

**GLOBALIZATION AND TAX SYSTEMS:
IMPLICATIONS FOR DEVELOPING COUNTRIES WITH
PARTICULAR REFERENCE TO SOUTHEAST ASIA**

by

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Abstract

The unfolding globalization process, centring on production and distribution network and on financial institutions, products, and transactions, is having a profound impact on a wide range of policies and practices in both the private and the public sectors. This paper analyzes the implications of the globalization and the resulting greater integration of the world economy on tax systems in developing countries in general, and Southeast Asian countries in particular. Issues discussed include international factor mobility and the resulting consequences for efficiency and burden of taxation; tax competition among various jurisdictions to attract foreign direct investment (FDI) and professional and technical manpower; the impact of globalization on indirect taxation, including international trade taxation; tax implications of the Internet and E-commerce; taxation of global portfolio flows (i.e. non-FDI flows); and the impact of globalization on fiscal sustainability in Southeast Asia.

Keywords: *FDI, globalization, Internet, Southeast Asia, tax competition,*

JEL Codes: *F20, H20, H29, H87*

1. Introduction

The unfolding globalization process, centring on production and distribution networks and on financial institutions, products, and transactions, is having a profound impact on a wide range of policies and practices in both the private and the public sectors.

Present tax systems evolved when each country formulated its own tax policy and focused on the requirements of its domestic economy. When tax treaties, agreements and conventions among nations were negotiated, they were within the framework of national sovereignty in tax policy. The globalization process has changed this, particularly with respect to the level of taxation, mix of taxes, design of particular taxes, and the manner of their administration and compliance. Countries are being forced to exhibit much greater awareness of and sensitivity to the tax changes being undertaken by their trading partners and competitors, reducing autonomy concerning their tax policies (Lodin, 2000, Owens, 1998 and Tanzi, 1998, 2000,).

Tanzi has used the term “fiscal termites” to depict how globalization and technological changes will impact on national tax systems (2000)¹. In other words, adaptation of the tax systems to globalization is expected to be slow and subtle rather than discontinuous (Slemrod, 1995). It is also possible that even as the tax administrators confront challenges in administering current taxes, new types of taxes may become feasible with the rise of new technologies and activities (Tanzi, 2000)². This paper analyzes the implications of the globalization and the resulting greater integration of the world economy on tax systems in developing countries in general,

¹ Tanzi (2000) identifies eight fiscal termites: E-commerce and transactions; use of E-money; intra-company trade; off-shore financial centres and tax heavens; derivatives and hedge funds; inability to tax financial capital; growing foreign activities; and foreign shopping.

² As an example, France has recently levied royalties tax on blank CDs, DCDs, and mini-disks. It is considering imposing such tax on anything that can be used to record an original work, such as computers, DVD players, and Video recorders, with the aim of compensating artists whose works may be copied (**Business Times**, Singapore, January 18, 2001).

and Southeast Asian countries in particular³. The remainder of the paper is organized as follows.

Globalization has greatly increased the international mobility of goods, services, factors (particularly capital), finance, and consumers (or more precisely consumption activities). The issue of international mobility and the resulting distribution of tax burden between mobile versus immobile factors is analyzed in the next section. Globalization and international factor mobility has implications for efficient taxation of firms operating in multiple tax jurisdictions. These are discussed in section 3. This is followed by an analysis of the phenomenon of tax competition among various jurisdictions to attract foreign direct investment (FDI) in Section 4; and professional and technical manpower in Section 5. Section 6 deals with the impact of globalization on indirect taxation, including international trade taxation. Section 7 briefly discusses tax implications of the Internet and E-commerce. Taxation of global portfolio flows (i.e. non-FDI flows) is taken up in section 8. The final section concludes with an extended discussion of the impact of globalization on fiscal sustainability in Southeast Asia, and on ways to deal with the implications of globalization for the tax systems.

2. International Factor Mobility and Burden of Taxation

The degree of international mobility varies among the factors of production. Labor is typically less mobile than capital, though certain types of professional and technical human resources have not only become moderately mobile but have also become more sensitive to cross-border differentials in tax burdens. Financial capital is considered highly mobile and sensitive to tax-induced changes in net returns. FDI has increasingly become more “footloose” as globalization has led to production-distribution chain being divided among many tax jurisdictions. Globalization has thus

³ The Southeast Asian region is usually defined to include ten countries, Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

enhanced the power of capital, and of net capital-exporting countries, while the relative power of labor and of capital importing countries has declined. This is of particular relevance to developing countries in general and to Southeast Asia in particular. In Southeast Asia, only Singapore is a net lender abroad⁴. Factors or activities with low mobility include types of labor which have little demand internationally, natural resources and real estate, and domestic country-specific investments due to a combination of prohibitively high sunk costs, asymmetric information and absence of minimum size or level of operations.

2.1 Capital Mobility

High degree of capital mobility has created intense tax competition among developing countries with the objective of influencing location decisions (section 4). The intensity has been given added impetus by the declining importance of flows, that are not sensitive to tax factors, such as official development assistance (Bird and Rajan, 2001). In federal countries, inter-state tax competition has also intensified, increasing the weight of tax factors in location decisions within a country. Tax competition has also spilled over to the expenditure side, providing further advantage to fiscally strong jurisdictions. At the extreme, many financial transactions such as those involving foreign exchange (forex) and derivatives, have been virtually untaxed, despite being potentially lucrative sources of global tax revenue (section 8).

2.2 Labor Mobility

In the case of labor, demographic factors are going to play an increasing role, as the ratio of retired to working population increases in some countries and decreases in others. Countries with ageing populations will need to make use of the huge pools of young and skilled labor in other developing and transition countries to remain cost competitive. Such trends are already appearing in many East Asian

⁴ Some developing countries such as India and Malaysia are net capital-importing countries, but they nevertheless have significant investments in selected sectors abroad.

countries, such as Japan, Taiwan and Singapore, where fertility rates are below those needed for population replacement⁵. On the other hand, unskilled labor remains relatively immobile and less responsive to tax considerations. Many East Asian countries have maintained very tight restrictions on unskilled foreign workers, using them as a buffer to even out business cycles (Freeman and Mo, 1996 and Rod and Williams, 1996). Moreover, unskilled labor is taxed heavily in the recipient countries, particularly in Singapore and Malaysia (Asher, 2001)⁶.

2.3 Implications for Distribution of Tax Burdens

The preceding discussion suggests that globalization implies higher supply elasticity by any one tax-jurisdiction for footloose factors such as capital and skilled labor, while increasing the (derived) demand elasticity for immobile factors such as land and unskilled labor. What are the consequent implications for tax policy?

First, the inverse elasticity rule (so-called Ramsey Rule) suggests that, on efficiency grounds, the marginal tax rate should be inversely related to the elasticity of factor supply. Therefore, preferential tax treatment for mobile factors relative to immobile ones - i.e., portfolio investment over physical investment; foreign and large domestic investment over small and medium sized domestic ones; and skilled over unskilled labor is justified on efficiency grounds. Relatively high supply elasticity of mobile factors implies that the burden of tax on these factors will fall *primarily* on the immobile factors⁷. Indeed, at the extreme, complete factor mobility (i.e. perfect

⁵ ADB (1997) and Heller (1997) discuss the general fiscal policy implications of ageing in East Asia; while Heller and Symanski (1997) explore the savings implications of these demographic trends. As a consequence of these rapidly ageing populations, an important priority in Southeast Asia is reforming existing social security systems with a view to enhancing their sustainability, adequacy, and equity (Asher, 1998).

⁶ Freeman and Mo (1996) have made reference to the immigration goals and policies of the East Asian countries as being characterized by the '3-S' strategy of skilled, short-term and sectorally targeted migration. There are indications that the inflows of immigrants (as percentages of the respective host country populations), peaked in 1990, and has been declining ever since (**The Economist**, November 1, 1997, p.91).

⁷ The assumption in this section is that the residence principle of taxation is not applied. This is elaborated upon in the next section.

elasticity of supply) will imply that any tax on the mobile factor will fall *solely* on the immobile ones, as the mobile factors will relocate overseas unless there is corresponding compensation (through subsidies, reduction in other costs, etc.).

Given the need to maintain a certain amount of public spending, particularly for increasingly elaborate and expensive infrastructure and human resource development, globalization will lead to a lessening of progressivity of tax structures (increased inequity)⁸. Thus, taxes levied directly on relatively immobile factors would be welfare-enhancing in the sense of having the same incidence as taxes on the mobile factors without leading to flight of the latter to *evade* and *avoid* the burden of the tax⁹. Absent broad and sustained political support in both the developing and the industrial countries, globalization process could generate considerable conflict and may take forms which dilute its potential welfare gains.

Second, globalization has greatly reinforced the conventional wisdom explained by Musgrave (1959) that corporate income tax rates cannot be much lower than the top rate of individual income tax. This is to discourage individual or family business from incorporating to minimise the tax burden. Globalization has also reinforced the conventional wisdom that income tax rates in capital-importing countries should be no higher than those in the capital-exporting countries.

Table 1 provides data on individual and company income tax rates, and their respective number of brackets in six Southeast Asian countries. The highest marginal company income tax rates in Southeast Asia range from a low of 26 percent in

⁸ While this is true in general, to the extent that tax rates on property may increase (given its immobility), the extent of regressivity may be somewhat mitigated. However, one would expect the direct effect to outweigh the indirect one, thus leading to the conclusion that the impact of globalization on tax structures will probably be regressive on balance. In federal countries, mobility of real estate investments within the country is high. Since these taxes are usually assigned to lower levels of government, this mobility imposes an additional constraint on increasing property taxes.

⁹ A subtle, but conceptually useful distinction to make is that between tax *evasion* and *avoidance*. The latter is a situation in which the taxpayer makes use of all available loopholes and ambiguities in the statutes, including leaving the country altogether (if there is no control on capital flows). Tax avoidance is entirely legal (if not always moral), and is therefore also referred to as tax *planning*. Tax evasion is illegal and carries with it the possible imposition of penalties if caught. Thus, if there existed capital controls (on outflows) and capital flight were done through the parallel market, that would be tax evasion.

Singapore to high of 32 percent in Philippines. In Vietnam, the standard rate is also 32 percent, though for some types of activities, the highest rate is 50 percent. Thus, the rates vary in a narrow range. These rates are also lower than the corresponding standard federal corporate income tax rate of 35 percent for the United States. Some states in the United States also levy corporate income taxes.

The range for individual income tax rates among Southeast Asian countries is somewhat wider. Thus, Singapore's range of 2 to 28 percent with 10 brackets is much lower than 10 to 60 percent with 6 brackets for Vietnam (Table 1). Except for Vietnam, the top marginal rate is lower in Southeast Asia than the 39.6 percent federal rate in the United States. In addition, some states in the United States also levy individual income taxes.

It is however important to keep in mind that effective tax burden (even if the economic incidence is not taken in to account) depends both on the tax rates and on how the tax base is defined. International variations in the definition of the tax base for corporate (or company) and personal income taxes, remain quite considerable. In Singapore and Malaysia, income tax is partially integrated through the dividend-received-credit method; while the other Southeast Asian countries employ classical method of corporate taxation under which dividend income is double taxed (Das-Gupta and Mookherjee, 1998 and Asher, 2001). These variations could lead to greater differences in effective rates than nominal rate comparisons alone may suggest. Nevertheless, a close bunching of nominal income tax rates is observable in the case of Southeast Asia, suggesting that these countries do take into account the rates in the neighboring countries.

Third, it is often argued that the loss of opportunity to tax some of the income base of mobile factors, and the political economy consequences of income tax regressivity of taxing immobile factors, implies that there may be a move to replace taxes on income with those on consumption.

Consumption taxes can be of the personal type (called expenditure tax) which recognize the specific tax paying attributes of individuals, such as the income level

and the family size. Alternatively, increased share of consumption taxes may involve in-rem taxes such as VAT and excise taxes, which do not take into account such attributes. Among the Southeast Asian countries, Indonesia, Thailand and the Philippines levy a VAT at 10 percent, Singapore has a 3 percent VAT. Malaysia has been gradually broadening its manufacturing level sales tax and a tax on services as steps towards the eventual introduction of a VAT. Vietnam introduced a VAT in January 1999, at rates varying between 0-20 percent. All countries levy excise taxes on selected commodities.

It can thus be seen that the scope of increasing relative importance of consumption taxes may in fact be limited in developing countries in Southeast Asia. This is because income taxes are currently narrowly based, both in terms of proportion of national income and in term of the proportion of labor force subjected to income tax. Hence, there appears to be more scope for increasing the share of the individual income tax.

3. Efficiency And Taxation of Firms Operating In Multiple Tax Jurisdictions

International factor mobility has increased the need for efficient and equitable tax treatment of firms operating in multiple tax jurisdictions. Current procedures used by most countries to allocate tax base between jurisdictions and to avoid double taxation through a network of more than 1500 bilateral double taxation treaties (DTAs), most of which are modeled after the OECD conventions (Owens, 1998), is not only cumbersome, but will also come under increasing pressure as the scope and volume of cross-border activities expands sharply. This is because the DTAs are based on the assumption of national sovereignty in tax policy, which will become less relevant as globalization progresses.

Each subsidiary of the **parent company** located in different tax jurisdictions is currently taxed as a separate entity. This provides incentives for firms engaged in activities in multiple tax jurisdictions to lower their worldwide tax liabilities through transfer pricing, i.e. manipulation of costs of inputs imported from subsidiaries in

different tax jurisdictions and through allocation of joint costs of the headquarters, and research and development (Rajan, 2000).

Currently, the recipient (or host) country in which investment or activity is based has the first right to tax the resulting income. The sending (or home) country then has the right to tax the income (which it need not exercise) according to whether it follows residence principle or source (i.e. territorial) principle. Under the residence principle, a country reserves the right to tax the income of its residents regardless of where in the world it is earned. The countries however do attempt to offset taxes paid abroad (i.e. to avoid double taxation) through tax credit (so long as income tax rates abroad do not exceed the income tax rates at home), through deduction of foreign taxes paid from taxable income, or a combination of methods.

The tax credit method, if perfectly administered, and without the deferment of taxes on foreign income not brought back to the home country, implies that tax burden of an economic entity will be identical regardless of where in the world the activity occurs. This is consistent with the notion of the global efficiency and capital export neutrality (CEN). Even if a country uses residence principle but permits foreign taxes to be deducted, it would meet the requirements of national efficiency and not global efficiency or CEN. National efficiency requires that capital exports be carried to the point where the return *after* foreign tax abroad equals the *before-tax* return on domestic investment.

Under the source (or territorial) principle, capital income is taxed as income under the personal income tax, and the tax liabilities are assessed on the basis of where the income originates, regardless of whether it is by residents or non-residents. Thus, residents are not liable for their income earned abroad but not brought into the territory. A source-based taxing might be considered as a tax on investments. Insofar as the tax rates between countries vary, there will be an incentive to allocate savings differentially to profit from the different tax rates. Thus, it is in effect a tax on investment, and does distort investment allocation (i.e., the marginal returns on capital pre-tax are not equalized). Consequently, the source-

based tax does not fulfil the CEN criteria if applied at different rates. However, the source principle implies that all savers within a country face the same tax burden regardless of the country of residence. Under unfettered global capital flows, this will equalize the *net returns* to savers (inter-temporal marginal rate of substitution) across countries, hence ensuring that world savings are efficiently allocated. This notion of efficiency (of savings allocation) is referred to as the principle of capital import neutrality (CIN). In contrast, the residence principle is not consistent with CIN (of course, unless it is levied at the same rate by all countries).

In conventional (closed economy) tax parlance, the residence principle may be viewed more as approximating the ability-to-pay approach to taxation while the source principle may be viewed as akin to the benefits approach to taxation. The principles of both CEN and CIN could also be theoretically attained if all countries choose a single tax principle (either one) and apply uniform proportional tax rate. In the absence of such harmonization/coordination, this outcome will not occur. The residence principle is seen as being preferable as a second-best alternative to tax harmonization, as it will not induce tax competition between countries to attract mobile factors, and will lead to maximization of global production¹⁰. It therefore seems to satisfy the criteria for evaluating a country's tax policy set out by Slemrod (1990), viz. how well resources are allocated internationally and how successfully a country is able to protect its revenue base against other countries¹¹.

However, a residence-based tax system has very high informational requirements. In particular, it requires that either the authorities in factor-importing country provide the necessary information to tax authorities in the factor-exporting country, or that the mobile factors truthfully report their foreign incomes, both of

¹⁰ Of course, conventional (neoclassical) trade theory tells us that - as long as factor proportions do not vary "too much" - product flows are substitutes for factor flows, in that both lead to factor price equalization. However, the presence of various market imperfections or differing technologies between countries may prevent trade from equalizing such factor returns, thus making international free capital flows and labor necessary for factor price convergence.

¹¹ The residence principle may be seen as the open economy version of the aggregate efficiency theorem in optimal tax theory *a la* Diamond and Mirrlees (1971).

which are highly unlikely. This makes it relatively unfeasible to impose such a system unilaterally by the home (capital-exporting) country¹². In cases where such information is freely available (such as in the case of state taxes in the US), the residence principle may result in limited intra-state tax competition, despite free inter-jurisdictional mobility of factors of production and no explicit attempt at tax harmonization (Tanzi, 1995, and Tanzi and Zee, 1998)¹³. In the US, national earnings of the corporations are allocated to different states on the basis of a weighted formula based on sales, expenses, and property of a corporation in each state. So each firm is not considered as a separate entity in each state, though each state is free to set its own corporate income tax rate.

The residence principle is far from distortion-free. Apart from the failure to meet the CIN efficiency criteria noted previously, two problems arise. First, a perpetual deferment of profit or income repatriation from abroad will reduce the present value of the tax burden substantially, driving it to zero at the limit¹⁴. Second, the requirement of “country of domicile” may be abused in the sense that individuals and firms may claim tax havens as their ‘tax address’ of residence.

Direct taxation gets highly convoluted in an interdependent world as some countries adopt the residence principle, others the source principle or, as is most frequent, a combination of the two. For instance, France, Germany and Netherlands

¹² Bacchetta and Espinosa (1995) have developed a game-theoretic model in which information transmission may be used as a strategic device by inter-jurisdictional authorities acting in a non-cooperative manner. In particular, the motivation for such cross-border information sharing is that it allows both governments to set higher tax rates. This is so, as the capital-importing country will have information on the exact amount of investment, while the capital-exporting country is able to ensure tax evasion/avoidance is minimized. On the other hand, the cost of such information sharing by the capital-importing country is that it is less able to attract foreign investment attempting to minimize global tax burdens. These two effects may lead to partial sharing of information between countries.

¹³ According to Tanzi and Zee (1998), this is unlike the EU, in which inter-union informational flows are far more limited, hence making the residence-based tax far less workable. According to the authors, the coefficient of variation of personal income taxes in 1994 in the EU was about one third that in the US, suggesting that there is greater tax competition among EU member countries. Part of the reason for restrained tax competition among US states may also be due to the limited role state taxes play relative to the federal tax system, which collects over two thirds of total taxes.

¹⁴ Most countries allow for deferment of active incomes, while requiring that passive income (such as dividends) be taxed on an accrual basis.

use the territorial approach to taxation; while Japan, Canada, the US and UK use the residence approach. In Southeast Asia, all countries have adopted source or territorial principle for income tax.

4. Tax Competition and FDI

4.1 Fiscal Incentives

The recognition of the importance of FDI for overall economic growth (Athokorala and Hill, 1999) implies that countries have and will increasingly compete with each other to attract investments by offering tax incentives and other fiscal and non-fiscal concessions. In analyzing tax burdens, it may be useful to distinguish between the marginal effective tax rate (METR), the average effective tax rate (AETR), and the nominal tax rates. METR focuses on the present value of the accumulated cash flow that would be generated by an additional dollar of investment. The AETR is based on cash flow calculations, and measures the total amount of taxes payable divided by the total value of taxable input or output (Bird and Chen 1998). It measures ex-post performance, while the METR concerns the decisions at the margin. The nominal rates are the least satisfactory basis of comparison as they ignore the tax base. Moreover, the nominal rates are more susceptible of being used by business lobbies to pressure governments to reduce business taxes. Among the three, the METR is preferable on theoretical grounds, but its calculations require formidable set of assumptions and much greater data.

Bird and Chen (1998) have estimated METR for capital for East Asian countries. They find that the METR was highest in Japan, followed by Taiwan, Singapore, China, Korea, Malaysia, and Hong Kong (1998, p.51). Ranking according to the METR are different from those based on the nominal tax rates. However, it should be stressed that for business decisions it is the METR specific to a firms' project to which incentives are granted which matters rather than the METR of capital in general or of broad asset types.

While the theoretical literature on fiscal incentives and FDI is burgeoning (see review by Devereux, 1990), the empirical literature is lagging. However, the available empirical evidence to date suggests that such fiscal incentives are important at the margin in influencing investment decisions (see Chen et al., 1997 for a succinct review of the empirical studies)¹⁵.

Fiscal incentives are likely to be least effective when used as substitutes for necessary investment-conducive policies, such as overall macroeconomic policies, infrastructure and supporting facilities and the like. They tend to be most effective when authorities essentially use them as signalling devices about the government's/country's welcoming attitude towards foreign investment; their determination to ensure commercial success in targeted areas; and to improve on the overall business environment (Tanzi and Shome, 1992). It is therefore important that they be designed appropriately so as to impact on the investment decisions at the margin and be a part of a transparent process. It is also important that a competent and effective post-incentive evaluation division be set up in investment promotion agencies (Asher and Heij, 1999).

To address issues relating to a global efficiency and protection of legitimate tax base, it is also essential that countries do not engage in what the OECD has called "harmful tax competition" (1998). The OECD's (1998) report distinguishes between simple tax heavens and more sophisticated fiscal incentive regimes in certain sectors of non-tax heaven countries. Regimes of the countries engaging in harmful tax competition are not structured to attract FDI, but contain predatory measures which may result in a shift of part of the tax base of another country.

Potentially harmful tax competition is typically found in banking, finance, insurance, location of regional headquarters, distribution and other similar services.

¹⁵ Apart from the more formal empirical studies, one of the most revealing anecdotal instances of this is the intense competition between Thailand and the Philippines to attract a new General Motors automotive plant in the mid 1990s. The Philippines lobbied particularly aggressively, reportedly offering incentives such as the Subic Bay site and other fiscal inducements (**Business Week**, June 3, 1996, p.56). The project was eventually located in Thailand.

While these are legitimate commercial activities, when these are targeted at only foreign companies, lack transparency, and are not subject to international exchange of information, they could potentially create harmful tax practices. The OECD has been putting pressure on its member countries to address such practices, including attempting to persuade tax-heavens governed by its members to change their behaviour in this regard. For the tax heaven countries and some financial centres, OECD's effort have also centred on addressing the issue of money-laundering, and bank secrecy laws. Protection of the tax base of OECD countries is an important motivation, and the organization is not averse to levying sanctions on those tax jurisdictions which do not address these issues satisfactorily. The OECD has had very limited success so far in moderating harmful tax practices. But there will be increasing pressure on both the tax-heaven and other countries engaging in such harmful practices to modify their behaviour. Some countries, such as Australia have controlled foreign corporation (CFC) legislation to guard against such behaviour.

Many East Asian countries, such as Singapore and Malaysia have made extensive use of preferential tax treatment and other implicit and explicit subsidies to attract multinational enterprises (MNEs) to build their countries. The list of such incentives in Southeast Asia is growing and so are the agencies authorised to grant and administer them (Asher, 2001) Econometric investigation by Chen et al (1999) provides some empirical confirmation of the potential tax competition during the 1972-1980 period between certain East Asian countries (viz. Hong Kong, Malaysia, Singapore and Taiwan) for FDI from the major industrialized countries (viz. Germany, Japan, UK and US) between 1972 and 1980. In fact, Chia and Whalley (1995) suggest the existence of a sort of Stackelberg competition among Southeast Asian countries, with the rest of the countries emulating or responding to the tax incentives provided by Singapore¹⁶.

¹⁶ A similar pattern seems to prevail in Central Europe, with Hungary taking the lead and being most aggressive in providing investment incentives, Poland and the Czech Republic responding in kind (Easson, 1998).

Given the variation in tax rules and regulations defining the tax base for businesses and individuals, complete tax harmonization is neither desirable nor feasible in developing and developed countries, including those in Southeast Asia. Convergence of nominal tax rates should not be confused with convergence in effective tax rates (see Section 9).

Free-market advocates and economists have criticized differential taxation between relatively immobile domestic investment and the FDI. However, legislation and international agreements are unlikely to be successful in this area. While there has been a trend towards transparency in tax structures, preferential treatment is often negotiated on a case-by-case basis and agreements are not made public. Hence, enforcement of any type of international rule becomes virtually impossible. Furthermore, if limits are placed on tax concessions, preferential treatment can easily move to expenditure concessions, which are generally considered an area entirely sovereign¹⁷. It should be stressed that low corporate (or other) taxes applied across-the-abroad by non-tax heaven countries such as Hong Kong or Ireland, are usually not regarded as objectionable by the OECD.

At the same time, the formal tax incentives form only a part of the overall picture. The negotiation of customised informal tax incentives with investment promotion officials is not uncommon in Southeast Asian countries. Thus, formal tax incentives represent only a broad basis for negotiations with the prospective investors. For instance, Singapore provides customized subsidies to investors that go well beyond traditional tax measures, involving training, expenditure, pricing of land and utilities, and even taking rather large equity stakes in selected ventures.

As with the formal incentives, informal incentives are also likely to benefit large companies, both domestic and foreign, disproportionately. Transparency of the formal and informal fiscal incentives' regimes has been rather low in Southeast Asia.

¹⁷ However, Indonesia and Thailand's fiscal programs are effectively under the control of the IMF. While Malaysia, the Philippines, and Vietnam are not formally under the IMF programs, they are currently in an extremely weak position to pursue fiscal policies, including those relating to incentives not favored by the IMF. So the IMF's influence may be an important countervailing factor.

Except in Singapore, there has also been a noticeable lack of post-incentive evaluation of performance of firms granted formal fiscal incentives.

The 1997 East Asian crisis has put additional pressure on the investment promotion authorities (Asher and Heij, 1999). Even Indonesia, which removed income tax-based incentives as a part of its 1983-tax reform, continued with provisions of non-income tax incentives. Indonesia reintroduced income tax-based incentives after the crisis (**Jakarta Post**, Indonesia, May 15, 1999). The power of foreign and domestic capital has meant that Indonesia has had difficulties in reversing existing incentives, even when it has had the support of the IMF. Thus, Indonesia has been unable to bring the activities on the Batam Island under the VAT net due to investor resistance (Asher, 2001). Thailand has recently expanded the scope of tax-based incentives, such as income tax holidays, tariff and VAT exemptions, and of non-tax incentives such as guaranties, and provision of specific services. (Asher, 2001).

4.2 Free Trade Zones (FTZs)

In addition, there seems to be a trend towards making the existing free trade zones (FTZs) more attractive as well as the establishment of new FTZs. Indonesia is presently considering extending the Batam FTZ to the entire Bareleng area (a total of 42 islands), while Vietnam recently introduced specific tax incentives for the Lao Bao Trade Zone in the central province of Quang Tri. Moreover, Malaysia has widened the range of services that companies in the FTZ, Labuan, can offer to Malaysian residents¹⁸.

The Southeast Asian countries have operated on the basis that, in a globalized world, those able to locate a particular activity or a plant in their jurisdiction will be in a better position to grow. Thus, **it is** the insecurities of globalization that have been driving formal tax incentives in these countries. It is for

¹⁸ There is a preferential tax regime for Labuan, regulated by the Labuan Offshore Business Activity Tax Act (1990).

this reason that they have not been able to agree on the tax and non-tax rules for competing for investments. The East Asian crisis has made these countries more insecure and has enormously increased the complexity of their tax systems (e.g. in treatment of foreign exchange losses, asset revaluations, mergers and acquisitions and loss carry forward provisions). The crisis is also likely to lead to an even sharper demarcation between fiscally strong countries such as Singapore and Malaysia, on the one hand, and the remaining Southeast Asian countries, on the other. This suggests that prospects for cooperation concerning fiscal incentives have become even dimmer than before the crisis.

Nevertheless, the Southeast Asian countries will need to ensure that their activist fiscal incentives' stance is consistent with emerging international practices and norms that limit their use. However, such formal or informal tax competition - commonly referred to as "tax poaching", "tax piracy" or, more broadly, "fiscal dumping", may merely be replaced by non-tax forms such as countries "cutting corners" by relaxing environmental and other standards in an effort to reduce non-tax costs for mobile factors. – This is sometimes termed "race to the bottom"¹⁹.

4.3 Tax Sparing

In many DTAs, there is a tax-sparing clause. Assuming a DTA exists, this clause permits firms from a high-income country which have invested in the low-income treaty country to fully credit applicable income taxes even when because of tax holidays, no actual income tax is paid. There is evidence that such tax sparing agreements make repatriated profits less sensitive to taxes in home countries (Chen et al., 1997). While Canada, Japan and UK have made extensive use of such tax sparing agreements, the US has not. Most countries that provide fiscal incentives to

¹⁹ However, empirical studies (both econometric and surveys) have failed to discern any relation between low environmental standards and the amount of investment inflows (Chang and Rajan, 2001). Evidence for the race to bottom thesis, **interpreted to mean inability to maintain revenue levels, is also not strong** in OECD countries, though the revenue to GDP ratios have stopped growing (Messere, 2000; and Tanzi, 2000).

attract FDI have actively encouraged or even required tax-sparing clauses to be added in tax treaties. For instance, Thailand has not signed a tax treaty with the US for this reason (Leechor and Mintz, 1991).

The tax-sparing clause is usually employed when the DTA is between low to middle income capital importing country and high-income capital exporting country. The net benefit calculations of the clause are more complex in the case of a high-income country like Singapore which is both a gross capital importer and exporter. Traditional capital exporting countries would be reluctant to grant such a clause to Singapore (and to a lesser extent to Malaysia) when the DTA is renewed; capital-importing countries will expect such a clause in their DTAs with these countries.

4.4 Transfer Pricing

With growing specialization in production of components in different locations across the globe, intra-firm transactions account for a growing share of world trade. For instance, in 1994, 36 percent of US exports and 43 percent of US imports were of the intra-firm nature (Clausing, 1998). There is evidence that the share of intra-firm trade of the trading partners of the US is significantly higher, at least with regard to their bilateral trade with the US (He, 1995). With the global dominance of MNEs in trade and related transactions, one of the major issues of tax policy is the allocation of the tax base for these firms between countries.

Accounting manipulations allow for a transfer of tax bases (paper profits) even if physical capital (real activity) remains intact, as MNEs attempt to exploit differences in marginal statutory tax rates across countries, either actual or *de facto* (if there exist differing laxities with which tax administration is carried out). In most situations, this involves maintaining a judicious setting of the imputed values on the internal transfer of goods and services between operations in different countries. Such tax-shifting manipulations in which intra-firm sales are invoiced (i.e. 'transfer pricing') is often arbitrary, since no formal sales occur, and firms can play strategic

games in an effort to lower their tax liabilities. The customary notion of “arms length transaction” is not always easy to apply in practice²⁰.

It has been found that, for the period 1982 to 1994, the US has had a less favorable intra-firm trade balance with low tax countries. This might be expected *a priori* if we assume that US sales to affiliates based in low taxed countries are under priced, while those with high taxed ones are overpriced, and that the tax differential is not offset by import tariffs imposed by the low taxed countries (Clausing, 19998; also see Rajan, 2000). Similarly, evidence suggests that US MNEs reduce their tax burden by between 3 and 22 percent by shifting reported incomes from high- to low-tax countries (Harris, et al., 1993). The fact that transfer pricing is pervasive in the US despite the fact that US tax authorities are among the most technically well-equipped in the world and thus most effective in imposing penalties on flagrant tax violations, suggests that its existence on a global scale is indeed widespread.

Firms from developing countries such as India are setting up subsidiaries abroad, or those firms which are also listed abroad, particularly in the US, need to be aware of the tax reporting and other tax implications of their moves (**Business India**, December 11-24, 2000, pp 119 and 122). They also need to establish transfer-pricing guidelines which are internationally acceptable for IT-enabled services, and other high priority sectors to provide comfort and security to investors, so as to preserve the revenue base.

As the globalization process unfolds further, it may be increasingly difficult to sustain the current methods of taxing MNEs operating in different tax jurisdictions. Instead of taking each jurisdiction as a separate entity as is currently done, consideration may need to be given to the adoption of the unitary or world-wide tax base for the corporate income tax, with an internationally agreed system of tax credits or allocation procedures to prevent double taxation and to maintain international competitiveness. As noted, in the United States, the tax base of the

²⁰ There exist four different methods determining arms-length transactions - i.e., prices that would be objectively charged if the parties were not related - as described in the OECD (1997)

corporate income tax at the state level is already allocated on the basis of a formula. Nonetheless, to adopt such an approach at an international level will neither be easy nor quick.

As developing countries including Southeast Asia rely much more on revenue from corporate taxes²¹ and use fiscal incentives more widely, they have a vital stake in international rules and formulae adopted for taxing corporations.

5. Tax Competition and Human Capital

For individuals, particularly high net-worth individuals, the proportion of income earned or derived from foreign sources is increasing. As the foreign component is highly sensitive to tax regimes, erosion of the tax base and departure from the accepted global taxation principle - viz., that all income of the individual should be aggregated and taxed at the same rate (a la Simons, 1938) are occurring. Individual income is increasingly being taxed at different rates according to the nature of income, i.e. whether it is in the form of wages, interest or dividends. Such “discriminatory” or a schedular approach to taxation is increasingly common. For instance, Scandinavian countries have moved towards a “dual” income tax, with lower taxation on income from capital than from labor earnings. The problem with this approach is that, if the tax differential is significant, it provides incentives for tax evasion and avoidance, with incomes from higher taxed sources being disclosed as having been derived from the lower taxed sources²².

For the developing countries, the migration of skilled labor has been a major issue (so-called “brain drain”). Jagdish Bhagwati had proposed a “brain drain tax” (or “emigration rents”) for developing countries to benefit from the higher incomes earned by their migrants who work abroad (see for instance, collection of Bhagwati’s

²¹ For the 1993-97 period, corporate income tax revenue to GDP ratio in Southeast Asia averaged 4.4 percent of GDP annually, while the corresponding ratio for the selected industrial countries was 2.6 percent (Asher,2001,Table 1).

²² This also comes into conflict with the trend towards harmonization of income tax on skilled labor and capital, thus suggesting that the burden may fall disproportionately on low-skilled (low wage) labor.

papers in Irwin, ed., 1991). Such a tax is particularly defensible, since most have benefited from highly subsidized higher education in their home country (India is a prime example in this regard). While a similar result could conceptually be attained by a residence tax, the problems involved in administering the tax also hamper the implementation of this proposal in the absence of tax cooperation. Further, even if effectively administered, if the home country tax rates are significantly higher than what the migrant pays in the host country, there is always the possibility of tax avoidance through a change in citizenship (assuming the alternative is feasible)²³.

Consideration may be given to studying the feasibility of a global trust fund approach. Under this approach, net labor-receiving countries make a contribution to the fund based on an agreed formula, and these then can be channelled to agreed upon activities in the labor exporting countries.

Globalization has also resulted in increased cross-border movement of professional personnel for short periods, particularly in information technology (IT) sector. How to facilitate this and how to tax their activities, has become an important issue. The World Trade Organisation (WTO) is addressing this issue under the Movement of Natural Persons, but regional and international co-operation is also needed.

6. Globalization and Indirect Taxation

For both Malaysia and Singapore, non-tax revenue (as a share of GDP) is exceptionally high. Thus, during the 1993-1997 period, this ratio averaged 20.0 percent for Singapore and 5.7 percent for Malaysia (Asher, 2001, Table 1). In the case of Singapore, this is due to investment income, and revenue from the lease of land. In Singapore, there is no constitutional or common law right to own land. The state owns around 85 percent of total land in Singapore, which it leases out for

²³ The Philippines is one of the few countries to have, until recently, taxed its citizens abroad. This has however been scrapped under the currently applicable Philippines income tax law. Most other developing countries also do not tax their citizens working overseas, given the inevitable inability to administer such a tax effectively.

varying periods to different users. Several Southeast Asian countries, notably Singapore and Malaysia, have also made extensive use of regulatory taxes, not only on goods (e.g. motor vehicles), but also on factors (e.g. monthly levy on foreign workers), and on asset transactions (e.g. leasing of land). For Vietnam, total revenue (excluding grants) to GDP ratio in 1997 was estimated to be 21.9 percent (The World Bank, 1998, Table 5.2b, pp.95-96). This ratio is in line with the other Southeast Asian countries²⁴.

Greater ease of international trading, reductions in transactions costs and eight rounds of multilateral trade agreements, are making it difficult for countries to sustain large tariff differentials with others. Under the concluded Uruguay GATT agreement, tariffs on manufactured imports into industrial and developing countries were reduced by about 40 percent and 30 percent respectively, the reductions to be phased in over a five year period. Substantial progress was also made with regard to tariff bindings (i.e. commitment not to levy a duty exceeding a particular, "bound" rate) by all countries (Martin and Winters, 1996).

The role of routine cross-border trade among adjacent areas of two countries is also increasing. Regional free trade agreements may be expected to give impetus to this trend. Thus, for instance, the revenue reliance on import duties is significant for Malaysia, Philippines, and Thailand. During the 1993-97 period, import duties to GDP ratio averaged 4.7 percent for the Philippines, 3.3 percent for Malaysia, and 2.9 percent for Thailand (Asher, 2001, Table 1). As a result, shift towards minimum tariff barriers, as required under the ASEAN FTA (AFTA), will put particular pressure on their revenue systems. This is also likely to be the case in Vietnam as trade taxes formed around a quarter of total tax revenue in 1997. (The World bank, 1998, Table 5.2b, pp. 95-96). Vietnam has made a commitment to implement provisions of AFTA

²⁴ However, it needs to be emphasized that in this socialist-economy attempting to enhance the role of the market, the role of the state is significantly larger than in some of the other countries. Although Vietnam has made significant improvements in moving away from the dependence on state owned enterprises (SOEs), the Vietnamese government still depends for around 40 percent of its total revenue on income from SOEs. The revenue from SOEs is expected to drop significantly, as it appears that some of them are financially fragile, and are mainly surviving due to significant direct and indirect government assistance.

by 2003. A shift from quotas to tariffs as required under the WTO commitments may however help mitigate the revenue loss to these countries.

Various distortions generated by such trade taxes, which drive a wedge between domestic and world prices, suggest that efficiency gains far outweigh the loss of such revenue sources (Dixit, 1985)²⁵.

Globalization also has implications for sales and excise taxes, especially on products with high value but little weight or volume, such as perfumes, electronic goods and jewellery. The possibility and increasing popularity of cross-border shopping (including airports becoming huge shopping centers and major shopping outlets close to tax borders), the use of the Internet (see Section 7), mail or phone-order shopping, and the like, have placed a ceiling on sales and excise tax rates on such tradable²⁶. Various negotiations under multilateral and regional trade and investment agreements are under way in the area of telecommunications and IT, thus further reducing the scope for levying taxes on these sectors through pricing policies of state monopolies. This in turn could lead to reduced state revenues.

The preceding will affect all Southeast Asian countries, particularly those with capacity substantially above domestic demand such as Singapore. Singapore would also need to contend with increasing willingness of Malaysia and, to a lesser extent, Indonesia, to use fiscal and other measures to reduce the share of their international trade conducted through Singapore.

²⁵ However, Rodrik (1992) has made the important observation that:
(w)hile trade taxes would not be on any theorist's list of optimal tax instruments...practical and administrative considerations dictate that trade taxes will be an important source of revenue for developing country. The poorer the economy, the higher the reliance on trade taxes (p.312).

²⁶ For instance, the significant revenue losses on beer and spirits as a number of Britons made their purchases in France to avoid the excise duties levied in their home country, led to the British government setting a cap on the excise duty on these products. Similarly, Canada's attempts at a steep tax hike on cigarettes to discourage smoking had to be revoked in 1994 because of their *de facto* ineffectiveness due to smuggling from the US (**The Economist**, May 31, 1997, p.21). Japan is considering reducing the differential in prices of branded goods between Japan and other Asian countries to stimulate domestic activity and generate government revenue.

State enterprises in Southeast Asia, including monopolies in telecommunications sector, are also likely to find it much more difficult to continue to enjoy high profit margins. The overall tax mix is likely to shift even more towards in-rem taxes which do not take into account individual taxpayers' relevant circumstances, as compared to personal taxes that do. But the generation of revenue from newer taxes will not be automatic. State agencies will need to acquire the necessary expertise to implement and regular these activities. To the extent the Southeast Asian countries are able to generate revenue from newer sources such as more extensive use of auctions, permits, cost-recovery policies and user charges, the share of revenue from conventional taxes can be expected to decline.

7. Globalization, E-commerce and Taxation of the Internet

New technologies are resulting in a growing importance of sophisticated barter and E-commerce (also known as "Net Commerce"). According to the OECD (1997):

E-commerce refers generally to commercial transactions, involving both organizations and individuals, that are based upon the processing and transmission of digitalized data, including text, sound and visual image and that are carried out over open networks (like the Internet) or closed networks...that have a gateway onto an open network (p.1).

The number of Internet hosts worldwide were 16 million as of January 1997 (Owens, 1997). While estimates of the global use of the Internet worldwide fluctuate wildly (from anywhere between 30 and 60 million), of relevance is the fact that even the lower end of this figure represent a sharp increase from only a few thousand in the early 1990s. This figure is expected to reach some 140-150 million over the next several years on the basis of current growth trajectories. The varieties of transactions conducted on the Internet, includes the provision of on-line information, payments and settlement of accounts, advertising, gambling and other entertainment (music, games, etc.), sale-lease of goods, banking, insurance and brokerage services, legal services, real estate services, travel services, and increasingly,

health-care, education and government services, share trading, reservations and ticketing (OECD, 1997 and Owens, 1997).

Two types of commodities are particularly amenable to trade on the cyber way. First, the products delivered electronically on the Internet. Second, physical items ordered on the Internet and shipped across borders. The value of E-commerce of all types, including transactions among businesses in particular (which has accounted for about 70 percent of E-commerce transactions), but also between business and consumers, is expected to grow very rapidly. Thus, while business-to-business E-commerce transactions in 1997 were valued at US\$5 billion, the US Commerce Department forecasts that by the year 2002 this trade will reach US\$327 billion, equal to 2.3 per cent of GDP and increasing to about 6.0 per cent of GDP by the year 2005 (Rath, 1998). However, the usual caveat regarding hazards of such projections is particularly relevant in this case.

E-commerce will require major adjustments in the transitional means of allocating revenue among jurisdictions and in the current systems of tax administration. Thus, it would be difficult to apply the permanent establishment and source-based taxation methods to businesses involved in E-commerce (Au, 1998). E-commerce transactions could result in the disappearance of traditional audit trails (through creation of electronic books), in greater accessibility of tax havens and offshore banking facilities - indeed, E-commerce uses its own payments system, referred to as "cyber-payments" - and in the weakening or elimination of convenient points of taxation in the production–distribution process due to disintermediation (OECD, 1997 and Owens, 1997). Business-to-business E-commerce transactions could facilitate the use of transfer pricing by MNEs and makes them increasingly difficult for governments to detect. As noted by Owens (1997):

(t)he communications revolution presents no new problems, no fundamentally or categorically different dimensions, for transfer pricing. It just presents all the old problems more quickly (p.1849).

The inability to tax Internet-based transactions, on the one hand, and non-zero tariffs on physical cross-border trade, on the other, may hasten the pace of substitution of the mode of transactions to virtual commerce as it gets technically feasible to do so. This in turn will further erode the tax base on tradable goods. Global agreements and standards will be needed before E-commerce can be taxed effectively. The communications revolution, which has led to the rapid growth of the Internet, could also offer some benefits to tax administration. These include, possibilities of more accurate and efficient record-keeping, faster and easier compliance with tax requirements, including through electronic filing of returns and automated deductions of certain taxes such as payroll and social security taxes and provision of information to tax-payers. The communications revolution could also assist in improved exchange of information among the tax administrators of different countries.

However, the advantages of the communications revolution for tax administrators, particularly those in developing countries, will definitely not be automatic. Tax administration systems would need to be revamped, requiring substantial investments in IT hardware, development of specialized software, intensive high quality training for existing tax officials and modifications in personnel policies to secure requisite manpower comfortable with new technologies. The governments would need transparent, consistent, and realistic policies for taxing E-commerce. While countries such as Singapore are well-positioned to harness the benefits of these new technologies (Das-Gupta and Mookherjee, 1998, chapter 11), the new technologies will pose severe short- and medium-term challenges to most developing countries, particularly in terms of making it increasingly difficult for them to collect even the existing taxes. Absent effective policy coordination and collective action on at least a regional **if not on a** global basis, the Internet and accompanying new communication technologies will pose grave challenges to governments in maintaining fiscal sustainability (an issue taken up in Section 8).

The OECD (1997, p.9) has summarized the key issues of E-commerce and the Internet for tax authorities as follows: a) to review existing taxation arrangements, including concepts of sources, residency, permanent establishment and place of supply, and to modify the existing arrangements or develop fair alternatives, if required; b) to ensure that E-commerce technologies, including electronic payment systems, are not used to undermine the ability of tax authorities to properly administer tax law; c) to provide a clear and equitable taxation environment for businesses engaged in both physical and E-commerce; and d) to examine how these new technologies can be exploited to provide a better service to taxpayers. Developing countries must take the lead of the OECD in undertaking analyzes of how E-commerce will impact the tax base and tax regulations, administration and compliance for specific taxes such as the VAT and plan for a coordinated approach to tackle the challenges posed by the Internet.

In the November 1997 meeting of Asia Pacific Economic Cooperation (APEC) Economic Leaders, E-commerce was at the top of the agenda and a task force and work-program to deal with E-commerce was established (Felton-Taylor, 1998). There are however differences between Europe and the United States on how the internet transactions should be taxed, particularly as these concern the VAT, with the former in favor of taxing them like any other transactions, and United States in favor of not taxing (or at least having an extended moratorium on current taxes) on such transactions.

It should be recognized that the information technologies giving rise to e-commerce also provide opportunities for the tax authorities. Thus, direct deposits could replace checks as standard method for issuing payments; electronic availability of tax forms and filling could reduce transaction and hassle costs, automatic deductions of income and other taxes, including provident fund contributions could become possible; customs procedures can be streamlined, and exchange of information between different government agencies in the same country and between different countries, could become more feasible.

Some of the Southeast Asian countries have made progress in using the new tax technologies for tax administration. However, none of them have made much progress in developing special principles or measures to subject E-commerce to income and sale taxes. Singapore has recently enacted an Electronic Transactions Act which provides that electronic transactions are deemed to be dispatched from the originator's place of business, and are deemed to be received at the place where the addressee has its place of business. The Southeast Asian countries also need to address the possible impact of E-commerce on their sales tax revenue.

8. Financial Globalization and the Tobin Tax

Financial globalization has not been an unmitigated blessing, as this period has simultaneously witnessed several episodes of severe financial turbulence in global currency markets (Rajan, 2001). With the ever-escalating frequency and intensity of financial crises, they can no longer be dismissed as mere aberrations in an otherwise well-functioning global capital market. While emphasizing the need for measures to enhance the soundness of banking and financial systems (particularly prudential supervision), the ferocity of the East Asian crises have belatedly but surely awakened policy-makers to consider the need to impose some friction on the sand of the wheels of international finance.

The theoretical rationale outlined for the possible imposition of some form of restraints on international capital flows may be summarized as follows (Rajan, 1998). The first best rationale for such levies (on a permanent basis) are based on the existence of capital market distortions, which include the prevalence of multiple equilibriums in foreign exchange markets and the herd behaviour of financial market participants. Second best rationale (for temporary controls) include the possible "over borrowing" syndrome due to incomplete or inappropriately sequenced financial sector reforms (including inadequate prudential regulations).

A tax on international foreign exchange activities was originally proposed by James Tobin (1978). The so-called Tobin tax is essentially a permanent, uniform, ad-

valorem transactions tax on international foreign exchange (forex) flows. It is claimed to be inversely proportional to the length of the transaction, i.e., the shorter the holding period, the heavier the burden of tax. For instance, a Tobin tax of 0.25 percent implies that a twice daily round trip carries an annualized rate of 365 percent; while in contrast, a round trip made twice a year, carries a rate of 1 percent. Accordingly, and considering that 80 percent of forex turnover in 1995 involves round trips of a week or less, it has been argued that the Tobin tax ought to help reduce exchange rate volatility and consequently curtail the intensity of “boom-bust” cycles due to international capital flows.

8.1 What does Available Research Tell us about the Tobin Tax?

Based on available research on the topic, the following policy conclusions may be drawn²⁷.

The Tobin tax cannot be applied unilaterally, as this will merely lead to a migration of forex transactions to untaxed countries (i.e., avoidance via migration). If the Tobin tax is limited to spot transactions (as per Tobin’s original suggestion), this will lead to a tax-saving reallocation of financial transactions from traditional spot transactions to derivative instruments. As such, to prevent tax avoidance via asset substitution, it ought to be applied on all derivative products such as forwards, futures, options and swaps.

There is broad consensus that the tax must be levied at a rate designed to minimize the incentive to undertake synthetic transactions in order to evade the tax (i.e., geographical or asset substitution) or to alter the forex market structure from a decentralized, dealer-driven market to one that is centralized and customer-driven. Suggestions of the “most appropriate” rate of taxation have generally ranged between 0.1 and 0.25 percent. A Tobin tax will probably be far more successful in (and ought to be aimed at) moderating (short-term) capital *inflows* (especially debt financing), rather than *outflows*. In other words, the aim should be to prevent

²⁷ This section draws on Bird and Rajan (1999, 2001).

excessive “booms” from occurring in the first instance, rather than attempting to mitigate the effects of (let alone, eliminate) the “busts” that invariably follow.

Given the above (preventive) objective of a Tobin tax, it needs to be imposed in a counter-cyclical manner, i.e., raise the tax rate during a boom period and lower it (even eliminate altogether) at other times. This is consistent with the Chilean experience with and management of its interest-free deposit requirement as well as the empirical literature on capital restraints, which seems to indicate that capital controls have been more effective at preventing “excessive” capital build-up than at stemming capital flight.

Estimating the revenue from currency taxation is a complicated methodological exercise since much depends on the rate and coverage of the tax; the level of transactions costs; the elasticity of capital movements with respect to the effective increase in transaction costs associated with the tax; as well as the extent to which it is avoided. Based on tax rates of between 0.1 to 0.25 percent, estimates of tax revenue range from a low of US\$140 billion to a high of US\$290. While all such estimates must be viewed with some skepticism (given the complex calculations of tax rates and elasticities), what is certainly true is that a Tobin tax may be expected to raise a lot of money. Nonetheless, the political economy of currency taxation suggests that it will receive greater support if it can be shown to make a significant contribution to offsetting the perceived inefficiencies of private international capital markets.

8.2 Globalization, Financial Flows and Perverse Fiscal Incentives

The expected inaction of the international community with regard to implementation of the Tobin tax, or measures to deal with global capital market failures, more generally, makes it all the more imperative for small and open developing economies in Southeast Asia and elsewhere, to take appropriate measures to strengthen their domestic financial sectors. This is a must if they are to enjoy the benefits of globalization while being able to withstand future such crises.

Domestic financial reforms include the removal of policy-induced tax and other distortions. For instance, certain tax measures may have contributed to the severity of the boom bust capital flow cycles in Southeast Asia (Nellor, 1999). This is so, as some Southeast Asian countries (Thailand and the Philippines in particular) have provided quite favorable tax treatment (e.g. lower corporate income tax rates, partial or full exemption from stamp duties and other business taxes) for foreign currency deposits held domestically. These deposits are then lent to domestic entities, thus exposing the banks and domestic financial system to huge foreign exchange risks, particularly as hedging and other risk-managing devices do not receive favorable tax treatment in these countries. As noted by Nellor (1999):

(t)he complexity and volume of financial transactions, associated with the opening of emerging markets, have made tax administration a more challenging task. Just as strengthening financial systems must be a precursor to capital account liberalization, tax administrations clearly also require strengthening in such an environment (p.2).

9. Concluding Observations

The globalization process and the consequent reduction of economic distances between nations pose severe challenges to tax structures around the world. Nations have been and will continue to experience far-reaching but gradual changes in the level of tax revenue, tax mix and systems of tax administration and compliance.

The globalization process is making it more difficult to tax the full range of economic activities, hence making it increasingly difficult to attain “fiscal sustainability”. This loosely refers to trends and levels in budgetary revenue and expenditure that are consistent with the macroeconomic objectives of high employment, low inflation and the appropriate real exchange rate. Some have argued that one of the benefits of tax competition is exactly that it ought to lead to a reduction in tax bases and public spending, which is often unproductive and wasteful. Consequently, tax competition is argued to be net welfare-enhancing.

However, political economy compulsions will almost inevitably mean that the burden of such adjustments fall on the social sector and on public infrastructure expenditure at the time when the need for both is quite great. Indeed, the 1997-98 economic crises in Southeast Asia has emphasized the need for social safety nets if social cohesion is to be maintained in times of adversity. More generally, Rodrik's (1998) empirical study, which reveals a positive correlation between openness and government consumption, **may be** interpreted as suggesting that government consumption plays a cushioning role in more open countries (which are) subject to external shocks²⁸.

Grunberg (1998) refers to this increasing difficulty in mobilizing revenues (due to a shrinking tax base) and the growing need for fiscal expenditure concurrently as the "fiscal squeeze" model due to globalization. Moreover, as discussed in the previous sections, globalization has led to tax structures becoming less progressive. This is so, as the burden of taxation will increasingly fall on the immobile factors, while those on the mobile factors are driven down; and there may be tendency to move to greater dependence on indirect taxes such as those on consumption, which are generally less progressive than taxes on income, profits, and assets.

The Southeast **Asian** countries are likely to find the task of pursuing sustainable fiscal policy much more difficult than in the past. The crisis and its aftermath are likely to reduce the revenue levels considerably, while there are both cyclical and structural pressures for increasing government expenditure. The need for greater efficiency in the delivery of public services, in project planning and implementation and a significant reduction in the leakages in public expenditure has thus acquired much greater urgency. On the revenue side, the government in

²⁸ Alseina and Wacziarg (1998) have argued that Rodrik's result may be capturing a spurious relation, as smaller countries have a larger share of government consumption in GDP and more open trade. They however confirm that Rodrik's result (and thus insight) hold if government expenditures are limited to transfer payments.

Southeast Asia need to become more adept at raising resources through auctions, permits and various types of cost-recovery and user charges.

Efforts at comprehensive and rigorous analysis of the changes needed to cope with implications of globalization for the tax systems, particularly as these relate to the institutional design, are at an early stage. Tax and more broadly, fiscal policy, is at the heart of any country's political economy. Therefore, rapid or smooth progress in such public finance reforms is far too much to be expected. Vito Tanzi, the former Director of IMF's Fiscal Affairs Department and an authority on international tax policy, has argued that a 'Global Tax Organization' (GTO), along the lines of the WTO may be necessary to enable systematic thinking on the need for international cooperation (Tanzi, 1998)²⁹.

As envisaged by Tanzi (1998, pp.342-3), activities under the umbrella of the GTO could include identification of main tax trends and problems and compilation and/or generation of relevant statistics and tax information, provision of technical assistance to countries; acting as a catalyst for the development of international norms in tax policy and administration; and acting as an arbiter and provider of surveillance over individual country, regional and global developments. Prospects for the GTO however are not bright as leading countries have other priorities, such as the new trade round; and developing countries are suspicious of any new world bodies in which they have little influence. It also appears that regional cooperation and lesson drawing are likely to be more feasible and desirable approaches than tax harmonization.

More generally, the process of tax reform in an era of globalization must constantly strike a balance between the ideal tax system and practical needs. Far too

²⁹ Tanzi has used the term 'World' Tax Organization'. We however prefer the term *Global* rather than *World* Tax Organization. This is so, as in case such an organization does eventually come into existence, the acronym GTO would cause no problem, as opposed to the WTO which currently refers to the World Trade Organization or to the World Tourism Organization.

often the need for clarity and simplicity of tax laws and integrity and professionalism in administration, is lost in the search for higher ideals. Tax structures of the 21st century will only meet the needs of society if they can first gain acceptance from the public, the business community and the government officials who are relied upon for implementation and day-to-day operation of this and other economic policies.

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Table 1
Individual and Company Income Tax Rates in Southeast Asia
(Applicable December 2000)

Country	Rate Structure	
	Individual Income Tax	Company Income Tax
Indonesia	5 - 35 percent (5 brackets)	10 - 15 - 30percent (3 brackets)
Malaysia ^a	1 - 29 percent (9 brackets)	28 percent
Philippines	5 - 32 percent (7 brackets)	32 percent
Singapore	2 - 28 percent (10 brackets)	26 percent ^b
Thailand	5 - 37percent (5 brackets)	30 percent
Vietnam	10-60 percent (6 brackets) (Foreigners residing in Vietnam are taxed 10-50 percent)	10 - 50 percent (Standard rate of 32, with numerous exceptions and room for interpretation) Special rates for foreign investment (Standard rate of 25 percent)

Notes: a) Malaysia's 1999 Budget proposed that corporate and individual income tax for 1999 be waived. This is to bring tax payments to a current year basis from the year 2000 onwards. Since before this change, there was a one-year lag in the payment of income tax (e.g. Income tax payable in 1999 is based on the income earned in 1998), this change did not affect 1999 tax revenue flows materially

b) For 1999, a 10 percent rebate on income tax was provided, reducing the effective rate to 23.4 percent.

Sources: Adapted from Asher (2001); country sources