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Taxation in Asia

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Abbreviations

CIT	–	corporate income tax
GDP	–	gross domestic product
OECD	–	Organisation for Economic Co-operation and Development
PIT	–	personal income tax
PRC	–	People’s Republic of China
VAT	–	value-added tax

Acknowledgments

This Policy Note transcribes the main content of the presentation that Professor Jorge Martinez-Vazquez, Andrew Young School of Policy Studies, Georgia State University delivered in Manila at the Asian Development Bank headquarters on 7 October 2010, at the invitation of the Governance and Public Management Community of Practice. The work was completed under the overall direction of Sandra Nicoll, director, Public Management, Governance and Participation Division of the Regional and Sustainable Development Department; and Bruno Carrasco, director, Public Management, Financial Sector, and Trade Division of South Asia Department. Tariq H. Niazi, principal public management specialist, provided substantial inputs and technical edits.

Introduction

Tax systems—the combination of tax policy and tax administration—are central to successful fiscal policy and the overall management of the public sector. Too little tax revenue can make it difficult for governments to spend adequately in critical areas for economic growth, including public infrastructure and investment in human capital creation through education and health services. But tax burdens that are too high can also be detrimental to economic growth; these decrease private investment and discourage savings and work effort. In addition, tax revenues can be raised with a minimum of distortions in the economy, or else can carry significant excess welfare losses due to poor design and disincentives to economic activity.

This note takes a look at the current state of tax systems in Asia and how they compare with those in other regions of the world.[1] We also examine the individual country performance of tax systems in the region. Next we examine the question of the effectiveness of tax administration and the extent of the shadow economy in Asia compared with other regions of the world, and extract some lessons on reforming tax administrations. We conclude with some thoughts on the process and timing of tax reform.

[1] There is some literature on the subject. See, for example, Bernardi, Gandullia, and Fumagalli 2005; Sudsawasd 2008; and RSM Asia Pacific Limited 2009.

The Singularity of Asia's Tax Systems

When compared with other areas of the world's economy, the case of Asia is somewhat peculiar. The region is highly integrated from an economic viewpoint, as is the case in, for example, North America or Western Europe. However, the participant countries are not entirely homogeneous, as is the case in South America or, to a lesser degree, in Eastern Europe. On the other hand, no supranational authority serves to coordinate single countries' policies and harmonize their institutions, as in the case of Europe. In this section, we look at how these peculiarities are manifested in terms of overall tax burdens and the use of different taxes.

Our review plainly acknowledges that any uniform analysis of Asian countries' tax policy issues would be quite futile. In fact, we will see that there is large variation in the practice of tax policy across Asian countries. Nevertheless, we are able to focus on some of the tax policy issues which commonly arise within the whole region. Our discussion also highlights specific tax issues for many countries in the region.

Overall Tax Burdens

A significant feature of tax systems in Asia is that tax burdens at a regional scale are among the lowest in the world. However, this statement does not necessarily hold for a number of individual Asian countries.

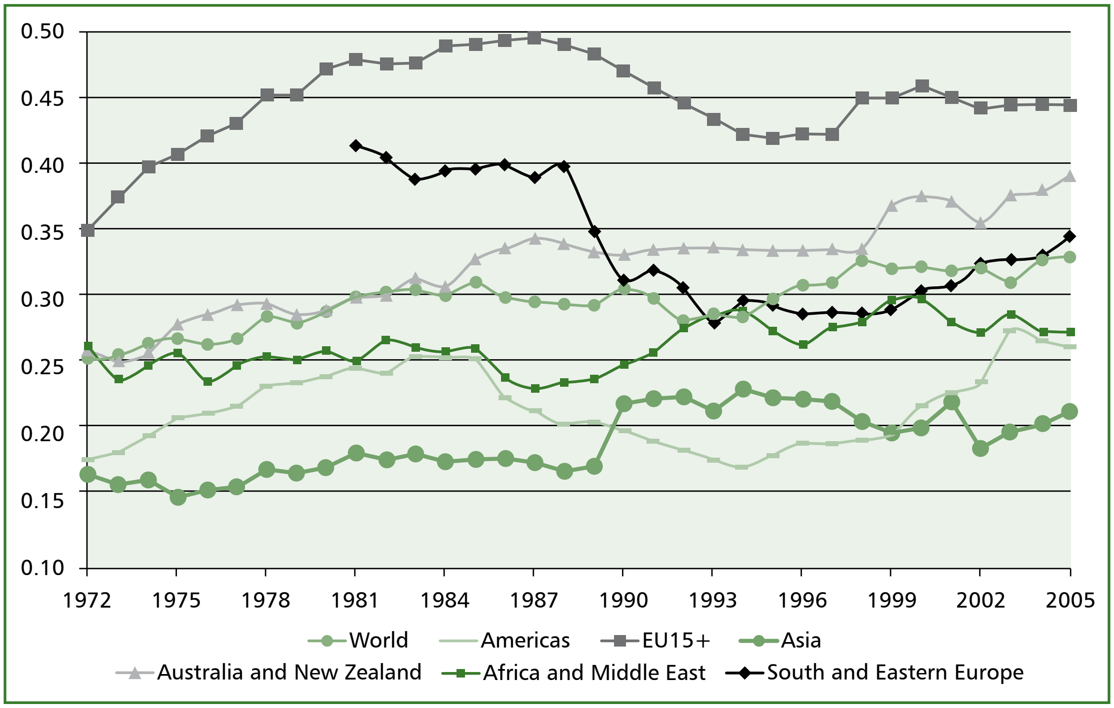
In Figure 1, we show the evolution of total revenue to gross domestic product (GDP) by region of the world covering the period 1972 to 2005. In the most recent years, the average tax–GDP ratio in Asia has been approximately half that of European Union 15+ countries;[2] it is also below the ratio for Africa and the Middle East, and for the Americas.

Determination of the tax–GDP ratio is a complex process involving many variables but it ultimately reflects a political decision of how much economic activity should be channeled through the public sector. The advantages of a low tax–GDP ratio include a more business-friendly environment and attracting foreign direct investment. Disadvantages include possible lack of resources to provide adequate public services, including those for building human capital (education and health) and public infrastructure. It may also mean lower welfare services and less equitable outcomes.

As shown in Figure 2, there are significant disparities among Asian countries in the tax–GDP ratio. For example, the ratio for Viet Nam is twice that for Pakistan. But note, nevertheless, that even the ratio for Viet Nam is approximately half of that observed in most European Union countries.

[2] Top first 15 members of the European Union per January 1995 plus Iceland, Norway, and Switzerland.

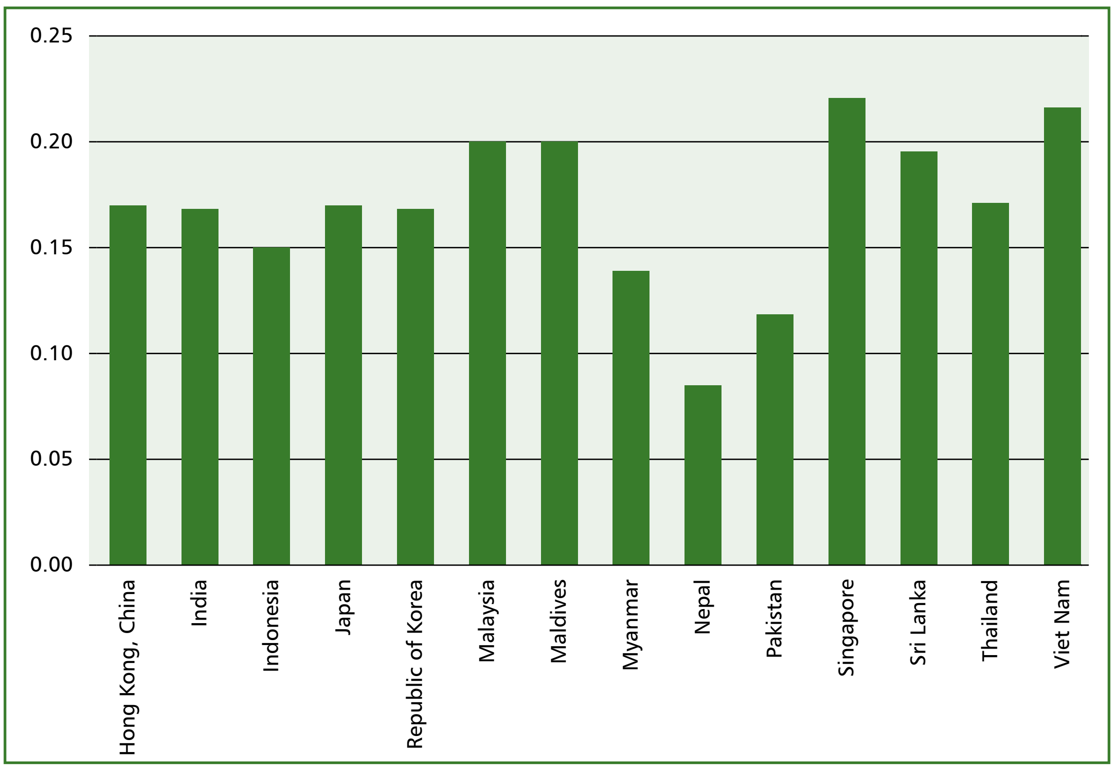
Figure 1 **Total Revenue to Gross Domestic Product by Region, 1972–2005**



Notes: Consolidated General Government Data; EU15+ includes EU15, Iceland, Norway, and Switzerland.

Source: IMF Government Finance Statistics Database.

Figure 2 **Total Tax to Gross Domestic Product Ratio in Selected Asian Economies, 1990–2005**



Note: Consolidated General Government Data.

Sources: IMF Government Finance Statistics Database; World Development Indicators.

Tax Composition: Direct versus Indirect Taxes in Asia and the World

The composition or relative reliance on different taxes in Asia is quite different from that observed in other regions of the world. As shown in Table 1, direct taxes (personal income tax [PIT], corporate income tax [CIT], payroll, social security taxes, etc.) are larger than indirect taxes (value-added tax [VAT], sales tax, excises, foreign trade, etc.) in the world average by 50% and in Organisation for Economic Co-operation and Development (OECD) countries by over 100%. However, in Asia, indirect taxes dominate direct taxes by 10% (Martinez-Vazquez and Bird 2010).

Among the reasons explaining the difference in composition is that PIT, payroll, and social security taxes are less important in Asian countries (Table 2). At the same time, taxes on foreign trade are still quite important in Asia and indirect domestic taxes have grown faster as a share of GDP than direct taxes over the past 2 decades (Figure 3).

By individual country, note, for example, that the People's Republic of China (PRC) and India have lower and similar ratios between direct and indirect taxes; of note is that in the PRC and India, social security contributions are lacking. Japan and the Republic of Korea share similar figures for direct taxes, while Japan has higher social security contributions than the Republic of Korea (where social contributions are present and growing) for indirect taxes. In Malaysia, the ratio between direct and indirect taxes tends to be higher because of profit taxes on petroleum companies. Social contributions do not exist in Malaysia, and in Thailand they are very small.

Table 1 **Direct to Indirect Tax Ratio, 1995–2005**

Year	Average	OECD	Asia
1995	1.67	2.52	0.44
1996	1.69	2.50	0.53
1997	1.71	2.39	0.62
1998	1.79	2.40	0.56
1999	1.64	2.34	0.50
2000	1.72	2.30	0.50
2001	1.75	2.36	0.76
2002	1.56	2.27	0.92
2003	1.47	2.21	0.91
2004	1.48	2.22	0.92
2005	1.49	2.27	0.91

OECD = Organisation for Economic Co-operation and Development.

Notes:

1. Data at the consolidated general government level.
2. Property taxes treated as direct taxes.

Source: IMF Government Finance Statistics Database.

Table 2 **Share of Income Taxes in Direct Taxes, 1995–2005**

Year	Average	OECD	Asia
1995	0.58	0.41	0.88
1996	0.61	0.42	0.89
1997	0.61	0.43	0.90
1998	0.62	0.52	0.91
1999	0.63	0.54	0.87
2000	0.60	0.54	0.88
2001	0.60	0.53	0.88
2002	0.58	0.52	0.86
2003	0.56	0.52	0.79
2004	0.56	0.53	0.78
2005	0.56	0.52	0.73

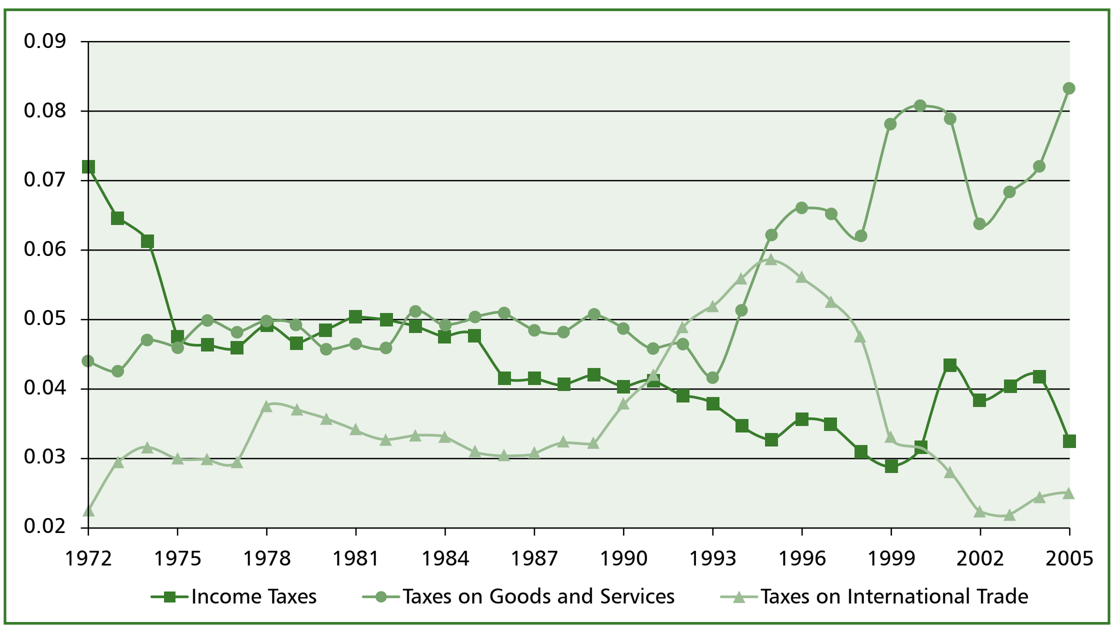
OECD = Organisation for Economic Co-operation and Development.

Notes:

1. Data at the consolidated general government level.
2. Property taxes treated as direct taxes.

Source: IMF Government Finance Statistics Database.

Figure 3 **Evolution of Selected Tax Instruments as Share in Gross Domestic Product in Asian Countries, 1972–2005**



Note: Consolidated General Government Data.

Sources: IMF Government Finance Statistics Database; World Development Indicators.

Some Further Issues on Tax Composition

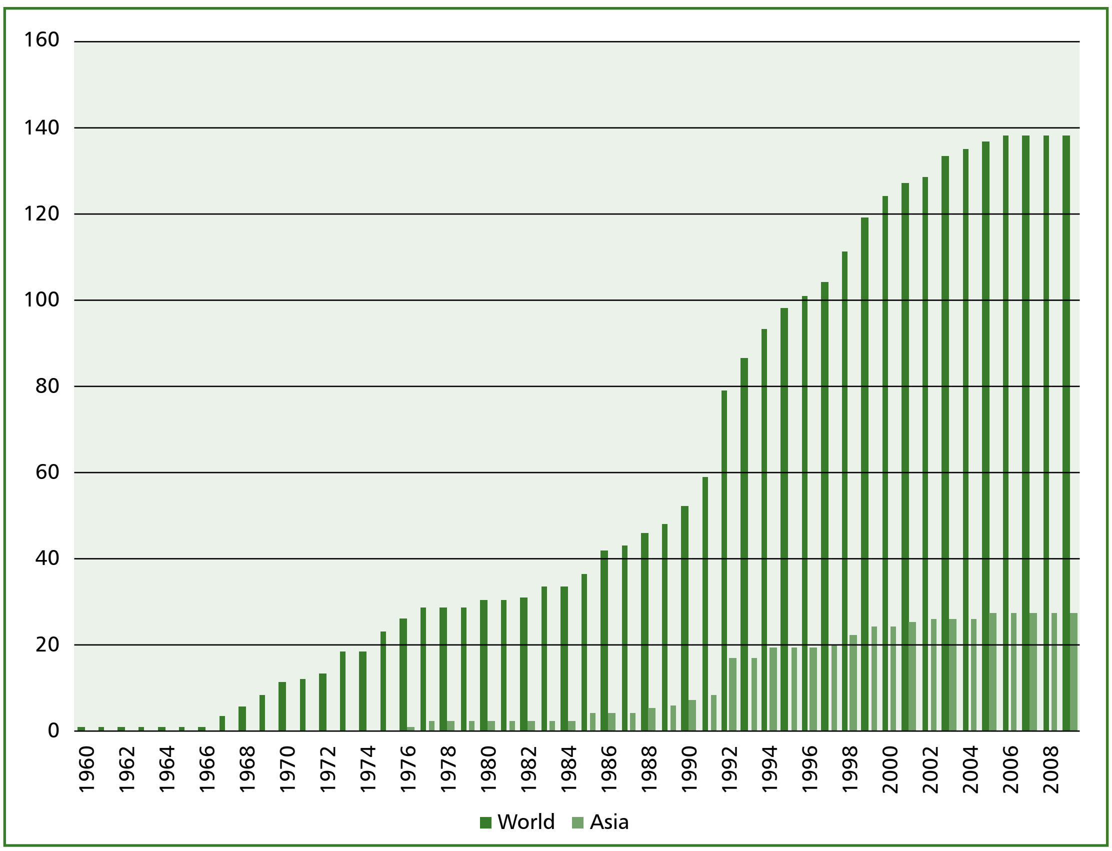
The adoption of VAT in Asia has generally followed worldwide trends (Figure 4). In Asia, it started in earnest in the early 1990s (Cnossen 2010). VAT is well established in the PRC, Japan, and the Republic of Korea, but Malaysia, Pakistan, and Singapore have yet to introduce one. In the PRC, the VAT was recently reformed from a production VAT to a consumption VAT (now providing full credit for capital input purchases). Also of note is that a full VAT was introduced in India in 2005.

In terms of overall indirect taxes, VAT still represents a smaller share of total revenues in Asia than in other regions of the world (Table 3). The smaller importance of VAT is reflected in the general low VAT rates in Asia (Table 5). The share of excise taxes in consumption taxes is in line with world averages, but is slightly higher. The most significant difference is that customs duties still represent a much higher share of total revenues in Asia than in most other regions of the world (Table 4). Note that, as a share of GDP, taxes on goods and services are still smaller in Asia than in other parts of the world (Figure 5) (Martinez-Vazquez and Bird 2010).

Customs Duties

Customs duties are more important in India, the PRC, and Viet Nam. In the transition economies of Southeast Asia (Cambodia, the Lao People's Democratic Republic, and Myanmar), the role of trade taxes is still predominant, but they are generally lower in Malaysia and Thailand. On the

Figure 4 **Number of Countries with a Value-Added Tax as of 2008**



Source: Author.

Table 3 **Share of General Sales in Total Revenues: World Average, OECD, and Asia, 1990–2008**

Year	Average	OECD	Asia
1990	0.13	0.16	0.12
1991	0.14	0.16	0.12
1992	0.14	0.16	0.12
1993	0.15	0.16	0.12
1994	0.16	0.17	0.13
1995	0.17	0.16	0.13
1996	0.17	0.16	0.13
1997	0.18	0.17	0.13
1998	0.19	0.17	0.17
1999	0.19	0.17	0.18
2000	0.20	0.17	0.18
2001	0.20	0.17	0.18
2002	0.20	0.17	0.18
2003	0.20	0.17	0.19
2004	0.21	0.18	0.20
2005	0.21	0.18	0.18
2006	0.21	0.17	0.17
2007	0.22	0.17	0.15
2008	0.24	0.21	0.16

OECD = Organisation for Economic Co-operation and Development.

Note: Data at the consolidated central government level.

Source: IMF Government Finance Statistics Database.

other hand, customs duties are practically absent in Japan and the Republic of Korea. As a whole, customs taxes as a share of GDP are only higher in Africa and the Middle East (Figure 6).

The question is how participation in free trade areas will affect overall revenues. Trade liberalization policies will inevitably result in substantial declines in customs duties. However, the increase in VAT revenues should more than compensate for this decline, although this has not been true in all cases around the world.

Relative Lower Development of Personal Income Tax

PIT is still in its primary stages everywhere in Asia other than in Japan and the Republic of Korea and, to a lesser extent, in Indonesia and Hong Kong, China. Only in Japan and the Republic of Korea is labor income more heavily taxed than capital and consumption. Thus, although PIT is the dominant form of direct taxation in OECD countries, this is not so in Asia.

There are significant differences in terms of PIT structures among Asian countries. Japan and the Republic of Korea show important dissimilarities, with two alternative theoretical visions for PIT, although both use large exemptions and deductions (Broadway 2010). The original (1940s) PIT of Japan, based on comprehensive taxation, was soon transformed into a system founded on expenditure income. The Republic of Korea still maintains a "global" income taxation that

Table 4 **Share of Excises in Consumption Taxes: World Average, OECD, and Asia, 1990–2008**

Year	Average	OECD	Asia
1990	0.54	0.46	0.57
1991	0.51	0.46	0.57
1992	0.50	0.46	0.57
1993	0.48	0.46	0.55
1994	0.45	0.47	0.55
1995	0.46	0.52	0.55
1996	0.46	0.53	0.54
1997	0.43	0.48	0.52
1998	0.42	0.47	0.48
1999	0.43	0.49	0.46
2000	0.40	0.43	0.46
2001	0.31	0.18	0.40
2002	0.37	0.40	0.41
2003	0.39	0.41	0.41
2004	0.25	0.02	0.37
2005	0.34	0.39	0.42
2006	0.33	0.38	0.35
2007	0.17	0.35	0.34
2008	0.26	0.32	0.33

OECD = Organisation for Economic Co-operation and Development.

Note: Data at the consolidated central government level.

Source: IMF Government Finance Statistics Database.

aggregates most personal income, inclusive of many forms of capital revenues, taxing it at progressive rates. In India, PIT at the central government level has a global income base, few tax brackets, and not a steep tax schedule; however, the tax base is considerably narrowed by generous personal exemptions. At the other extreme stands the PRC system of personal income taxation with a scheduled structure with different types of income taxed at different rates. In Malaysia and Thailand, PIT is of only limited importance and relies on a progressive schedule with many brackets and a widely spread set of tax rates. In Viet Nam, the top marginal tax rate is 40% but there is a large number of exemptions.

Corporate Income Taxation in Asia Shows Big Variations

This diversity in corporate income taxation takes different forms.[3] Singapore offers one of the lowest tax rates in the region while Japan has the highest CIT rate among OECD countries with an effective tax rate of over 40%. In the PRC, India, Malaysia, and Thailand, CIT remains more important than PIT, but this does not apply in the Republic of Korea and Japan. CIT plays a large role in Malaysia; however, 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

[3] See Albi (2010).

Table 5 **Some Tax Instruments in Selected Asian Countries, Australia, and New Zealand**

Tax Instrument	Australia	New Zealand	Brunei Darussalam	Cambodia	PRC	India	Indonesia
Corporate income tax	30%	33%	30%	5%–30%	33%	34.0%, 42.2%	10%–30%
Value-added tax	10%	12.50%	No	10%	13%, 17%	12.50%	10%
Tax incentives							
Tax holidays, tax exemptions	Yes	Yes	up to 5 years	up to 6 years	Yes	up to 15 years	Yes
Import duty exemptions	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Tax Instrument	**Japan**	**Republic of Korea**	**Malaysia**	**Philippines**	**Singapore**	**Thailand**	**Viet Nam**
Corporate income tax	30%	14.3%, 27.5%	27%	35%	18%	30%	28%
Value-added tax	5%	10%	5%–10%	12%	7%	7%	0%–10%
Tax incentives							
Tax holidays, tax exemptions	Yes	5 years	Yes	3–8 years	up to 15 years	3–8 years	Yes
Import duty exemptions	Yes	Yes	Yes	Yes	Yes	Yes	Yes

PRC = People's Republic of China.

Source: PricewaterhouseCoopers.

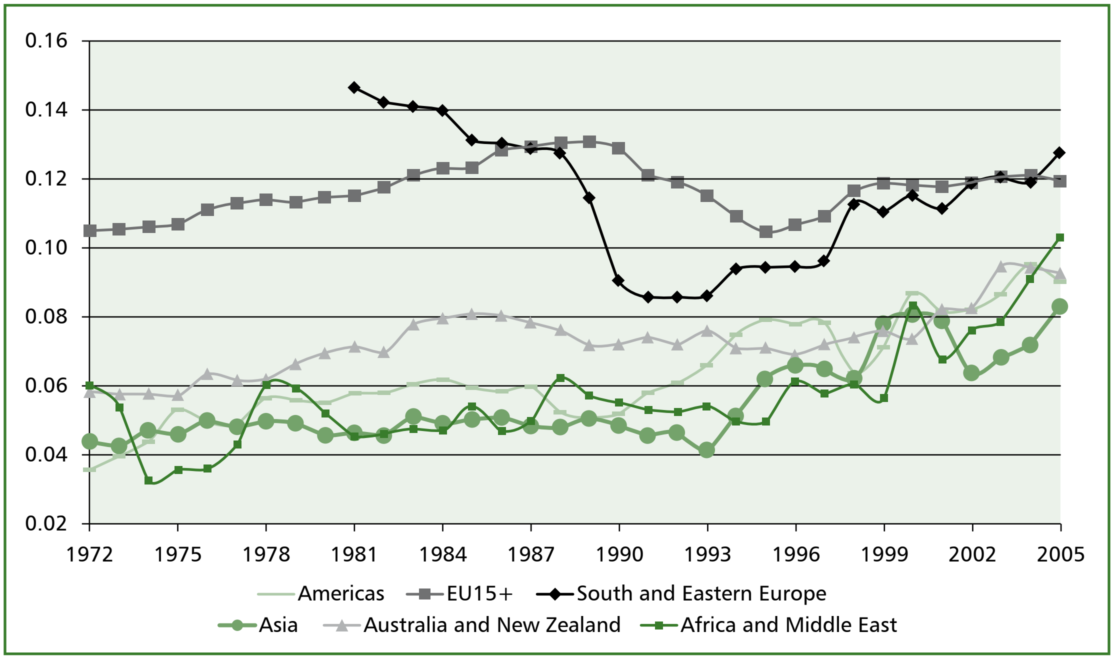
on petroleum companies, whose tax rate is much higher than the standard one. In the PRC, CIT is heavily affected by special incentives—particularly a generous tax holiday—granted to foreign enterprises.

On the other hand, with very few exceptions, CIT rates in Asia are considerably uniform (Table 5); this is likely to reflect some degree of cross-country competition for foreign direct investment.

High Taxation Diversity in Asia

Mapping the different share of taxes in total revenues for different countries in Asia reveals that there is a high degree of diversity (Figure 7). It is in this sense that it is not correct to talk about an Asian tax model.

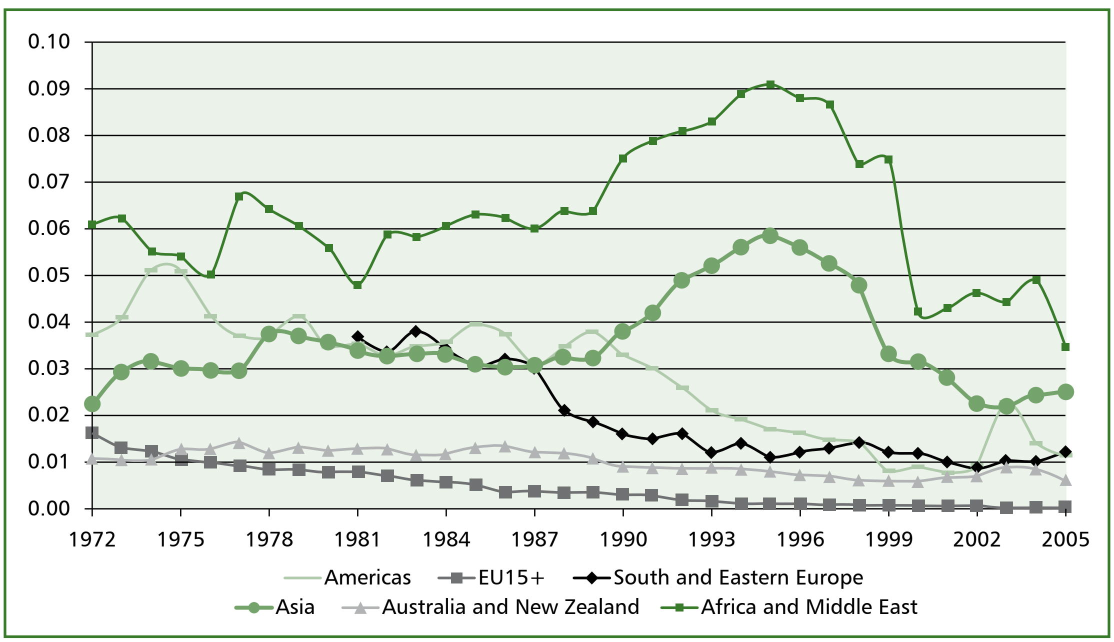
Figure 5 **Taxes on Goods and Services as a Share of Gross Domestic Product by Region, 1972–2005**



Notes: Consolidated General Government Data; EU15+ includes EU15, Iceland, Norway, and Switzerland.

Sources: IMF Government Finance Statistics Database; World Development Indicators.

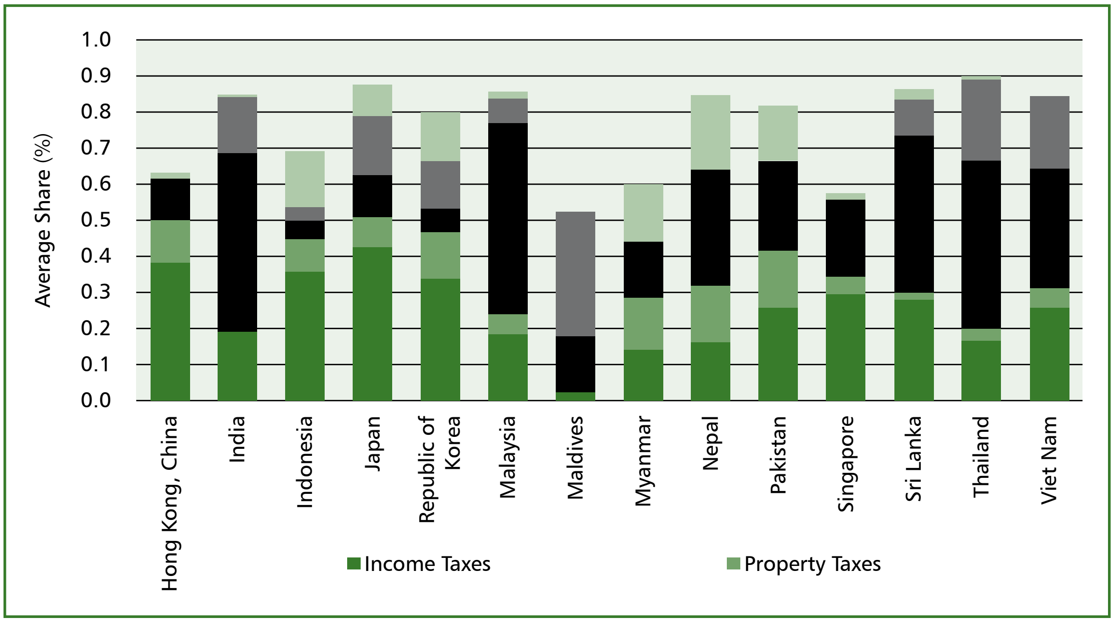
Figure 6 **Taxes on International Trade as a Share of Gross Domestic Product, 1972–2005**



Notes: Consolidated General Government Data; EU15+ includes EU15, Iceland, Norway, and Switzerland.

Sources: IMF Government Finance Statistics Database; World Development Indicators.

Figure 7 **Tax Structure in Selected Asian Economies: Share of Total Taxes, Average 1990–2005**



Notes: Consolidated General Government Data; Data on Social Security Contributions and Payroll Taxes not available for Maldives, Singapore, and Viet Nam; Data on Property Taxes not available for Maldives; Data on Taxes on Goods and Services not available for Myanmar, Nepal, and Pakistan.

Sources: IMF Government Finance Statistics Database; World Development Indicators.

General Scope for Tax Policy Reform

The review of tax policy above makes it clear that there is ample margin for higher tax levels in Asia through more direct taxation, especially PIT (except for possibly Japan and the Republic of Korea). This reform of PIT could take the form of tax simplification through broader tax bases and somewhat higher tax rates. The higher tax pressure could also come from providing a wider role for VAT and a diminished role for customs duties. However, there needs to be awareness that full recovery of the foregone customs duties through VAT is far from automatic. It is at this point that we need to highlight the important role to be played by a modernized tax administration system.

Centrality of Tax Administration Issues for Improving Performance

A well-known truism among fiscal experts is that good systems of tax laws with poor tax administration only lead to a dysfunctional tax system. It is also true that when the tax laws are unclear, the actual practice of tax administration makes the tax law, which is an equally undesirable situation. A well-performing tax system requires both good tax policy and a modern and effective tax administration system.

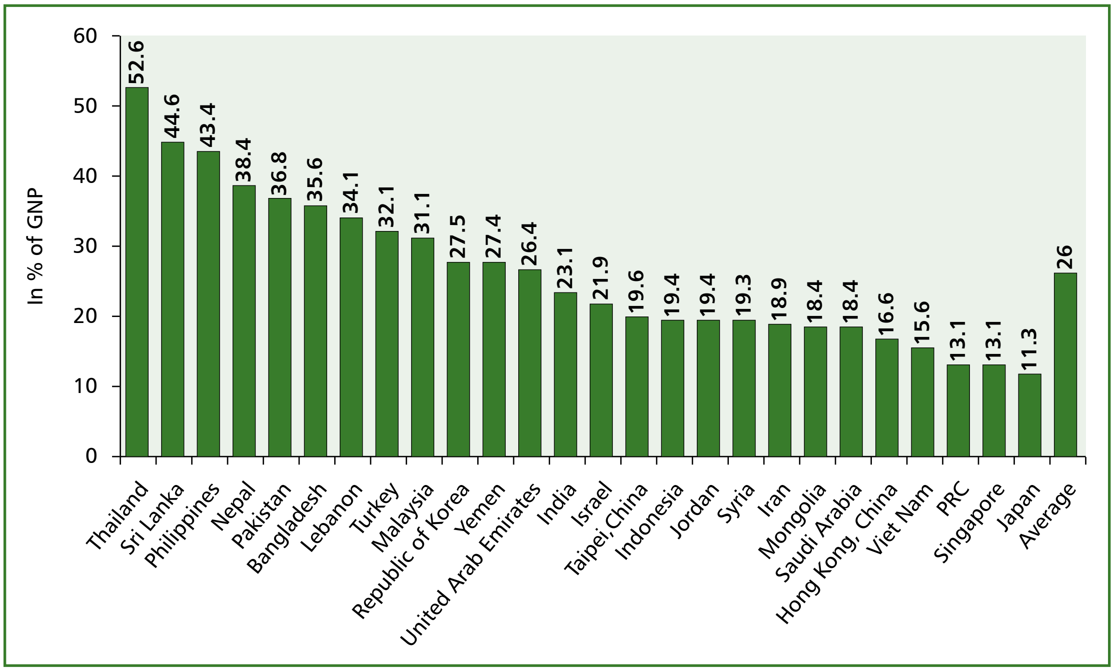
Over the years, countries all over the world have found it easier to undertake piecemeal tax policy reform than to invest heavily in the reform and modernization of their tax administrations. Knowing when such tax administration reform is necessary is not always easy. The need for tax administration reform may be gauged by a number of indicators, including the following:

(i) total tax revenue to GDP,
(ii) the tax revenue gap (actual collections versus potential collections),
(iii) additional revenue collected versus the number of declarations audited,
(iv) tax arrears collected versus total tax arrears,
(v) cost of tax compliance by taxpayers, and
(vi) cost of tax administration.

There are no reliable data on many of those standards, but by some measures (e.g., tax revenue to GDP) it would seem that some attention should be paid to tax administration. The hard issue to determine is the extent of tax evasion in a country. It is common in the literature to gauge an approximate level of tax evasion by the relative importance of the underground economy in the entire system. To judge from single-country estimates (Figure 8), the underground economy is very large in some countries (e.g., Thailand) and quite insignificant in others (e.g., Japan), but on average, it is higher in Asia than in OECD countries, although lower than in Africa and Central and South America (Table 6).

By other standards of normal tax administration practice and the transaction costs faced by firms to work with tax administration institutions (what are generally known as compliance costs), the average country in Asia still ranks far below best international practices in OECD countries (Table 7). In summary, by a number of standards, it appears that tax administration reform and modernization should become part of the policy agenda of many countries in Asia.

Figure 8 **Asia Shadow Economy in Percentage of Gross National Product, 1999–2000**



GNP = gross national product, PRC = People's Republic of China.

Sources: IMF Government Finance Statistics Database; World Development Indicators.

Table 6 **Average Size of the Shadow Economy for Developing, Transition, and OECD Countries in Terms of Value Added and of the Labor Force over Two Periods, 1999–2000**

Countries	Average Size of the Shadow Economy – Value Added in % of Official GDP 1999/2000 Currency Demand and DYMIMIC Method (Number of Countries)	Average Size of the Shadow Economy Labor Force in % of Official Labor Force 1999/2000 Survey and Discrepancy Methods (Number of Countries)
Developing Countries		
Africa	41 (23)	48.2 (23)
Central and South America	41 (18)	45.1 (18)
Asia[1]	29 (26)	33.4 (26)
Transition countries	35 (23)	–
Western OECD Countries – Europe	18 (16)	16.4 (7)
North America and Pacific OECD Countries	13.5 (4)	–

– = not available, DYMIMIC = Dynamic Multiple Indicator Multiple Cause, GDP = gross domestic product, OECD = Organisation for Economic Co-operation and Development.

[1] Here not all economies are developing countries like Japan, Singapore, or Hong Kong, China.

Source: Alm et al. (2004).

Table 7 **Paying Taxes by Region**

Region	**Payments** (Number per Year)	**Time** (Hours per Year)	**Profit Tax** (%)	**Labor Tax and Contributions** (%)	**Other Taxes** (%)	**Total Tax Rate** (% Profit)
East Asia and Pacific	24.6	227.2	18.3	10.3	7.5	36.1
South Asia	31.3	284.5	17.9	7.8	14.2	40.0
Eastern Europe and Central Asia	46.3	336.3	10.9	23.1	9.4	43.4
Latin America and Caribbean	33.2	385.2	20.4	14.7	13.2	48.3
Middle East and North Africa	22.9	204.2	12.7	15.2	5.0	32.9
OECD	12.8	194.1	16.8	24.4	3.3	44.5
Sub-Saharan Africa	37.7	306.3	23.9	13.1	30.5	67.5

OECD = Organisation for Economic Co-operation and Development.

Source: www.doingbusiness.org/data/exploretopics/paying-taxes

General Tax Administration Reform

Some general lessons for tax administration reform from international experience are applicable to countries in Asia.

Goals

The reform of tax administration systems must follow simple transparent goals that bring enforcement closer to the most important objectives of tax policy. Goals for tax administration reform include the following:

(i) Increasing the effectiveness, efficiency, and integrity of tax administration systems.
(ii) Improving fairness of the tax system.
(iii) Broadening the tax base.
(iv) Improving tax compliance.

Modernizing Tax Administrations and Improving Revenues and Compliance

International experience shows several critical steps that should be followed in the modernization of tax administration to improve collection and compliance:

(i) Reorganize tax administration along functional lines (collections, audit, etc., as opposed to by tax); merge customs and tax administration and collect social security contributions with tax administration.
(ii) Decentralize the organizational structure by adopting semiautonomous revenue agencies and creating large-taxpayer units; introduce highly automated information technology systems driven by final users (for registration, audit, and taxpayer education).
(iii) Promote voluntary compliance by establishing self-assessment systems, taxpayer education programs, e-filing, and pre-populated income tax returns. In addition, use public relations campaigns to draw attention to the benefits of taxes (e.g., public services), and introduce reasonable appeals and dispute resolution systems.
(iv) Develop tax audit capabilities with risk assessment (audit selection) programs, computerized third-party information systems, and record matching.
(v) Fight corruption by implementing a modern code of conduct and ethics, increasing flexibility in setting wages and career promotion and staff training, strengthening specialized internal audit for enforcing the code of ethics, and removing opportunity by using e-filing.

Increasing Detection and Punishment: The Enforcement Paradigm

The effectiveness of tax enforcement and voluntary compliance depend critically on the perception that evaders are likely to be caught and if so, punished. General reforms in this direction include the following:

(i) Increase the number of audits, either by hiring additional auditors or by contracting out audits to private sector firms.
(ii) Improve the quality of audits and auditors.
(iii) Increase penalties for tax cheating, such as the interest rate on unpaid taxes.
(iv) Publicize tax evasion convictions in the media as an alternative nonfinancial type of penalty.
(v) Improve the effectiveness of audits via adoption of modern audit technology, including more systematic selection of returns for audit and greater use of "scoring" tax returns.
(vi) Improve state government follow up on taxpayers found to be noncompliant with the federal personal income tax.

Changing the Culture of Paying Taxes: The Service Paradigm Again

The services of the tax administration can be improved by becoming more consumer-friendly, following the service paradigm by

(i) promoting taxpayer education;
(ii) providing services to assist taxpayers in filing returns and paying taxes;
(iii) improving phone advice services;
(iv) improving tax agency websites;
(v) simplifying taxes;
(vi) simplifying the payment of taxes;
(vii) simplifying tax forms;
(viii) using mass media to reinforce tax compliance as the social norm, and publicize tax cheats;
(ix) emphasizing the link between payment of taxes and the receipt of government services;
(x) targeting certain groups (e.g., new firms or employees) to introduce from the start the notion that paying taxes is the social norm;
(xi) enlisting other organizations to promote compliance, so that it is seen (again) that paying taxes is the accepted pattern of behavior;
(xii) avoiding individuals who think cheating is acceptable; a tax amnesty is a classic example of sending the wrong signal; and
(xiii) addressing perceived inequities in the ways people feel that they are treated.

Some Common Lessons for Tax System Reform

We conclude this note by offering some of the conventional wisdom on the timing and procedures for tax reform:

(i) Comprehensive reforms are often better than piecemeal reforms.
(ii) The best time for comprehensive reform is—paradoxically—often in bad economic times.
(iii) In many instances, base broadening is consistent with equity and efficiency concerns.
(iv) Tax reforms must consider the specific circumstances of the country (there is no one-size-fits-all tax reform) but even so there must be a plan.
(v) Tax reforms must recognize and balance the trade-offs.
(vi) Empirical analysis is often difficult but is crucial for determining the details of any reform and for selling any reform.
(vii) The administrative dimension is important everywhere but it is necessary to first get the policy right before dealing with administrative problems.
(viii) Tax reform should pay attention to intergovernment dimensions.
(ix) Reforms must consider implementation (and transition) issues.

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Taxation in Asia

This publication presents an overview of tax policy and tax administration issues—how countries in Asia and the Pacific compare with the rest of the world in main taxes, revenue collections, tax morale, and others. The implications of reducing reliance on customs tariff revenues and of using the value-added tax on a broader basis, especially in the services sector, have been analyzed. This note suggests an agenda for reform by discussing whether there is space to increase national revenue collections, how to improve tax administration and enforcement, and how these reforms interact with the decentralization paradigm. The individual country performances, the extent of the shadow economy, and lessons on reforming tax administration have been referenced.

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