the thorough reform of the middle 1990s, in China the system of public finance is more centralized and is based on a "pyramidal" structure in which most taxes (inclusive of VAT) are charged by the central government which, successively, share part of the tax revenues to the inferior governmental levels by means of a broad set of transfers. In principle the use of transfers from the center could be powerful in per-equating local fiscal capacity but could generate provinces' excess of spending behavior while weakening fiscal responsibility. Now however, it is crucial to redefine the system of transfers, given that provincial governments have a small fiscal autonomy. Hence, to avoid harmful fiscal imbalances at lower government levels and in order to increase herein budget transparency and fiscal effort,<sup>28</sup> many rule-based mechanisms have been introduced.<sup>29</sup>

It is almost mandatory to conclude now that in India most of the current debate about taxation concerns the 2005 introduced value added tax. The reform, whose features are not completely clear yet, introduces a two rate tax (4 percent and 12.5 percent) and it will cover more than 500 different goods. The Indian VAT will present some characteristics that we have described while analyzing the Thai tax system. In fact traders with turnovers of less than rupees 500,000 will be completely exempt from the tax<sup>30</sup> so that it is worthwhile to think of this measure as a progressivity-enhancing tool. Nevertheless, the main argument in favor of VAT states that such a change helps to improve transparency, may contribute to limit tax evasion<sup>31</sup> and will simplify the system, while correcting distortionary effects on prices. An important question is whether to charge an indirect tax on services. At the moment in India services constitute 53.3 percent of GDP. Thus, whereas incomes from services are taxed with incomes, services themselves face very few indirect taxes. According

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28 Jha *et al.* (1999) showed that the higher the share of central financing of state government expenditures the lower is their tax effort.

29 More broadly on fiscal federalism in China and in India.

30 Actually this threshold is different in some states where the exemption applies to traders with an annual turnover of up to 1 million rupees.

<sup>31</sup> Developing countries have a genuine faith in the conventional wisdoms according to which VAT, by providing input credit from the manufacturing stage to the retail stage, should reduce underreporting. This may happen because whoever does not provide correct declarations incurs in a loss by getting lesser input credit. Countries, like the EU members, where VAT is in force for decades, do not all confirm this feature of the "VAT's chain." (see Table 6, especially for the Mediterranean countries, where corruption and inefficiency of tax administration is high and taxpayers' compliance is low). In fact, this chain breaks down at the link between the retailer and the final consumer, since the latter is not interested in crediting paid VAT. Collusive evasion may arise, and then feeds back along the chain so that it undermines the same income tax returns. Remind that from the supply side, VAT's basis is broadly the sum of wages and profits (less investment in the EU model).

to Jha (2001) 'this is inefficient as well as inequitable because it discriminates between providers of good and services, inefficient because it has the potential of creating several distortions thus increasing non-labor costs.' Certainly, the transition from a multifaceted system of indirect taxes to a homogeneous value added tax will not be easy since central sales taxes will continue to run alongside VAT at least until 1 April 2006.

Also in China the debates and the changes concerning VAT are relevant too. Firstly, the tax base has been broadened, the number of tax rates have been reduced and the whole system has been simplified. Secondly, in three north eastern provinces, the Chinese government is about to carry out a new project which has the principal aim of replacing the current production-type VAT with a new consumption-type VAT. Such a change is in line with the rapid growth of Chinese industry that is becoming more and more capital intensive. In fact consumption-type VAT does not discourage investment in capital because the expense for capital goods can be deducted from the VAT tax base.

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