

# TAX AND DEVELOPMENT

*Challenges in Asia and the Pacific*



Edited by Satoru Araki and Shinichi Nakabayashi



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*Edited by*

*Satoru Araki and Shinichi Nakabayashi*

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**Donghyun Park** is a principal economist at the Economic Research and Regional Cooperation Department of ADB, which he joined in April 2007. Prior to that, he was a tenured associate professor of economics at Nanyang Technological University in Singapore. He has a PhD in economics from UCLA, and his main research fields are international finance, international trade, and development economics. His research, which has been published extensively in journals and books, revolves around policy-oriented topics relevant for Asia’s long-term development, including the role of fiscal policy in economic growth, service sector development, and financial sector development. He plays a leading role in the production of the *Asian Development Outlook*, ADB’s biannual flagship publication on macroeconomic issues, and leads the team that produces *Asia Bond Monitor*, ADB’s quarterly flagship report on emerging Asian bond markets.

**David Tansey** was formerly with the Australian Taxation Office. He has a BA and an MA in taxation and a Master of Business and Technology from the University of New South Wales in Sydney. David has worked

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# Abbreviations

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ADB	Asian Development Bank
ADB I	Asian Development Bank Institute
AEOI	automatic exchange of information
ASEAN	Association of Southeast Asian Nations
ATI	Addis Tax Initiative
B2C	business-to-consumer
BEPS	base erosion and profit shifting
BIR	Bureau of Internal Revenue
BTAC	Basic Tax Administration Course
CBT	capacity building and training
CPC	Communist Party of China
CPTA	certified public tax accountant
DMCs	developing member countries
DRM	domestic resource mobilization
DRMTF	Domestic Resource Mobilization Trust Fund
DTA	double taxation agreement
EIOR	exchange of information on request
EMEs	emerging market economies
FDI	foreign direct investment
FSA	Financial Services Agency
FY	fiscal year
G7	Group of Seven
G20	Group of Twenty
GCRO	General Course for Revenue Officers
GDP	gross domestic product
GFC	global financial crisis
GST	goods and services tax
ICT	information and communication technology
IT	information technology
LICs	low-income countries
LTO	Large Taxpayers Office
MDBs	multilateral development banks
MIRA	Maldives Inland Revenue Authority
NTA	National Tax Agency
NTC	National Tax College
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OMB	Office of the Ombudsman

PE	permanent establishment
POC	Personnel Orientation Course
PPP	public–private partnership
PRC	People’s Republic of China
PSM	public sector management
R&D	research and development
RIPS	Revenue Integrity Protection Service
SALN	Statement of Assets, Liabilities, and Net Worth
SDGs	Sustainable Development Goals
SGATAR	Study Group on Asian Tax Administration and Research
SMEs	small and medium-sized enterprises
SOE	state-owned enterprise
SSCs	social security contributions
TA	technical assistance
TRD	Revenue Department of Thailand
VAT	value-added tax

# Preface

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Discussions on taxation are as old as the hills; *The Republic* (Πολιτεία) written by Plato (Πλάτων) in the 4th century BC, refers to the fairness of taxation. At the same time, taxation is a hot topic and increasingly in the limelight as a development agenda item, particularly with the emergence of the Group of Twenty (G20) as the premier international forum. Discussions on tax and development are greatly relevant to the development of the Asia and Pacific region.

While fiscal policy and tax administration are primarily conducted by fiscal and tax authorities in national governments, other players including international organizations, bilateral aid agencies, and academics are working on tax and development issues as well.

The Asian Development Bank (ADB), a regional development bank, and the Asian Development Bank Institute (ADBI), its think tank, play an important role in the development of public financial management systems in the Asia and Pacific region.

This publication is an anthology by 15 contributors with varied backgrounds, who have been involved in ADB and ADBI's activities in various capacities. The idea of publishing a book on tax and development from the perspective of Asia and the Pacific was floated about May 2017. As background, ADB and ADBI's activities related to fiscal policy and taxation are thought to have been gaining ground for the last several years, and a number of people involved in these activities are increasing both inside and outside the organizations. On the other hand, it still appears that there is a perception gap between development specialists and tax specialists, and that region-wide literature on tax and development in Asia and the Pacific is limited in comparison with other regions.

This publication is an attempt to share the knowledge and experiences of contributors who have worked on tax and development issues, and to highlight what they think are challenges facing the region. The editors and contributors would be grateful if this publication could contribute to furthering work on tax and development—not simply in Asia and the Pacific, but globally.

Satoru Araki and Shinichi Nakabayashi

# Introduction

*Satoru Araki and Shinichi Nakabayashi*

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Tax and development—these two words are closely connected *in theory*, as development means the reduction of poverty in developing countries, and taxes support the financial base of a government working for her people. On the other hand, the editors’ experience shows that *in reality* development specialists in international development organizations and tax specialists do not necessarily understand each other very well. While development specialists do not argue against the importance of taxation, they consider it a bit too technical to include in the overall development agenda of a country. Indeed, taxation is a highly specialized subject, and it is no exaggeration that even an experienced and seasoned tax specialist may not be familiar with all the tax issues. It is often the case that tax specialists struggle to explain how their work is relevant to or contributes toward the development of countries.

There is currently a buzzword that connects development specialists and tax specialists—*domestic resource mobilization*. While international organizations have been working on revenue and tax issues for decades, the editors think that domestic resource mobilization began to attract public attention as a key development agenda item after the global financial crisis and the emergence of the Group of Twenty (G20) as the premier international forum. The *Multi-Year Action Plan on Development* adopted by the G20 Seoul Summit in 2010 set domestic resource mobilization as one of its nine development pillars as “[i]t is essential to continue to strengthen tax regimes and fiscal policies in developing countries to provide a sustainable revenue base for inclusive growth and social equity.”<sup>1</sup> The *Addis Ababa Action Agenda of the Third International Conference on Finance for Development*, endorsed by the United Nations General Assembly in July 2015, listed domestic public resources at the top of its action agenda, and “commit[ted] to enhancing revenue administration through modernized, progressive tax systems, improved tax policy, and more efficient tax collection.”<sup>2</sup>

Is tax and development an important issue in Asia and the Pacific? According to the *Key Indicators for Asia and the Pacific 2017*, published

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<sup>1</sup> G20 Seoul Summit. 2010. *Annex II: Multi-Year Action Plan on Development*. 12 November. Seoul.

<sup>2</sup> United Nations. 2015. *Addis Ababa Action Agenda of the Third International Conference on Finance for Development*, para. 22. July. New York.



by the Asian Development Bank (ADB), the region accounted for 40.9% of global gross domestic product (GDP) at purchasing power parity in 2016, up from 29.4% in 2000.<sup>3</sup> Despite the economic prosperity in the region, the same indicators also show that roughly 330 million people in Asia and the Pacific are still living on less than \$1.90 a day (2011 purchasing power parity), representing roughly 9.0% of the region's total population,<sup>4</sup> and three-quarters of the region's economies had a fiscal deficit in 2016.<sup>5</sup> With respect to the tax-to-GDP ratio, the economy of Asia and the Pacific is still significantly lower than that of Organisation for Economic Co-operation and Development (OECD) member countries (ADB 2016).<sup>6</sup> Possible factors that explain the low tax-to-GDP ratios in Asian countries include low tax compliance and narrow tax bases due to numerous tax exemptions and incentives (OECD 2017).<sup>7</sup>

ADB and the Asian Development Bank Institute (ADB I) have long been working on taxation issues as they relate to developing countries. For example, from 1991 to 2011, ADB and ADB I hosted an annual tax conference, which sought to develop their developing member countries' capacity by sharing knowledge and experiences on emerging tax issues including international taxation. ADB's technical assistance projects can broadly be classified into two categories: country-level and regional. Country-level projects work toward the capacity building of a single country, while regional projects target the capacity building of a group of countries with respect to a common regional issue. David Tansey's Chapter 8 in this publication, *Improving the Training Function in the Tax Authority of the Philippines* contains an account of a country-level project, for example. On the other hand, the annual tax conference mentioned *supra* is an example of regional activities. Since 2016, ADB has been implementing another regional technical assistance program: *Strengthening Tax Policy and Administration Capacity to Mobilize Domestic Resources*, which seeks to enhance the capacity of tax administrations in eight target countries.<sup>8</sup>

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<sup>3</sup> Asian Development Bank (ADB). 2017. *Key Indicators for the Asia and the Pacific 2017*, p. 134. Manila: ADB.

<sup>4</sup> Ibid. p. xxxii.

<sup>5</sup> Ibid. p. 247.

<sup>6</sup> ADB. 2016. *A Comparative Analysis of Tax Administration in Asia and the Pacific 2016 Edition*, p. 4. Manila: ADB.

<sup>7</sup> Organisation for Economic Co-operation and Development (OECD). 2017. *Revenue Statistics in Asian Countries 2017: Trends in Indonesia, Japan, Kazakhstan, Korea, Malaysia, the Philippines, and Singapore*, p. 16. Paris: OECD.

<sup>8</sup> ADB. 2016. Technical Assistance Report: *Strengthening Tax Policy and Administration Capacity to Mobilize Domestic Resources*. p. 3. November. Manila: ADB.

What is the scope of this book? First, it aims to highlight the challenges faced by the Asia and Pacific region regarding tax policy and administration. Partly reflecting the diversity of the region, the Asia and Pacific region's voice still appears to be low in comparison with that of other regions such as Europe and Latin America.<sup>9</sup> Second, as the region's leading organizations, ADB and ADBI play active roles in assisting developing countries with respect to taxation, and this book introduces their activities. Third, as mentioned at the beginning of this introduction, the editors assume that there is a gap in understanding between development specialists and tax specialists, and this book is an attempt to narrow that gap, if not eliminate it entirely. This publication is an anthology by contributors who have been involved in ADB/ADBI's activities on fiscal policy and taxation in various capacities. The contributors have varied backgrounds and expertise: macroeconomics, development policy, tax policy, and tax administration, and are highly experienced in international organizations, national governments, and academics. While the contributors have different backgrounds, they have worked for one common cause, namely, the development of the Asia and Pacific region with respect to fiscal policy and taxation. The editors believe that this collaborative work provides important insights about taxation and development in Asia and the Pacific.

The contributions of this book can be classified into three groups: (i) bird's-eye overviews that discuss tax and development issues in Asia and the Pacific; (ii) country case studies that present theoretical policy analysis of a particular economy; and (iii) another set of country case studies that share practical experiences regarding the tax system of a particular economy.

The main conclusions of the first group of contributions are that domestic resource mobilization is vital for the public finances of developing countries in the Asia and Pacific region, and that ADB/ADBI and other organizations and frameworks can make a significant difference in reforming tax policy and enhancing the region's capacity regarding tax administration.

Shinichi Nakabayashi discusses the challenges faced by developing countries in Asia and the Pacific with respect to public finance, tax policy (including taxation in the digital economy), and tax administration. The chapter draws attention to ADBI's role in capacity building activities in the area of taxation including the sharing of knowledge and experiences in the region. Satoru Araki introduces a global framework where a

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<sup>9</sup> As an example of recent work that focuses on international taxation, see S. Sim and M.-J. Soo, eds. 2017. *Asian Voices: BEPS and Beyond*. Amsterdam: International Bureau of Fiscal Documentation.

variety of organizations and frameworks are working together for the formulation and implementation of international taxation standards and argues that international development organizations are playing an important part as *enablers* that help developing countries adopt international standards. Yuji Miyaki points out that domestic resource mobilization and strengthening tax systems have emerged as a key development priority and a core element of the Sustainable Development Goal framework led by the United Nations and outlines how ADB is assisting its developing member countries in the area of public sector management. Brian McAuley presents concrete tax issues, such as the taxation of the digital economy, which tax authorities in Asia and the Pacific face.

The second group of contributions contain policy analyses focused on a particular country. In this group, contributors address a country's economy and public finances through the perspective of economists or policy analysts.

Jungsuk Kim, Mengxi Wang, Cynthia Castillejos-Petalcorin, and Donghun Park discuss fiscal policy in the People's Republic of China (PRC), and argue that taxation is used as a supplementary tool for economic growth in the PRC, and that long-term debt has a significant impact on the government's fiscal situation especially on the revenue side. Jurgen Conrad and Jian Zhuang also focus on tax policy in the PRC. They provide an overview of ongoing fiscal and tax reforms in the country including those regarding budget management and intergovernmental fiscal relations, and outline the remaining challenges. Wawan Juswanto and Milson Febriyadi study the taxation of small and medium-sized enterprises (SMEs) in Indonesia, which are showing a strong performance in the national economy and provide policy recommendations on the role of SME taxation in the national tax system.

The third group of the contributions focuses on practical experiences, and the contributors discuss their experiences regarding working for the tax authorities in a country either as member of a team implementing a country-level technical assistance project or as a tax official.

David Tansey shares his experiences regarding leading ADB's technical assistance project to enhance the training capacity of the staff of the tax authority of the Philippines, and also draws conclusions that are applicable to other countries. Similarly, Natalie Bertsch vividly relates her story of how ADB's technical assistance projects have made a difference to the tax system of Maldives in an interview-style piece. Patricia Mongkhonvanit provides a view from Thailand, and discusses how the Thai tax authority has been tackling tax policy

and administration issues including those pertaining to international taxation, and to what extent international organizations can help in this regard.

The editors would like to thank Naoyuki Yoshino, dean of ADBI for his support and encouragement for this publication. We would be delighted if this book could contribute to ADBI's resource base as a leading knowledge center in the Asia and Pacific region. We would also like to express our gratitude to Muriel Ordoñez and Ainslie Smith for their expertise on communication and publication. Without their professional advice and service, this book would not have been produced.

The editors and contributors would also like to acknowledge those who have been involved in tax-related activities organized by ADB and ADBI and other international organizations.



PART I

# **Regional Views on Tax and Development**

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# 1

## Tax Challenges in Asia and the Pacific

*Shinichi Nakabayashi*

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### 1.1 Introduction

*“Domestic resource mobilization (DRM) and its effective use is the crux of our common pursuit of sustainable development and achieving SDGs.” The Addis Tax Initiative-Declaration, July 2015.* Improving domestic resource mobilization (DRM) is a necessity for countries to achieve their Sustainable Development Goals (SDGs). While the SDGs do not set definite revenue targets, the tax-to-gross domestic product (GDP) ratio is selected as one of key monitoring indicators for tackling DRM efforts. An increase of 3% has been suggested by the Asian Development Bank (ADB) as an initial target. The SDGs’ DRM objective is not only about increasing government revenues, but also for supporting the development of more effective tax systems that foster sustainable economic growth, fairness, and “state building.”<sup>1</sup>

According to ADB’s thematic group of good governance, an effective tax system is important for the following reasons: it provides governments with reliable and sustainable revenue sources; reduces dependence on foreign aid, thus enhancing financial autonomy; strengthens the fiscal contract between the state and its citizens; encourages good governance, accountability, and transparency; helps formalize the economy and promote economic growth; leads to broader improvements in public administration and services; and reduces income and wealth inequalities.

Section 1.1 discusses the possible reasons behind the low tax-to-GDP ratio seen in Asia and the Pacific. Section 1.2 presents a primer on tax policy reforms, while Section 1.3 deals with tax administration

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<sup>1</sup> This and the next paragraph are based on presentation slides by Sissie Fung, ADB consultant, delivered at ADBI in February 2018.



reforms. Section 1.4 presents the Japanese experience of tax administration. Section 1.5 touches upon taxation in the digital age and use of information and communications technology (ICT). Section 1.6 introduces the role of the Asian Development Bank Institute (ADBI) in regional cooperation for capacity building and training. Section 1.7 offers the conclusions.

## 1.2 Low Tax-to-GDP Ratios in Asia and the Pacific and Possible Reasons

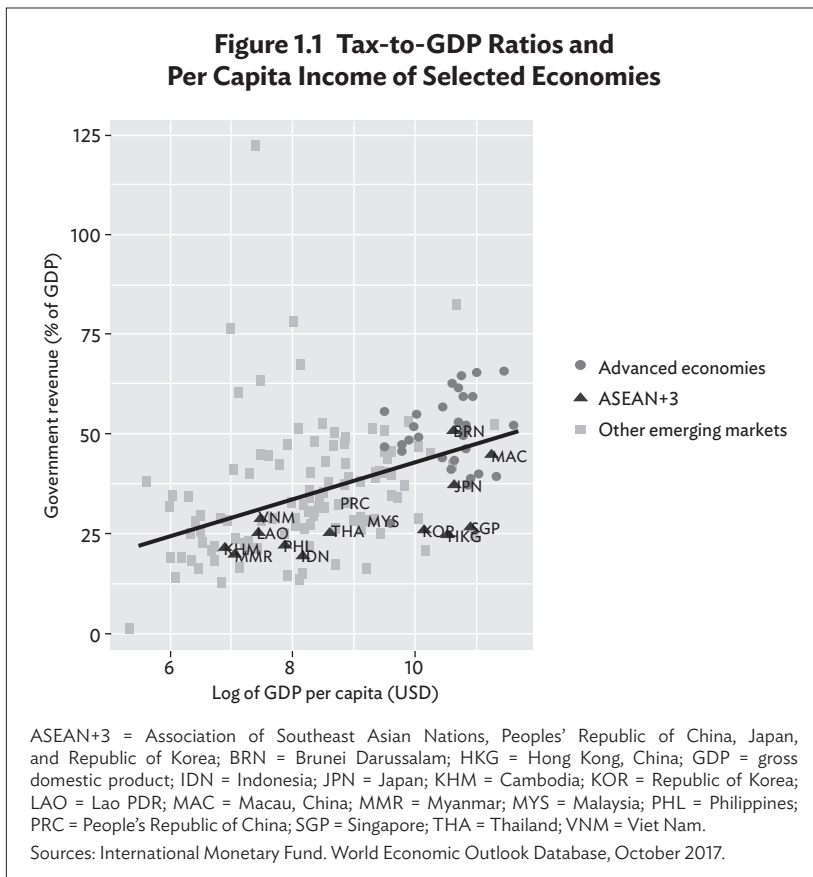


Figure 1.1 shows the tax-to-GDP ratio (the average of 2010–2015) and per capita income of advanced countries, ASEAN+3, and other emerging markets. The black line is a least square regression line, which shows

the average tax-to-GDP ratio after controlling for per capita income. It is upward-sloping since the room to tax, i.e., public savings, increases as the per capita income and the savings rate of households increases. All ASEAN+3 countries except Brunei Darussalam represented by Cambodia, the People's Republic of China, Indonesia, Japan, the Republic of Korea, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam are below the regression line, which means that their tax-to-GDP ratio is below the average for the respective level of per capita income. This partly reflects a policy choice, but tax yields, which broadly control for differences in tax rates, also tend to be smaller in several Asian emerging market economies and low-income countries.

Low tax-to-GDP ratios in the region partly reflect deliberate policy choices. East Asian countries have adopted an export-oriented development strategy. It is a private sector-led strategy, although the government has adopted various industrial policies as depicted in *The East Asian Miracle*, published by the World Bank in 1993.<sup>2</sup> Compared to an import substitution strategy where the government restricts imports and develops domestic industry by making public investments, and by establishing and expanding state-owned enterprises, the public sector remained small and therefore, tax burdens on the private sector remained low. Many emerging economies in Asia opened their economies and competed to attract foreign direct investment (FDI). To do so, generous tax incentives were provided for foreign investors.

Another important reason is tax policy design and limitations regarding the capacity of tax administration. For example, value-added tax (VAT) has had problems in its policy design and implementation in some Asian economies. A VAT revenue ratio is defined as a percentage of actual VAT revenue to full revenue potential. It reaches 100% when all VAT is collected on its potential tax base of consumption and there is no loss of revenue either due to tax exemptions, reduced rates, or tax evasion. A relatively large informal sector and the subsistence agricultural sector have also presented challenges for tax authorities. Finally, a relatively young demographic structure and related underdevelopment of social security services have resulted in low social security contributions (SSCs) in many Asian developing economies, while SSCs are a major revenue source for advanced economies.

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<sup>2</sup> World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy*. Washington, DC: Oxford University Press, pp. 23–26. <http://documents.worldbank.org/curated/en/975081468244550798/pdf/multi-page.pdf>

## 1.3 Tax Policies

The rapid development of ICT has made the globe smaller. Enterprise and capital transcend borders easily and international taxation is facing new challenges. In East Asia, the emerging and developing economies have been integrated into the global economy by forming a global supply chain. Economies in the region compete to attract global companies by providing tax incentives. However, these generous incentives raise equity concerns. They favor foreign capital at the expense of domestic capital. Domestic capital is also incentivized to pretend to be foreign by setting up a foreign company abroad and investing in the domestic market through that foreign entity.

When global companies choose the location of their production facilities, taxation is only one of the many considerations. It is important to provide a good business environment as shown by the “Ease of Doing Business” index compiled by the World Bank. Transparent and reliable tax administration is also one of the elements of a good business environment. Tax incentives should be controlled by the Ministry of Finance. If they are managed by the Investment Board or ministries to promote FDI, tax incentives proliferate and can become too complex at the expense of government coffers. In such a scenario, lost revenues will have to be raised from other distortionary taxes.

Tax distortions result from the wedge between market prices and after-tax prices. The deadweight loss is shown by a triangle, which is proportional to the squared tax rate (wedge). To minimize this distortion, the tax base should be broadened by minimizing tax exemptions. A broad tax base and low tax rates are desirable because they provide a level playing field for businesses. When companies design a global structure of production, tax incentives only affect their decisions through the differences in tax incentives. Therefore, when both country A and country B reduce the corporate tax rate, their tax reforms don’t impact FDI. This is why it is important to avoid a “race to the bottom” tax competition.

The above arguments suggest that it has become more and more difficult to rely on the corporate tax to raise adequate revenues in a globalized economy. Globally, the corporate tax rate has shown a downward trend in the past several decades. Nevertheless, corporate tax revenues have increased around the globe, which partly reflects global growth and thus expanding profits to be taxed. Another important policy issue is a broadening of the tax base by rationalizing tax incentives and exemptions.

## 1.4 Tax Administration

Common taxation challenges for Asia and the Pacific are the following: first, political leadership for strengthening tax administration is essential. Autonomy and resources should be secured for tax administration. The International Monetary Fund's (IMF) Article IV Consultation Reports find that Cambodia, Indonesia, and the Philippines have made meaningful progress on this front. Second, prevention and detection of corruption, which will improve voluntary tax compliance and donor support is crucial. In order to improve efficiency of tax administration and reduce compliance costs for taxpayers, ICT resources should be utilized much more. Third, transparent taxation of foreign-owned companies will improve the business environment and attract FDI. Fourth, international coordination to avoid harmful tax competition will be necessary to raise enough revenues and ensure a level playing field for local and foreign-owned businesses.

The IMF–Singapore Training Institute where I taught from 2011 to 2015 provides Asian developing economies with training for economic ministries and central bank staff. The IMF's Fiscal Affairs Department recommends the following for building effective tax administration.<sup>3</sup> First, efficient organizational and staffing arrangements, featuring strong headquarters; function-based organizational design; minimal management layers and appropriate control; streamlined field operations; organizational alignment with key taxpayer segments (for example, a large taxpayer office); and sufficient staff assigned to each level of the organization and each function.

Second, a system of self-assessment to create an environment of voluntary compliance, thereby minimizing intrusion of revenue officials in the affairs of voluntary taxpayers, while concentrating enforcement efforts on those representing high risk. Third, streamlined collection systems and procedures aimed at securing timely revenues when due without imposing undue compliance costs on the administration. Fourth, a service-oriented approach where the tax administration operates as a trusted advisor and educator, ensuring that taxpayers have the needed information and services to meet their obligations voluntarily. Fifth, risk-based audits and other verification programs aimed at detecting

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<sup>3</sup> The IMF's recommendations presented here are based on presentation slides by Vinette Keene, Fiscal Affairs Department, IMF, delivered at the IMF–Singapore Training Institute in 2016.

taxpayers who present the greatest risks to the tax system, supported by effective dispute resolution procedures.

Sixth, extensive use of information technology to gather and process taxpayer information, undertake selective checks based on risk analysis, automatically exchange information between government agencies, and provide timely information to support management decision making and tax policy formulation. Seventh, modern human resource management practices that provide incentives for strong performance and high integrity among tax officers, as well as those that develop staff competencies and professionalism. Eighth, effective models for ongoing institutional change, including enhancing strategic management capabilities, building coalitions with external stakeholders, and developing an organizational culture that is responsive to change. Ninth, an environment of integrity and good governance regarding transparency of taxpayer rights and appropriate staff conduct, with mechanisms to assure integrity of systems, procedures, and staff practices, and to regularly inform the public of organizational objectives, plans, and outcomes via annual reports.

## **1.5 Japan's Experience in Strengthening Tax Administration and Tax Compliance**

Japan's National Tax Administration (NTA) is based on the following five pillars of good governance: hiring through competitive examinations (meritocracy), well-structured training systems, an independent inspection system, salary levels equivalent to the private sector's, and regular reshuffling of staff (every 2 to 3 years). The NTA has put extra emphasis on training to develop skills and maintain the integrity of staff. New recruits receive intensive training at the beginning of their career at the National Tax College covering tax laws, basic accounting, and related subjects, followed by 3-year, on-the-job-training at a tax office. Then, advanced courses on tax laws, accounting, and civil law, and other subjects are provided. For high-performing officials, there are opportunities to participate in international and domestic research courses.

Laws and regulations against corruption of tax officials have the following structure: government officials may be dismissed, suspended, suffer pay reduction, or be admonished if they violate the National Public Service Act or the National Public Service Ethics Act/Code, which regulate public officials' actions that may give rise to citizens' suspicion and distrust. In addition, Article 197 of the Penal Code prohibits acceptance of bribes by public officials.

Internal inspection systems play an important role in detecting corruption at an early stage. Administrative audits are used as monitoring tools to prevent and detect corruption in tax administration. Access to detailed information on financial affairs and personal relationships is a very effective way for discovering problematic behaviors of staff. When officials are suspected of crimes, their cases are reported to law enforcement and then investigations begin. Internal reporting systems complement administrative audits as another anticorruption strategy. There are consultation offices where officials can report corruption incidents within the NTA. Whistleblowers are protected from dismissal and other punitive treatment. Ethics training, which includes learning about actual corruption cases and disciplinary actions, is regularly conducted to raise awareness among staff.

Collaboration among stakeholders is rigorously pursued at various levels nationwide. The NTA headquarters is in Tokyo, local taxation bureaus are located in major cities, and tax offices cooperate with national and local private tax organizations. Private tax organizations consist of “blue return” associations<sup>4</sup> that are formed mainly by small business owners, corporate associations are formed mainly by medium-sized enterprises, and indirect tax associations are formed largely by breweries that cooperate in liquor tax administration. The certified public tax accountant (CPTA) system is a uniquely Japanese creation that helps the public file tax returns. There are about 70,000 CPTAs in Japan and they form national and local CPTA associations. They are strong stakeholders who cooperate with tax authorities in disseminating knowledge on taxation and help improve tax compliance. Retired tax officials can become CPTAs after a certain number of years of service as a tax official. If a CPTA colludes with a taxpayer in tax evasion, his/her license is revoked. The NTA also has close communication with prefectural and municipal tax authorities.

Education to nurture a tax compliance culture is crucial and many developing countries are interested in the Japanese experience in this regard. The NTA Commissioner has sought the education vice minister’s support to strengthen tax education at all school levels. The NTA, the CPTA system, and corporate associations send lecturers to various schools. Students take future budget sustainability more seriously than adults after they learn how taxes are used to finance public services such as building and maintaining roads as well as funding education and social security services.

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<sup>4</sup> A blue return system offers beneficial treatment regarding personal income tax filing for individual business owners who maintain a certain standard of bookkeeping and file adequate tax returns.

So far, we have discussed various ways to prevent corruption of tax officials. However, tax officials also play a positive role in preventing taxpayer corruption. Tax audits can detect corruption because auditors are highly trained and regularly examine financial transactions. Bribery such as kickbacks, secret commissions, and facilitation payments; embezzlement; and extortion are typical cases of corruption. Other illicit transactions include money laundering, organized crime, accounting fraud such as window dressing, smuggling, and poaching.

## 1.6 Taxation in the Digital Economy

Digitalization of the economy is rapidly changing the tax environment. Fintech and cryptocurrency (some people call it “crypto-asset” because it lacks basic functions of currency and is primarily used for speculation) will pose new challenges for tax authorities. The anonymity of cryptocurrency will also raise concerns on the anti-money-laundering front. The Japanese Financial Services Agency has passed a law that requires cryptocurrency exchanges (financial services firms) to notify the authorities in case of suspicious trading. While the law also stipulates user protection, a recent incident of a major theft of cryptocurrency by a hacker has raised alarms regarding safety of user information. While excessive volatility of the value of cryptocurrency puts a question mark on its viability, blockchain technology has the potential to stay and transform the financial markets. When blockchain becomes more widely used, the ability of central banks to control the money supply will be adversely affected.

International taxation is going to change in the digital age. Traditionally, an international business is taxed in the host country only if it has a permanent establishment (PE) in the jurisdiction. PE signifies a physical presence, and “no PE, no tax” has been the norm in international taxation. The development of e-commerce companies such as Amazon or Google has led to a heated debate on taxation. So long as foreign giants of e-commerce don’t have a PE in the country, they are not taxed, which becomes a political problem when they penetrate local markets, and local retailers and/or businesses are adversely affected.

However, unilateral actions to tax a foreign company will deter private investment, innovation, and economic growth. Therefore, multilateral solutions will be necessary. The Organisation for Economic Co-operation and Development/Group of 20 (OECD/G20) base erosion and profit shifting projects have made some progress in providing a level playing field internationally, as well as dealing with tax loopholes in international taxation. The OECD Taskforce on the Digital Economy is working on taxation of corporations in the digital age and has submitted

*Tax Challenges Arising from Digitalisation – Interim Report 2018 to the G20* on 16 March 2018.

Rapid developments in ICT also provide opportunities for tax authorities to mobilize tax revenues, increase efficiency in tax administration, and provide taxpayers with better services through e-filing and e-payment. Successfully harnessing ICT opportunities, however, presents numerous challenges for tax administrations. A special feature on electronic services in tax administration in *Revenue Statistics in Asian Countries*<sup>5</sup> points out that the following factors have influenced outcomes of ICT projects: proper planning and prioritization for ICT investments; standardization of work processes for project implementation; strong governance structures; and applications of staged implementation based on the likelihood of potential benefits.

## **1.7 ADBI's Role in Fostering Regional Cooperation in Capacity Building in Taxation**

ADBI is the think tank of ADB. It was established in 1997 to share knowledge and skills to reduce poverty and support long-term growth and competitiveness in developing Asia and the Pacific. ADBI helps policy makers in developing Asia through research that focuses on medium- to long-term development, and through training that helps reduce poverty.

ADBI's capacity building and training activities include policy dialogue, course-based training, and e-learning for mid-level and senior officials from ADB's developing member countries. These activities tackle development issues and solutions, build consensus among policy makers and stakeholders, and provide a forum for sharing development practices and country experiences.

ADBI's activities are demand based. When Dean Yoshino meets policy makers of ADB's developing member countries, he often receives questions about why Japanese tax administration is clean and has avoided corruption. Income inequality has recently become an important policy issue in Asia and the Pacific, too. The anti-globalization sentiment has been relatively weak in the region, especially when compared with advanced economies such as the US and the UK, because the region has greatly benefitted from open, liberal, and multilateral international trade and FDI. Nevertheless, Asia and the Pacific has not been immune

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<sup>5</sup> Organisation for Economic Co-operation and Development (OECD). 2017. *Revenue Statistics in Trends in Asian Countries: Trends in Indonesia, Japan, Kazakhstan, Korea, Malaysia, the Philippines, and Singapore*. Paris: OECD Publishing.



to income inequality, which has been threatening its social cohesion, political stability, and long-term economic growth.

The progressive tax system and clean and reliable tax administration are the essential elements for sustainable economic development. ADBI has provided a platform for sharing knowledge and experiences in cooperation with ADB and OECD. Peer learning from neighboring countries' experience will provide a unique opportunity for regional policy makers. It will also be vital for avoiding harmful tax competition in the corporate tax system within the region where attracting FDI has been an important policy objective. Transparent and reliable tax administration will also provide a good business environment, which will facilitate FDI. Regional cooperation in taxation will be an important catalyst for further economic integration by expanding and deepening global supply chains that have been an engine of growth and industrialization in the last three decades.

## 1.8. Conclusion

In conclusion, this chapter maps various tax challenges facing Asia and the Pacific. It has become the growth center of the world by adopting an export-led development strategy. Each economy has been integrated into global supply chains. Tax incentives have been granted to attract FDI. In a globalized economy, every country faces constraints regarding its reliance on the corporate tax system in raising sufficient revenues to fund the public sector's ever-increasing roles. To secure enough revenues, the tax base should be shifted to consumption and property. Broad-based consumption taxes such as VAT or goods and services tax should be introduced. To minimize distortion caused by taxation, the tax base should be as broad as possible by minimizing tax exemptions. The capacity of the tax administration will also be very important to generate enough revenues. While taxation on property will be most preferable in terms of economic growth, building effective institutions to successfully implement the property tax system will be significant for many developing economies.

International cooperation to avoid tax competition will be especially important in Asia and the Pacific as the region's economies become more and more integrated. When cross-border economic transactions increase, international exchange of information among tax authorities becomes more important. International taxation is also facing new challenges as the digital economy brings about new forms of international business models. To maintain the momentum of innovation and economic growth, international discussions are going

on at the OECD/G20 level. The tax authorities in Asia and the Pacific should participate in these discussions constructively.

The digital economy also presents new opportunities for tax administrations. Capacity building of the tax officials of developing economies will be a high priority item on the global development agenda. ADBI provides a platform for that purpose in close cooperation with ADB, the OECD, IMF, the World Bank Group, and other partners and tax experts.

# 2

## A Global Framework on International Taxation Standards and the Role of International Development Organizations

*Satoru Araki*

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### 2.1 Introduction

The Group of 20 (G20) *Leaders' Communiqué* of the 2016 G20 Hangzhou Summit, held in September in Zhejiang Province, the People's Republic of China (PRC), dedicates a lengthy, full paragraph to tax issues such as base erosion and profit shifting (BEPS), tax information exchange, tax capacity building in developing countries, and tax policies to promote growth and tax certainty.<sup>1</sup> In particular, BEPS and the automatic exchange of bank information under a Common Reporting Standard<sup>2</sup>—both projects led by the Organisation for Economic Co-operation and Development (OECD)—are vital for those involved in international taxation issues.

Indeed, since the G20 has emerged as the premier forum for international economic cooperation after the global financial crisis in

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<sup>1</sup> Ministry of Foreign Affairs of the People's Republic of China. September 2016. *G20 Leaders' Communiqué, Hangzhou Summit*, para 19. [http://www.g20chn.org/English/Dynamic/201609/t20160906\\_3396.html](http://www.g20chn.org/English/Dynamic/201609/t20160906_3396.html)

<sup>2</sup> Organisation for Economic Co-operation and Development (OECD). 2017. *Standard for Automatic Exchange of Financial Account Information in Tax Matters, Second Edition*. March. Paris: OECD.

2007–2008,<sup>3</sup> international taxation has always been part of its global agenda. The *players* working on the international taxation agenda are not merely the G20, the OECD, and national tax authorities, but also other development organizations and international frameworks. For instance, the aforementioned G20 *Leaders' Communiqué* acknowledges a platform of collaboration among such international organizations as the International Monetary Fund (IMF), the OECD, the United Nations, and the World Bank Group for assistance to developing countries on tax issues.

As Shakespeare put it, *all the world's a stage*.<sup>4</sup> This chapter will identify the *players* working on international taxation issues, i.e., international organizations and frameworks and government organizations, and propose a global framework model under which the various groups of players could compose the process of formulating and implementing international taxation standards.

Of the groups of players, this chapter will focus on the role of international development organizations, which include not only the IMF, the OECD, and the World Bank Group as universal international organizations, but also regional development organizations such as the Asian Development Bank (ADB) in the Asia and Pacific region.

As background, taxation in general, not limited to international taxation dealing with cross-border transactions, is increasingly becoming part of development agenda. For example, in 2015, the United Nations' *Addis Ababa Action Agenda of the Third International Conference on Financing for Development* identified domestic public resources to be enhanced by the tax system and revenue administration as one of its action areas.<sup>5</sup> International taxation measures, including the international exchange of tax information, are discussed in the context of illicit financial outflows from developing countries as well.<sup>6</sup>

With respect to international taxation standards, emphasis was traditionally placed on the process of their formulation led by the OECD. On the other hand, their implementation process in advanced and developing countries alike has increasingly been in the spotlight. Taking into account the above-mentioned importance of taxation in

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<sup>3</sup> *G20 Leaders' Statement* of the 2009 G20 Pittsburgh Summit designated the G20 to be the premier forum for international economic cooperation. Cf. *G20 Leaders' Statement: The Pittsburgh Summit*, para 19. September 2009. Pittsburgh.

<sup>4</sup> Shakespeare, W. *As You Like It*, Act II, Scene VII.

<sup>5</sup> United Nations. 2015. *Addis Ababa Action Agenda of the Third International Conference on Financing for Development*, para 22. July. New York.

<sup>6</sup> Pogge, T., and K. Mehta. 2016. Introduction: The Moral Significance of Tax-Motivated Illicit Financial Outflows. In *Global Tax Fairness*, edited by T. Pogge and K. Mehta. Oxford: Oxford University Press.

the development agenda, one can say that international development organizations are expected to play a greater role in a global framework on international taxation standards.

## 2.2 What are International Taxation Standards?

International taxation standards deal with international taxation issues, which many countries are expected to follow. International taxation is, in a broad sense, taxation issues about cross-border transactions and other international economic activities. A classic example is double taxation under which a country where a taxpayer resides and another country where the same taxpayer conducts economic activities both impose taxes on the same income.

In order to eliminate double taxation, two countries conclude a tax treaty, which is the basic infrastructure or a hard law for international taxation issues. As each country is bound to conclude bilateral tax treaties with its trading partners, it is desirable to have a model or guidelines that reflect the common understanding among a number of countries; hence the need for an international standard. The first international work on double taxation was initiated by the League of Nations about 1921, and the first model tax treaties (conventions) were drafted by 1927.<sup>7</sup>

The following are representative international taxation standards:

- (i) Model Convention with respect to Taxes on Income and on Capital;
- (ii) United Nations Model Double Taxation Convention between Developed and Developing Countries;
- (iii) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations;
- (iv) 2016 Terms of Reference to Monitor and Review Progress toward Transparency and Exchange of Information on Request for Tax Purposes
- (v) Standard for Automatic Exchange of Financial Account Information in Tax Matters; and
- (vi) OECD/G20 Base Erosion and Profit Shifting Project 2015 Final Reports.

How are international taxation standards developed? International standards are mostly formulated through discussion at international organizations, and taxation is no exception. Among the six international

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<sup>7</sup> United Nations. Department of Economic & Social Affairs. 2001. *United Nations Model Double Taxation Convention Between Developed and Developing Countries*, p. xv. New York: United Nations.

taxation standards mentioned above, all except the United Nations Model Double Taxation Convention were formulated through the OECD. The importance of the OECD as a standard setter in the international taxation field reflects the work initiated by the League of Nations in the 1920s, which was eventually taken over by the forerunner of the OECD, i.e., the Organisation for European Economic Cooperation in the 1950s.<sup>8</sup>

If work on international taxation standards is mainly led by the OECD, where a majority of its member countries are advanced European economies, to what extent are the standards relevant to developing countries? First, developing countries are likewise faced with international taxation issues, which emerge as cross-border economic activities with developed countries as well as between developing countries.

In addition, in a world where major advanced economies represented by the G7 do not dominate the world economy as much as they used to, it is not until international taxation standards are adopted by emerging and developing countries as well that the international taxation system can function properly. In this regard, it is no exaggeration to say that the participation of emerging and developing countries in the process of formulating and implementing international taxation standards is *essential* for a sound international taxation system.

## 2.3 Who is Working on International Taxation Standards?

In the G20 era, a number of international and governmental organizations are working on international taxation standards. Section 2.2 above shows that international standards on international taxation issues are set through the OECD and the United Nations, and of the two international organizations, the OECD is taking a leading role.

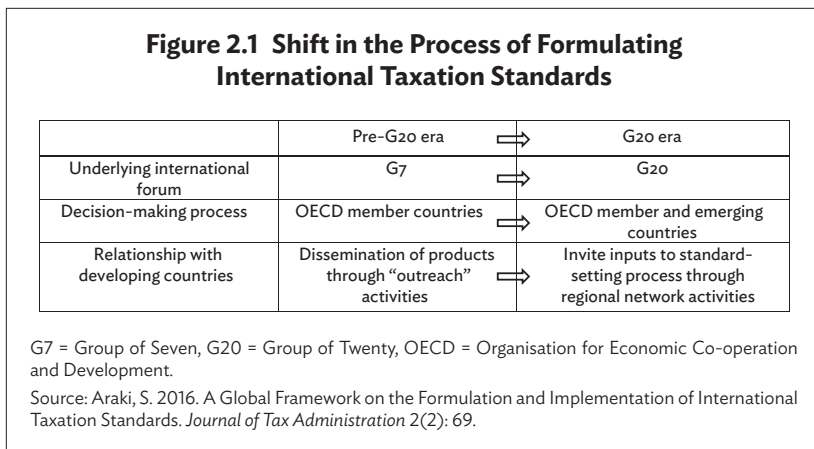
As international standards per se are not directly applicable to domestic cases in each jurisdiction, they are not fully effective until they are incorporated into domestic rules by each jurisdiction. In this regard, the tax authorities, which typically consist of the treasury or ministry of finance in charge of tax policy and an internal revenue body in charge of tax administration, are no doubt the protagonists of the international taxation world.

Before the global financial crisis of 2007–2008 and the emergence of the G20 as the premier international forum in 2008–2009, it could be said that the international taxation system was led by the official OECD member countries, including G7 members.

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<sup>8</sup> Ibid. p. xvii.

According to Grinberg (2016a), “all that began to change in 2009”.<sup>9</sup> In the international taxation world, the horizons of standards were expanded to cover emerging and developing countries, with the G20 London Summit in April 2009 being a watershed event. At that summit, in the context of tax information exchange, the G20 leaders were “committed to make it easier for developing countries to secure the benefits of a new cooperative tax environment”.<sup>10</sup> A shift from the pre-G20 era to the G20 era with respect to the process of formulating international taxation standards is illustrated in Figure 2.1:



As the players who work on international taxation standards have come to include emerging and developing countries, they have also begun to emphasize the implementation of international standards, not merely their formulation, as emerging and developing countries tend to have limited capacity to implement standards and rules. And this change invites new players to the discussion. First, it is necessary to have arrangements to monitor whether each jurisdiction has been conforming to international standards; and second, international financial institutions such as the IMF, World Bank Group, and other regional development organizations including ADB, which are equipped with the resources and expertise on technical assistance, are sought after.

<sup>9</sup> Grinberg, I. 2016a. The New International Tax Diplomacy. *The Georgetown Law Journal* 104(5): 1148.

<sup>10</sup> *Declaration on Strengthening the Financial System* – London Summit. 2 April 2009.

## 2.4. Global Framework Models for Financial Regulation Standards

Before studying the roles of players working on international taxation standards, this section will look at existing literature with respect to international financial regulation. Probably reflecting international regulatory responses to a series of currency crises in the 1990s, the discussion on global frameworks regarding financial regulation has been richer than that regarding international taxation.

Slaughter (2004) proposes the concept of global governance through government networks where government officials in a particular field, such as financial regulation, work together in order to formulate and implement public policy globally.<sup>11</sup> Drezner (2007) attaches importance to international governmental organizations in global governance processes, and categorizes them by three forms of membership: universes, clubs, and neighborhoods.<sup>12</sup> In the context of setting international codes and standards in financial regulation, he argues that international club organizations, such as the OECD, the Basel Committee on Banking Supervision, and the Financial Action Task Force, have played greater roles than universal-membership international financial institutions such as the IMF and World Bank Group, where reaching consensus has proved more challenging.<sup>13</sup>

More recently, Brummer (2015) argues that, in order to get a sense of how the global regulatory system works, it is better to look at the forest before inspecting the trees, and proposes a concept of a global financial architecture that sets international rules and standards in financial regulation, and ensures their implementation at the national level, largely through four entities: 1) Agenda Setters; 2) Standard Setters; 3) Implementers; and 4) Monitors.<sup>14</sup>

Grinberg (2016a) has further advanced Brummer's architecture model, and added a fifth entity, i.e., *Enablers*, which provide technical assistance to jurisdictions (as *Implementers*) not equipped with adequate resources to meet international standards.<sup>15</sup> In the context of international taxation, Grinberg (2016a) points out that the OECD as a *Standard Setter* does not appear to have sufficient capacity and experience of working in developing

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<sup>11</sup> Slaughter, A.-M. 2004. *A New World Order*. Princeton: Princeton University Press.

<sup>12</sup> Drezner, D. 2007. *All Politics Is Global*. pp. 67–68. Princeton: Princeton University Press.

<sup>13</sup> Ibid. Chapter 5.

<sup>14</sup> Brummer, C. 2015. *Soft Law and the Global Financial System: Rule Making in the 21st Century*, Second Edition. pp. 69–71. New York: Cambridge University Press.

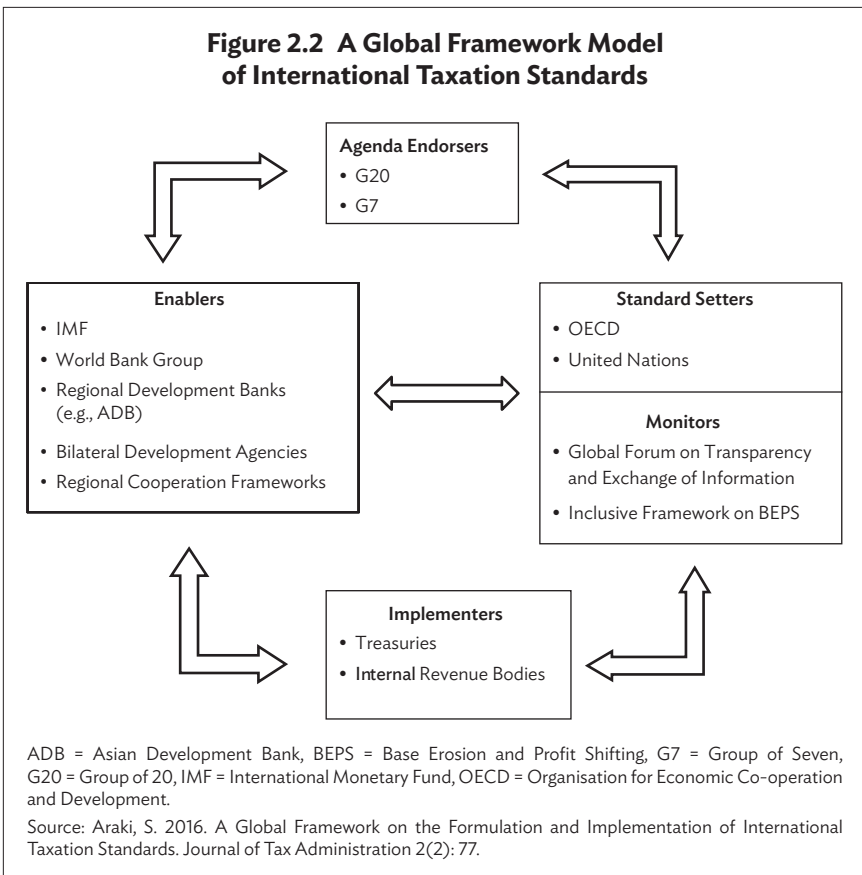
<sup>15</sup> Grinberg, *supra* note 9, pp. 1147–1148.



countries.<sup>16</sup> Therefore, international organizations with more experience regarding development issues, such as the IMF, the World Bank Group, and other regional development banks including ADB, can play a greater role in helping developing countries implement international standards.

## 2.5 Global Framework Model for International Taxation Standards

Brummer (2015) and Grinberg (2016a) have proposed global framework models that explain the functions and player organizations that constitute the world of global financial regulation. Borrowing the models developed by Brummer and Grinberg, a global framework model focused on international taxation standards can be illustrated as follows:



<sup>16</sup> Grinberg, *supra* note 9, p. 1150.

What is the role of each function, and what kinds of organizations perform the various functions in the global framework model? The G20 and G7 atop the framework as *Agenda Endorsers* give political legitimacy to projects undertaken by *Standard Setters*, notably the OECD. For example, with respect to the BEPS project, the *G20 Leaders' Declaration* of the 2017 Hamburg G20 Summit noted, "We [the Leaders of the G20] remain committed to the implementation of the Base Erosion and Profit Shifting (BEPS) package and encourage all relevant jurisdictions to join the Inclusive Framework [on BEPS]."<sup>17</sup>

Under the auspice of these *Agenda Endorsers*, particularly the G20 after about 2009, the *Standard Setters* proposed international standards through discussion among government delegates. As discussed in Section 2.2, the bulk of international taxation standards are currently set through the OECD.

The *Declaration on Strengthening the Financial System* of the G20 London Summit in April 2009, a turning point for the international taxation regime, proposed "mak[ing] it easier for developing countries to secure the benefits of a new cooperative tax environment."<sup>18</sup> As the scope of work has widened to cover emerging and developing countries, arrangements to ensure that countries comply with international standards through a peer review mechanism have emerged. In the international taxation field, the Global Forum on Transparency and Exchange of Information for Tax Purposes, restructured in 2009,<sup>19</sup> and the Inclusive Framework on BEPS, launched in 2016, are leading monitoring arrangements, both of which are led by the OECD.

While international standards are to be implemented by national authorities, which are, in the case of taxation, treasuries (ministries of finance), internal revenue bodies (tax administration bodies), these national authorities in developing countries will need technical assistance to facilitate the implementation process. In fact, the scope of such technical assistance should not be limited to prima facie compliance with international standards, but should also serve the performance of the tax system in developing countries.<sup>20</sup> Enablers for technical

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<sup>17</sup> *G20 Leaders' Declaration: Shaping an Interconnected World*, para 20. 8 July 2017. Hamburg. <http://www.g20.utoronto.ca/2017/2017-G20-leaders-declaration.html>

<sup>18</sup> *Declaration on Strengthening the Financial System* – London Summit. 2 April 2009. Tax Havens and Non-cooperative Jurisdictions.

<sup>19</sup> The Global Forum on Taxation, launched by the OECD in 2000 as a framework for dialogues with non-OECD economies, was renamed the Global Forum on Transparency and Exchange of Information for Tax Purposes, and restructured as a monitoring framework in 2009.

<sup>20</sup> Grinberg, I. 2016b. Building Institutions for a Globalized World. In *Global Tax Fairness*, edited by T. Pogge, and K. Mehta, pp. 22–24. Oxford: Oxford University Press.

assistance include international organizations such as the IMF, World Bank Group, and ADB, but also bilateral development agencies such as the Japan International Cooperation Agency and regional cooperation frameworks for tax administration bodies. For the latter, there is the Study Group on Asian Tax Administration and Research (SGATAR) in the Asia and Pacific region.<sup>21</sup>

## 2.6. The Role of International Financial Institutions

As Figure 2.2 shows, *Standard Setters* and *Monitors* represented by the OECD and the *Enablers* represented by international development organizations are working in tandem on formulating and implementing international taxation standards. How have international development organizations been working in this area?

As international taxation and domestic resource mobilization attracted attention as a development agenda, there was growing recognition regarding the need for further cooperation among international organizations working on tax issues. In April 2016, the IMF, OECD, United Nations, and World Bank Group jointly launched a Platform for Collaboration on Tax. The Platform aims to provide joint outputs and deliverables, strengthen interactions between standard setting, capacity building, and technical assistance, and share information on operational and knowledge activities more systematically.<sup>22</sup> As an example of its outputs, the Platform presented a report, *Enhancing the Effectiveness of External Support in Building Tax Capacity in Developing Countries*, to a G20 Finance Ministers and Central Governors Meeting in Chengdu, the PRC in July 2016,<sup>23</sup> and the report, among other things, recommended that developing countries formulate and implement a medium-term (5–10 years) revenue strategy.<sup>24</sup>

Bilateral technical assistance activities on the implementation of international taxation standards are also provided in partnership

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<sup>21</sup> The Study Group on Asian Tax Administration and Research (SGATAR) was initiated in 1970 as a study group for the review and exchange of information on tax structures in Southeast Asia, and currently has 17 member tax authorities from East Asia, Southeast Asia, and Oceania.

<sup>22</sup> IMF, OECD, United Nations, and World Bank. 2016. *The Platform for Collaboration on Tax: Concept Note*. p. 5. 19 April.

<sup>23</sup> People's Bank of China. 2016. *Communiqué, G20 Finance Ministers and Central Bank Governors Meeting*. Chengdu, PRC, para 10. 24 July.

<sup>24</sup> IMF, OECD, United Nations, and World Bank Group. 2016. *Enhancing the Effectiveness of External Support in Building Tax Capacity in Developing Countries*. p. 23. July.

among international organizations. An OECD secretary-general's report to the G20 Leaders for the G20 Hamburg Summit in July 2017 has acknowledged that, in the context of tax and development, bilateral country activities on transfer pricing and other BEPS issues had been scaled up; in many cases, these capacity-building programs were delivered in partnership with organizations such as the World Bank Group.<sup>25</sup>

From the perspective of international development organizations, whose mission is the economic and social development of developing countries, they are addressing international taxation issues as part of a broader concept of domestic resource mobilization. The *Addis Ababa Action Agenda of the Third International Conference on Financing for Development*, developed by the United Nations in July 2015, has proposed domestic public resource mobilization as an action area, and welcomes ongoing efforts to scale up international tax cooperation.<sup>26</sup> A 2017 report by the World Bank Group, *Strengthening Domestic Resource Mobilization* discusses tax system reforms from the point of view of domestic resource mobilization in low- and middle-income countries, and cites special measures to deal with transnational transactions as a key tax reform agenda item.<sup>27</sup>

## 2.7. An Asia and the Pacific Perspective

Is the global framework model presented in Section 2.5 relevant in the Asia and Pacific region? And to what extent are international organizations and frameworks in the region, such as ADB, contributing to the global framework? From the perspective of developing Asian countries, Jacinto-Henares (2017) notes that international organizations such as the World Bank and ADB can do more to ensure that the concerns and interests of developing countries are properly heard and addressed in the standard-setting process, where OECD member countries carry greater weight.<sup>28</sup>

On the other hand, Asian experts have louder voices on the implementation side. Konza and Thomson (2017) point out a

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<sup>25</sup> OECD. 2017. *OECD Secretary-General's Report to G20 Leaders*. p. 16. July. Hamburg.

<sup>26</sup> United Nations. 2015. *Addis Ababa Action Agenda of the Third International Conference on Financing for Development*. pp. 13–15. New York.

<sup>27</sup> Junquera-Varela, R., et al. 2017. *Strengthening Domestic Resource Mobilization: Moving from Theory to Practice in Low- and Middle-Income Countries*. pp. 35–37. Washington, DC: World Bank Group.

<sup>28</sup> Jacinto-Henares, K. 2017. A Commentary on the BEPS Project and Its Influence on Developing Countries. In *Asian Voices: BEPS and Beyond*, edited by S. Sim and M.-J. Soo, pp. 143–145. Amsterdam: International Bureau of Fiscal Documentation.

fundamental mismatch in skills and experience between multinational enterprises and tax administrations in developing Asian countries, and calls for international collaboration to help developing countries implement international taxation standards set by the BEPS project.<sup>29</sup> Shome (2017) also argues “A successful BEPS outcome cannot be achieved without considering how to obtain the capacity to implement it,” and suggests that regional organizations could play a greater role and garner resources for technical assistance activities.<sup>30</sup>

As a regional development bank in the Asia and Pacific region, ADB is helping developing countries enhance their capacity in the taxation area. ADB’s capacity building and technical assistance activities can broadly be classified into country-level projects, which target a single country; and regional projects, which are based on an issue common to a group of countries.

As international taxation issues pertain to interactions between tax authorities, and international standards are expected to be broadly observed, the regional approach will be more suitable for enhancing the capacity of tax authorities to address such issues. In this regard, ADB’s regional activities on taxation have a relatively long if modest record; the bank conducted an annual tax conference program, which focused on tax treaty and other taxation issues, from 1991 to 2011.

In 2014–2016, ADB conducted a regional technical assistance project, which aimed to enhance enforcement capacity in the member tax authorities of SGATAR, with a focus on a tax information exchange mechanism.<sup>31</sup> The project was conducted in partnership with the OECD, and the 2015 progress report of the OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes acknowledged ADB’s activities in building awareness and addressing impediments to transparency.<sup>32</sup> In November 2016, ADB launched another regional technical assistance project aimed at strengthening tax policy and administration capacity for domestic resource mobilization; in light of international taxation standards, the scope of the project

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<sup>29</sup> Konza, M., and R. Thomson. 2017. BEPS Challenges in Asia and Australia’s Response. In *Asian Voices: BEPS and Beyond*, edited by S. Sim and M.-J. Soo, pp. 147–148. Amsterdam: International Bureau of Fiscal Documentation.

<sup>30</sup> Shome, P. 2017. Tax Administration and BEPS Implementation in Asia. In *Asian Voices: BEPS and Beyond*, edited by S. Sim, and M.-J. Soo, pp. 118–119. Amsterdam: International Bureau of Fiscal Documentation.

<sup>31</sup> Asian Development Bank (ADB). 2014. Technical Assistance Report: Enhancing Transparency and Exchange of Information for Tax Purposes. April. Manila.

<sup>32</sup> Global Forum on Transparency and Exchange of Information for Tax Purposes. 2015. *Tax Transparency 2015: Report on Progress*. p. 25. Paris: OECD.

covers the implementation of BEPS recommendations (Final Reports) and the enhancement of tax information exchange.<sup>33</sup> In this regard, ADB is certainly playing the part of an *enabler* who helps national tax authorities implement international standards.

## 2.8. Conclusion

This chapter draws three broad conclusions. First, in the G20 era inclusive of developed and developing countries, standard-setting processes go in tandem with those of implementation. In this regard, international development organizations that have expertise and resources to assist developing countries are expected to play a significant role in the international taxation field as well.

Second, a variety of organizations and frameworks are acting as *enablers* in the global framework model presented in Figure 2.2. The IMF and World Bank Group are what Drezner (2007) calls universal-membership organizations,<sup>34</sup> and on international taxation issues, these international financial institutions are working closely with the OECD and the United Nations as *standard setters* under the framework of the Platform for Collaboration on Tax.

In addition, each region has a different set of *players*, who enhance the process of standard implementation, and also contribute to the standard-setting process by delivering regional views. In the Asia and Pacific region, ADB has been providing technical assistance projects that aim to enhance the capacity of tax authorities to address international taxation and other issues.

Apart from these large international organizations dealing with a wide range of economic and development issues, tax authorities are forming cooperation frameworks on a regional basis, and, as mentioned in Section 2.5, there is SGATAR with 17 member tax authorities from East Asia, Southeast Asia, and Oceania. While SGATAR's resources are limited, some expect it to play a significant role in "encouraging and facilitating the alignment of operations in the various tax systems in the region".<sup>35</sup>

Third, it should be noted that, while development organizations are playing a role in the formulation and implementation of international

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<sup>33</sup> Asian Development Bank (ADB). 2016. Technical Assistance Report: Strengthening Tax Policy and Administration Capacity to Mobilize Domestic Resources. November. Manila: ADB.

<sup>34</sup> Drezner, *supra* note 12.

<sup>35</sup> Konza and Thomson, *supra* note 29. p. 161.

taxation standards, the scope of their activities is beyond international taxation standards. The IMF assesses the importance of international taxation issues in light of its mandate on macroeconomic stability at country and global levels.<sup>36</sup> The expected impact of ADB's regional technical assistance project on tax policy and administration capacity, mentioned in Section 2.7, is sustainable tax revenue for development financing.<sup>37</sup>

Processes surrounding international taxation standards can be understood as a framework composed of various *players*—global, regional, and national—and international development organizations are certainly playing an indispensable role in this area.

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<sup>36</sup> IMF, 2013. *Issues in International Taxation and the Role of the IMF*. p. 10. June. Washington, DC: IMF.

<sup>37</sup> ADB, *supra* note 33. p. 3.

# 3

## How Can We Achieve an Integrated Approach to Accelerating the Financing of the SDGs? Asian Development Bank Support on Domestic Resource Mobilization

*Yuji Miyaki*

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### 3.1. Introduction

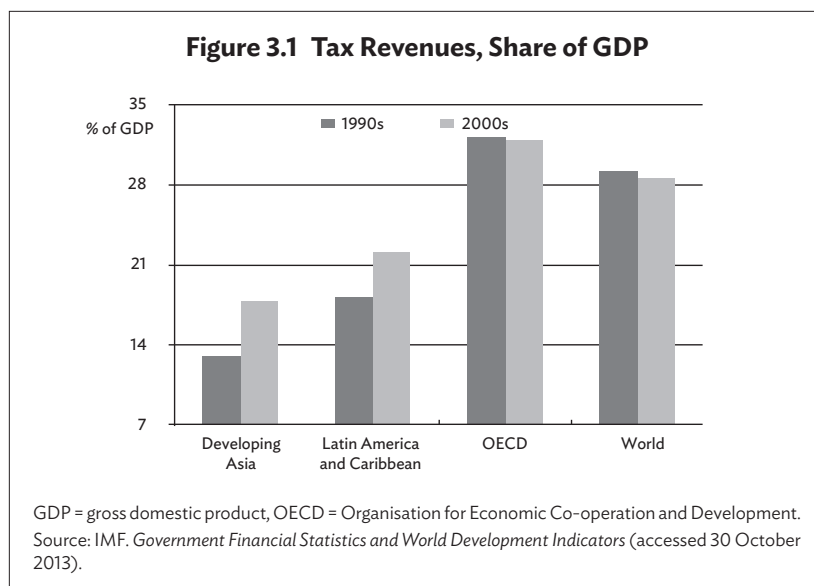
Strengthening tax systems—policy and administration—has emerged as a key development priority, being a core part of the Sustainable Development Goals<sup>1</sup> (SDGs) framework and the Addis Ababa Action Agenda for mobilization of greater resources domestically.<sup>2</sup> Significant

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<sup>1</sup> The United Nations' Open Working Group's proposed SDG Target 17.1 states "Strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection."

<sup>2</sup> The Addis Tax Initiative (ATI) was launched during the Third International Conference on Financing for Development in Addis Ababa in July 2015. The initiative (i) sets the importance of domestic revenue for financing development; (ii) calls for additional development cooperation in this area; and (iii) highlights the importance of tackling tax evasion and avoidance. The ATI aims to generate substantially more resources for capacity building in domestic resource mobilization as well as more ownership and commitment for the establishment of transparent, fair, and efficient tax systems. Australia, Indonesia, Republic of Korea, and the Philippines are among the 31 countries worldwide that currently subscribe to the Initiative.





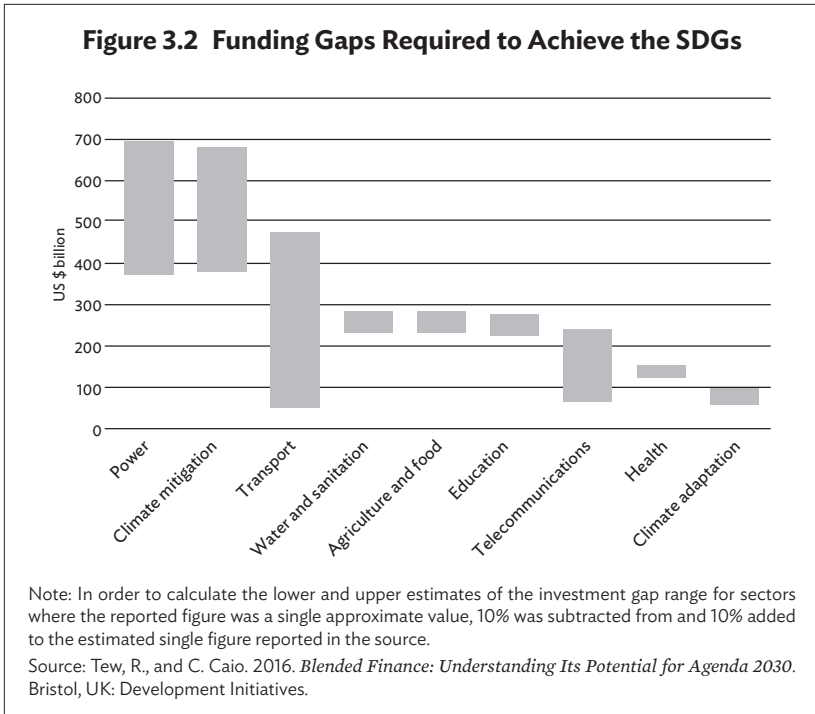
progress has been made by many developing countries, but weak capacity, corruption, and mismanagement, and the missing reciprocal link between tax and public and social expenditures remain challenges.

Government revenues in ADB developing member countries (DMCs) have grown during 2000–2012 from 13.3% to 19.5% of gross domestic product (GDP), but their tax effort continues to lag behind other major regions. For example, in the 2000s, the tax revenues-to-GDP ratio in developing Asia averaged only 17.8% compared with 21.8% in Latin America and 28.6% worldwide (Figure 3.1).<sup>3</sup> Improved domestic resource mobilization (DRM) through better tax administration, improved procurement, better targeting and graduation out of subsidies, and stronger capacity to negotiate and manage natural resource contracts, can widen the fiscal space considerably.

The United Nations Conference on Trade and Development (UNCTAD) estimates that globally the level of investment needed to achieve the SDGs will be \$5 trillion–\$7 trillion per year, on average, over the period 2015–2030.<sup>4</sup> In particular, total investment needs in

<sup>3</sup> Asian Development Bank (ADB). 2015. *Making Money Work: Financing Sustainable Infrastructure in Asia and the Pacific*. Manila: ADB.

<sup>4</sup> UNCTAD. 2014. *World Investment Report 2014 – Investing in the SDGs: An Action Plan*. New York and Geneva: UNCTAD.



developing countries are \$3.3 trillion–\$4.5 trillion annually. With current investments at \$1.4 trillion, there is an investment gap of \$1.9 trillion–\$3.1 trillion per year;<sup>5</sup> and there is much discussion on how this gap should be met (Figure 3.2). There are clear indications that official development assistance (ODA) will not be very high,<sup>6</sup> and many low-income countries are unable to attract high levels of foreign direct investment, or even philanthropic investments.

Where will the needed resources come from then? At the core will be reliance on taxes to finance the SDGs. The UN’s Third Financing

<sup>5</sup> Food and Agriculture Organization. 2016. *The Sustainable Development Summit 2015: Time for Global Action for People and Planet*. <http://www.fao.org/3/a-az717e.pdf> (accessed 21 September 2016).

<sup>6</sup> In 2015, net ODA from member countries of the Development Assistance Committee of OECD as a share of their gross national income was a mere 0.30%, and only seven countries (Denmark, Luxembourg, the Netherlands, Norway, Sweden, the United Arab Emirates, and the United Kingdom) met the UN target of ODA of 0.7% of gross national income (UN. 2016. “*Progress Towards the Sustainable Development Goals*”; Report of the Secretary General. E/2016/75. New York).

for Development Conference in Addis Ababa in 2015 focused on the need for greater domestic resource mobilization. One main strand of work will be on strengthening national tax administration systems and countries' capacity to generate more revenues (as measured by the tax-to-GDP ratio, for example).<sup>7</sup> Particular focus will be on more effective use of information technology in tax administration, and on building the capacity of relevant officials tasked with collecting taxes and mobilizing revenues. Building tax collection capacity is a good investment because, internationally, the rate of return on such support is considered to be over a factor of 10.<sup>8</sup>

Effective taxation provides a reliable and sustainable source of revenues needed to promote growth and offers an antidote to aid dependence. Strengthening domestic revenue systems is not just a question of raising revenue. It is also about designing a tax system that promotes inclusiveness, encourages good governance, promotes investments and job creation, matches society's views on reducing inequality, and promotes social justice. Thus, it strengthens the "fiscal contract" between the state and its citizens.<sup>9</sup> The UN estimate indicates that tapping the full potential of just 17 developing countries in the Asia and Pacific region could boost tax revenues by \$440 billion a year.<sup>10</sup>

A second strand of the focus on DRM has to do with issues of rapid globalization of financial services, investment, and trade—concurrently with the failure of domestic tax regimes to keep pace with globalization—which has significantly eroded the revenue base of developing countries. Cross-border financial transactions are increasingly used to aggressively

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<sup>7</sup> For most developing countries, tax revenue is 10%–15% of GDP. Even to meet the MDGs, the UN had assumed tax revenues at 20% of GDP. Source: UNDP. 2010. *What Will It Take to Achieve the Millennium Development Goals? An International Assessment*. New York. <http://www.undp.org/content/undp/en/home/librarypage/mdg/international-assessment>

<sup>8</sup> Speech of Lillianne Ploumen, Dutch Minister for Foreign Trade and Development Cooperation, during the International Tax Conference "Pay Your Taxes Where You Add the Value," The Hague, the Netherlands. 2 July 2015. <https://www.ibfd.org/sites/ibfd.org/files/content/pdf/Speech%20of%20Minister%20Lillianne%20Ploumen,%20International%20Tax%20Conference,%202%20Jul....pdf>

<sup>9</sup> Organisation for Economic Co-operation and Development (OECD). 2015. *Strengthening Tax Systems to Mobilize Domestic Resources in the Post-2015 Development Agenda*. The OECD Post-2015 Reflection Series. Element 11, Paper 2. Paris: OECD.

<sup>10</sup> UNESCAP. 2014. *Sustainable Development Financing: Perspectives from Asia and Pacific*. Background Paper. ESCAP Regional Outreach Meeting, United Nations Intergovernmental Committee of Experts on Sustainable Development Financing, 10–11 June. Jakarta.

avoid and evade taxes, resulting in reduced domestic tax revenues through the use of offshore financial centers. The OECD estimates that as much as \$240 billion is lost in tax revenue every year as a result of tax avoidance techniques. Multinational companies artificially shift their profits to countries with no or low tax jurisdictions. It is necessary to come up with steps to ensure that tax revenues are not lost, which means aggressive forms of tax avoidance and tax evasion must be effectively tackled.

The problem is particularly acute in Asia. From 2004–2013, illicit outflows averaged around 3.8% of GDP in Asia (close to the global average of 4.0% for all developing countries), comprising 38.8% of the global total.<sup>11</sup> Five of the top ten source economies globally are in Asia. Illicit financial outflows undermine international flows such as ODA and foreign direct investments.

Significant changes are underway in the international tax policy environment. The G20 has identified base erosion and profit shifting (BEPS) as a serious risk to tax revenues, sovereignty, and fair taxation systems worldwide.<sup>12</sup> The OECD reported to the G20 finance ministers at their meeting in October 2015 in Lima, Peru that developing countries can raise more revenue and create a more stable investment climate for businesses by addressing this issue. In 2015, the IMF estimated that developing countries lose approximately \$100 billion to \$300 billion in tax revenues through BEPS using tax havens.<sup>13</sup> In this regard, the work that the OECD, mandated by the G20, has been doing serves as an anchor for countries to try to manage this problem.

International organizations and national governments worldwide have combined efforts to reduce cross-border tax avoidance and increase transparency. The Global Forum on Transparency and Exchange of Information for Tax Purposes provides tools to enhance international tax cooperation and transparency.<sup>14</sup> As more countries become active in

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<sup>11</sup> Global Financial Integrity. 2015. *Illicit Financial Flows from Developing Countries: 2004–2013*. Washington, DC.

<sup>12</sup> The OECD/G20 Base Erosion and Profit Shifting Project provides governments with solutions to close gaps in existing domestic rules for international taxation that allow corporate profits to disappear or shift to low- or no-tax environments where little or no economic activity takes place.

<sup>13</sup> Cobham, A. 2015. IMF: Developing Countries' BEPS Revenue Losses Exceed \$200 Billion. *Tax Justice Research Bulletin* 1(5). <http://uncounted.org/2015/06/01/imf-developing-countries-beps-revenue-losses-exceed-200-billion/>

<sup>14</sup> The Global Forum on Transparency and Exchange of Information for Tax Purposes is an international organization mandated by the G20 and promoted by the Addis Tax Initiative.

the BEPS program and use a standard format for automatic exchange of information and exchange of information on request, opportunities to protect each country's domestic revenue base and provide finances for development are growing.

Multilateral development banks and the IMF, in a joint note to the Development Committee (April 2015), recognized the need to expand policy guidance and technical assistance for domestic resource mobilization and spending.<sup>15</sup> Multilateral development banks and the IMF can deepen their commitment and work to provide advisory services, build capacity, and help client countries both at national and subnational levels to increase domestic tax revenues and improve the quality of expenditures.

The Addis Tax Initiative (ATI) stresses the importance of tackling both cross-border and domestic tax evasion and avoidance. In April 2016, ADB expressed support for the ATI, joining over 30 countries and international organizations. ATI aims to boost resources for capacity on domestic resource mobilization, covering both tax effort and countering leakages through tax cooperation, in support of the SDGs.

ADB has updated its Anticorruption Policy to set out its response, at both country and project levels, to tax secrecy, tax evasion, and legal forms of tax evasion (tax integrity). At the country level, the policy sets out the role of ADB in supporting DMCs through technical assistance or policy dialogues, to enhance their capacity to meet the internationally agreed standards for tax transparency, counter tax evasion, and take steps to protect themselves against forms of aggressive tax planning (all of which increase the risks of corruption, money laundering, and financing of terrorism). At the project level, ADB commits to implement tax integrity principles, which require it to obtain reasonable assurances that the transactions it finances do not facilitate tax secrecy, evasion, and fraud.

Yet, DRM is not all about taxes and tax administration. Resources can be mobilized in many other ways, and these need to be recognized. Governments can ensure greater scope for private sector investments (including through public private partnerships and judicious deregulation); subsidies to state-owned enterprises (SOEs), a main drain of public resources in many DMCs, can be rationalized as part of SOE reform efforts; and lapses and inefficiencies in, for example, procurement (another potential source of revenue loss in many DMCs) can be better tackled. Further resource mobilization strategies moving

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<sup>15</sup> AfDB, ADB, EBRD, EIB, IADB, IMF, and WB Group. 2015. *From Billions to Trillions: Transforming Development Finance – Post-2015 Financing for Development: Multilateral Development Finance*. Development Committee Discussion Note. April.

away from taxation alone can include, for example, philanthropy (a new area of research),<sup>16</sup> remittances,<sup>17</sup> as well as considerations of how best to use the domestic capital market (if one exists), and tackling illicit financial flows.<sup>18</sup>

To respond to the region's needs, ADB has played a key role in supporting DMCs of the region not only in adhering to, and benefiting from global standards of tax integrity, but also in enhancing their capacity to generate more revenue domestically. ADB has undertaken this work by addressing domestic tax issues such as modernization of tax administration and international tax issues such as BEPS. The focus is on (i) domestic public sources of finance (although there is also a strong case to be made for private sources) and (ii) capacity building to improve tax policy and administration as a significant tool to mobilize greater domestic resources.

## **3.2. ADB Support to DMCs on Public Sector Management Reforms Covers Many Areas**

Public sector management is one of the core sectors of ADB support, and public expenditure management (including taxation), is one of the main subsectors of operations (given demands from DMCs on domestic resource mobilization). ADB has engaged with tax authorities of the DMCs—through regional conferences, tax policy and administration research, and training seminars on tax issues—to identify the challenges they face, enhance the capacity of tax authorities, and promote regional cooperation. ADB support for domestic resource management comes through regional and country-specific technical assistance, loans, grants, and policy-based lending.

There are various entry points for expanding operations for

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<sup>16</sup> Philanthropy has a key role to play in building the new generation of financial products that are needed. There is evidence of this in Africa, e.g., with small and medium-sized enterprises financier Grofin, a Shell Foundation partner, which has included different funders with different risk return appetites in a single fund for African small and medium-sized enterprises.

<sup>17</sup> The World Bank expects remittances to reach over \$600 billion in 2016. World Bank. 2016. *Migration and Development: A Role for the World Bank Group*. <http://documents.worldbank.org/curated/en/690381472677671445/pdf/108105-BR-PUBLIC-SecM2016-0242-2.pdf>

<sup>18</sup> It has been reported, for instance, that of the \$5.6 trillion lost in illicit financial outflows in 2001–2010, Asia accounted for 61% of such losses. Kar, D., and S. Freitas. 2012. *Illicit Financial Flows from Developing Countries: 2001–2010*. Washington, DC: Global Financial Integrity.

domestic resource mobilization among ADB's DMCs.<sup>19</sup> A cursory review of ADB's Country Partnership Strategies, Country Operations Business Plans 2016–2018, ADB Country Performance Assessment Reports 2014 for targeted countries, along with studies on past tax reform initiatives<sup>20</sup> in different countries, provides several observations.

Georgia, Indonesia, and Maldives have explicitly stated that an increase in government revenues is a country development target. Countries that selected public sector management as a sector for intervention indicated improvements in governance and/or public financial management as outcome objectives even if indicators do not lead to revenue generation.

The tax ratio (also called “tax effort”) is the summation of all collected taxes expressed as a share of gross domestic product (GDP). In computing tax-to-GDP ratios, the amount of tax collected is a readily ascertainable amount, which is recorded on tax authority computers and electronic banking records of tax payments. The GDP figure is another matter, especially where there is a large informal sector of the economy. The tax-to-GDP ratio of a country should be read in conjunction with attempted measurements of the “tax gap,” that is, the amount of tax, per tax type, that should be collected considering the size and nature of the economy, compared with the actual amount of taxes collected.<sup>21</sup>

The tax ratio is low in developing Asia, averaging 17.8% in 1994–2012 compared with 36.7% for advanced economies, below the minimum level of 20% considered by the UN as necessary to achieve even just the Millennium Development Goals. In many Asian countries, this is partly because of capacity constraints. A large shadow economy in developing Asia is also a contributing factor. Raising tax revenue poses

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<sup>19</sup> Current examples are (i) policy-based loans – Georgia: Improving Domestic Resource Mobilization for Inclusive Growth Program, the Philippines: Local Government Finance and Fiscal Decentralization Reform Program, and (ii) grant and technical assistance (TA) grant – Kyrgyz Republic: Tax Administration Reform and Modernization Project. Examples of ongoing TAs are (i) TA 8640-Regional – Enhancing Transparency and Exchange of Information for Tax Purposes; (ii) TA 8742-Mongolia – Transparency and Efficiency in Public Financial Management; and (iii) TA 8877-Indonesia – Tax Revenue Administration Modernization and Policy Improvement in Local Governments.

<sup>20</sup> Oliver, R., K. Murray, and S. Wyatt. 2014. *Evaluation of Taxation Reform in the Pacific*. Sapere Research Group; and Brys, B., S. Matthews, R. Herd, and X. Wang. 2013. *Tax Policy and Tax Reform in the People's Republic of China*. Paris: OECD.

<sup>21</sup> Fenochietto, R., and C. Pessino. 2013. Understanding Countries' Tax Effort. International Monetary Fund Working Paper WP/13/244. Washington, DC: International Monetary Fund.

many challenges for developing countries that have a difficult external environment and weak administrative capacity. Specific challenges that loom especially large in developing countries include weak tax administrations, low taxpayer morale and compliance, corruption, a small tax base, and the missing reciprocal link between tax collection and public and social expenditures.

Given the above, almost all of ADB's DMCs have been engaged in the installation, implementation, or institutionalization of tax reforms. The different types of reforms implemented in the past include (i) systems and process improvements, e.g., processes related to installation of tax appeals, automation; (ii) policy enhancements, e.g., simplification of tax codes; (iii) structural changes, e.g., unit created; (iv) leadership strengthened, e.g., goals/directions/policy framework/strategies mapped out; (v) competencies developed, e.g., training; (vi) knowledge management, e.g., improvements in quality of, and access to, information; and (vii) taxpayer service improved, e.g., reduction in taxpayer compliance costs.

Electronic taxation (e-taxation) is a promising approach to improve efficiency and transparency in tax administration through appropriate information and communications technology adoption. Successful e-tax administration is expected to increase taxation efficiency by reducing administrative costs, enhancing taxpayer convenience, and increasing tax compliance. ADB has engaged with the General Department of Taxation of Mongolia to support an e-taxation system.

Staff training and education, in particular initial training of new recruits, is a central part of effective tax administration. The need for properly and highly trained tax officers has been well confirmed and recognized by many of tax authorities in developing countries. For effective administration, the authorities need to strengthen tax officers' capacity for front-line operations of assessing and collecting taxes and the back-office operations of accounting and auditing. In this context, ADB has provided assistance to support capacity development for the Bureau of Internal Revenue of the Philippines.

At the regional level, ADB has been implementing Regional Technical Assistance: Strengthening Tax Policy and Administration Capacity to Mobilize Domestic Resources since 2016. This program aims to strengthen the capacity of tax authorities in Study Group on



Asian Tax Administration and Research (SGATAR)<sup>22</sup> countries to collect taxes by (i) broadening and protecting the domestic tax base by implementing the BEPS report recommendations; (ii) improving domestic tax compliance through efficient and transparent tax administration, enhanced exchange of information, and improved risk management practices; and (iii) improving the tools and procedures to stem both cross-border and domestic tax evasion and avoidance. ADB has also been implementing Regional Technical Assistance programs on enhancing transparency and exchange of information for tax purposes for ADB DMCs since 2014.

ADB's extensive experience and in-depth knowledge of countries in Asia and the Pacific along with its strong track record in sector operations and sector-level reforms make it well placed to effectively contribute to improving DRM, public sector performance, and public financial management in the region. In addition, the long-term impact of ADB's lending activities to stimulate growth, reduce poverty, and tackle climate change is largely influenced by the DMCs' ability to accomplish Agenda 2030.

However, as detailed above, ADB is well-placed to act in an integrated manner with other international organizations such as the OECD, IMF, and ATI to accelerate the financing of the SDGs and provide governments with the resources needed to alleviate poverty and provide a better quality of life to DMC populations.

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<sup>22</sup> SGATAR was initiated at the Fifth Southeast Asian Ministerial Conference for Economic Development in Yogyakarta in 1970 as a study group for the review and exchange of information on tax structures in Southeast Asia. The first SGATAR meeting was held in Manila in 1971; its members are Australia; Cambodia, the People's Republic of China; Hong Kong, China; Indonesia; Japan; the Republic of Korea; Macau, China; Malaysia; Mongolia; New Zealand; Papua New Guinea; the Philippines; Singapore; Taipei, China; Thailand; and Viet Nam.

### **Box 3.1 ADB Technical Assistance Projects**

#### **Country programs 2013–2018**

##### Tax Policy:

- Strengthening Tax and Fiscal Policy Capacity for Inclusive Growth Resource, the Philippines, launched in 2016
- Reforming the System of Personal Income Tax and Social Security Contributions, People's Republic of China, launched in 2017

##### Tax Administration Modernization:

- Enhancing Tax Administration Capacity, Maldives, launched in 2013
- Tax Revenue Administration Modernization and Policy Improvement in Local Governments, Indonesia, launched in 2015

##### Information and Communication Technology for Tax Administration

- Transparency and Efficiency in Public Financial Management, Mongolia, launched in 2014, 2017
- Strengthening Information and Communication Technology Systems for Efficient and Transparent Public Investment and Tax Administration, Mongolia, 2017

##### Human Resource Management and Capacity Development

- Supporting Capacity Development for the Bureau of Internal Revenue, Philippines, launched in 2013

#### **Regional programs 2014–2018**

##### Support to strengthen domestic resource mobilization

- Regional Technical Assistance: Strengthening Tax Policy and Administration Capacity to Mobilize Domestic Resources

##### Support to enhance transparency and exchange of information for tax purposes

- Regional Technical Assistance: Enhancing Transparency and Exchange of Information for Tax Purposes
- Knowledge and Support Technical Assistance on Enhancing Tax Transparency of ADB Developing Member Countries

Source: Asian Development Bank.

### **Box 3.2 Domestic Resource Mobilization Trust Fund for Sustainable Development**

#### **Achieving the SDGs will require strengthening of “Revenue Systems”**

Achieving the global agendas will require resources far beyond what the international community will be able to provide. The United Nations has estimated that accomplishing the Sustainable Development Goals (SDGs) will require a total of about \$7 trillion to \$5 trillion per year, on average, over the period 2015–2030, with developing countries having resource gaps of \$1.9 trillion to \$3.1 trillion a year. This issue of resource gap was at the center of the Addis Tax Initiative (ATI) in July 2015 which listed the need for improved domestic resource mobilization (DRM) as a necessity for countries to achieve their 2030 sustainable development targets.

#### **High potential for DRM in Asia and the Pacific**

The potential for DRM expansion may be particularly high in Asia and the Pacific since the region only had a tax revenue to gross domestic product (GDP) ratio of 17.8% compared to 21.8% for Latin America and 28.6% worldwide in the 2000s.

#### **ADB is well placed to help DMCs address capacity constraints**

ADB's vast experience and deep knowledge of regional traditions and practices, and a network of contacts and interactions, lends credibility to the support it provides to its developing member countries (DMCs). ADB is particularly well-placed to provide enhanced support for building capacity to improve DRM and public sector performance in the region and to provide an important link and aggregating function in ensuring that DMCs fully participate in the wider international tax architecture and the global discussion of tax issues.

#### **What is the Domestic Resource Mobilization Trust Fund?**

Domestic Resource Mobilization Trust Fund (DRMTF) is a trust fund with the aim to enhance Domestic Resource Mobilization which supports the translation of the 2030 Agenda for Sustainable Development, into specific plans, policies and projects necessary to achieve the SDGs. The expected outcome is improved realization of the SDGs in Asia and the Pacific region through increased mobilization of domestic resources. These play a key role in helping DMCs tackle some of the more urgent development challenges facing the world today.

#### **What are the eligible areas for support from the fund?**

- **Improved Revenue Performance** (national and sub-national levels)—Increase tax-to-GDP ratios and expand resource generation from non-tax sources in target DMCs by sound revenue policy and administration including;

*continued on next page*

**Box 3.2** *continued*

- **Better Revenue Policy**—Enhance broad based, simple, fair, comprehensive, and revenue-neutral systems by revising existing taxes or introducing new taxes, improved quality of tax legislation and regulations, and curbing wasteful tax incentives;
- **Improved Effectiveness, Efficiency, and Transparency in Tax Administration**—Reduce tax collection gap through enhanced tax compliance and effective, efficient, and transparent tax administrations;
- **Improved International Taxation and International Cooperation**—Increase tax system integrity and reduce tax impediments to cross-border trade and investment; and
- **Tax Policy and Administration Data and Information**—Increase internationally comparable tax revenue, tax policy and administration data, and information on benchmarks and good practices, including tax administration diagnostic analysis.

**What are the priorities of the fund?**

The supported activities must have strong links to ADB's operational activities and/or concerns consistent with the country partnership strategies; the stronger the link, the higher the priority. Further, given the same degree of linkage to operations, those activities that can be shown to contribute concretely to reducing poverty are given higher priority. Individual donor countries that may participate in the DRMTF at a later stage may specify further priorities for their respective contributions. The fund may be used to assist tax authorities in DMCs to prepare for implementation of internationally agreed standards including Base Erosion and Profit Shifting and Automatic Exchange of Information.

**What kind of activities will be supported by the fund?**

The DRMTF provides a key mechanism to coordinate and deliver speedy and flexible financing for technical assistance by ADB to promote DRM. It also streamlines operational and administrative arrangements to direct such support in an efficient and effective manner. These include (i) technical assistance through the DRMTF; (ii) knowledge provision and exchange on tax policy and administration; and (iii) any other activities that the DRMTF contributors and ADB agree upon.

**Who is eligible to receive the grant?**

All ADB DMCs are eligible.

**Who supports the grant?**

The fund is being established through an initial untied grant contribution of \$2 million from the Government of Japan. In-kind support has been promised by several governments and multilateral bodies (such as the OECD).

Source: Asian Development Bank.

# 4

## Learning from ADB's Regional Tax Projects

*Brian McAuley*

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### 4.1 Introduction

The Asian Development Bank (ADB) has used regional tax projects to address the United Nations' (UN) Sustainable Development Goals (SDGs), which aim to increase domestic resource mobilization in its developing member countries through improvements in tax policy and administration. While the initial focus was tackling tax evasion by improving transparency and international cooperation, it has expanded to a wider range of tax subjects from tax policy through tax administration to tax audit and investigation. In this chapter, I look at just a few of the issues that senior officials in the countries have raised during these projects as key concerns, and then seek to examine the context for capacity development for tax policy and administration. The key concerns include the digitalization of the economy, implementation of international tax standards, and tax policy reform. This short list is far from comprehensive and ADB's projects continue to engage in other critical areas as well. The challenges that tax administrations face in relation to these issues must be achieved within the context of a demanding and diverse program of improvements in tax policy and administration, and require strategic approaches and coordinated plans ensuring policy coherence and best use of resources from international organizations and other donors.

### 4.2 Digitalization of the Economy

Tax administrations in Asia, mostly members of the Association of Southeast Asian Nations (ASEAN), have indicated the development of the digital economy poses significant challenges regarding fair taxation and tax compliance. They have seen tax revenues decline as a result in the recent years, and are exploring changes to domestic tax laws

and administration and developing policy positions for influencing international standard setting and carrying out treaty negotiations.

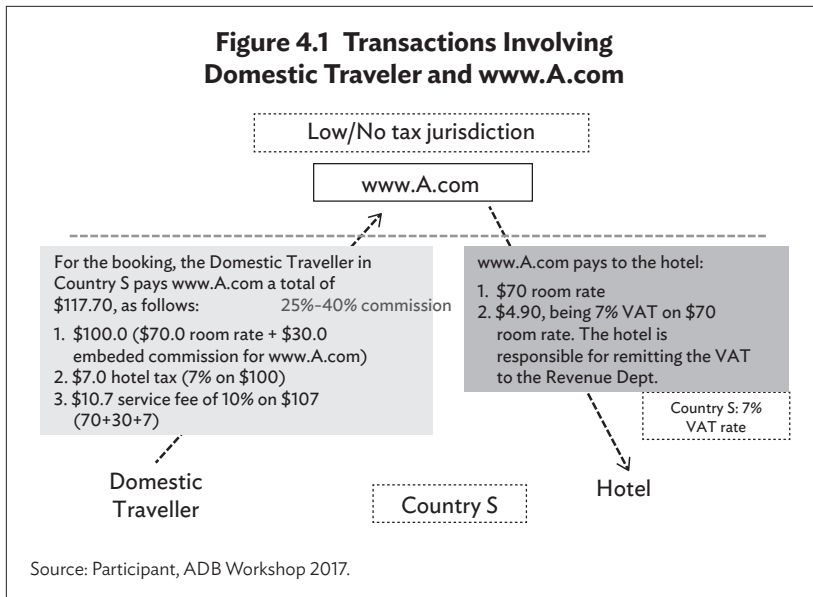
The Organisation for Economic Co-operation and Development's (OECD) work on taxation and the digitalization of the economy<sup>1</sup> emphasizes that there is no separate digital economy, but that digitalization of the economy is a further extension of globalization and its societal impact. The challenges posed, however, are significant for the design and collection of taxes. The resolution of internationally agreed taxing rights for corporate taxation is still to come (hopefully by 2020), and while some Asian countries are keen to implement stopgap tax provisions, others are anxiously awaiting the internationally approved solution. Of course, many are now members of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) and have a voice in determining the emerging new standards. At a workshop in 2017, participants shared information on types of use and abuse of digitalization to avoid and evade taxes. They increased their appreciation of the complexity of applying direct tax rules to the variety of business models that have evolved and of the problem in finding solutions that would apply to all business models to ensure fair taxation and a level playing field for businesses.

One area where some revenue protection is available is indirect taxation. The new business models have posed significant challenges to the imposition and collection of consumption tax, but effective solutions are now at hand. The measures developed by OECD address notably the challenge of collecting value-added tax (VAT) or goods and services tax (GST) on services and intangibles supplied by foreign suppliers and allow tax authorities to collect the tax in the jurisdiction where the consumer is located, in accordance with the destination principle. An illustration provided by one of the countries in the workshop brought general recognition of a shared problem. Tourism is an important sector in many of the Asian countries and innovation in business models has resulted in lost revenue for many. The case study (Figure 4.1) considers the VAT treatment of online hotel booking services rendered by offshore suppliers established in a low-/or no-tax jurisdiction. The services are accommodation services, offered by hotels located in the same jurisdiction as the final consumer–traveler (i.e., country S under the case study).

Advice from the expert present cautioned that a full analysis of the case would depend upon the detailed contractual arrangements between the three parties involved i.e., www.A. com, the traveler, and the hotel.

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<sup>1</sup> Organisation for Economic Co-operation and Development (OECD). 2018. *Tax Challenges Arising From Digitalization – Interim Report 2018*. Paris: OECD.



The main challenge faced by the tax authorities in Country S would be that in the absence of any nexus that would give the taxing rights to Country S, the accommodation as well as related services consumed in Country S remain outside its taxing jurisdiction. However, the OECD International VAT/GST Guidelines<sup>2</sup> provide the solutions/mechanisms to address those challenges. The Guidelines (endorsed by more than 100 countries, jurisdictions, and international organizations) provide that internationally traded services and intangibles “*should be taxed according to the rules of the jurisdiction of consumption.*” The guidelines set out rules for determining the taxing jurisdiction in a sensible and administrable manner. While the guidelines allocate taxing rights, it is up to the jurisdiction, determined as the jurisdiction of consumption/taxation with respect to a specific supply, to impose domestic VAT on that supply; or apply a special VAT regime (e.g., a special regime for small and medium-sized enterprises, or for a specific type of business activity). The guidelines also recommend appropriate collection mechanisms that avoid unnecessary burdens on suppliers.

Several economies that have implemented the guidelines have seen significant revenue increases in a short time, in particular Taipei, China.

<sup>2</sup> Organisation for Economic Co-operation and Development (OECD). 2017. International VAT/GST Guidelines. Paris: OECD.

The tax administrators in the region have recognized the benefits of knowledge sharing, increasing skills, and acquiring tools for monitoring, auditing, and investigating non-compliance in the digital economy. There are a range of new business models that are challenging for both direct and indirect taxes—and innovation will continue to generate new variants. The tax administrators engaged in the workshop are aiming to meet the challenges while seeking to retain the economic and other advantages of digitalization. The spread of digitalization has increased substantially, but unevenly, among countries in the region and some are concerned to take action to stimulate digitalization in order to achieve the economic growth that that can bring. Indeed, ASEAN has a vision for connectivity 2025 and aims for “digital innovation,” which could potentially be worth up to \$625 billion by 2030 for ASEAN economies.<sup>3</sup>

### 4.3 International Taxation Standards

International taxation and the application of global taxation standards have been a key component in tackling cross-border tax evasion and tax avoidance. The G20 leaders have been driving the work of the Global Forum on Transparency and Exchange of Information and the OECD's Committee on Fiscal Affairs' Inclusive Framework on BEPS. These initiatives have a direct link to raising tax revenues—domestic resource mobilization—by combating tax evasion and avoidance, but the emphasis for developing countries in Asia has often felt like external pressure to make important legislation changes and implement new processes and organizational structures—issues that are challenging even in more developed countries with mature tax administrations.

A degree of resistance to international standards is therefore understandable. The regional strategic workshops in ADB's program have enabled some countries to move more quickly in making the decisions to adopt the standards and become active members of the Global Forum on Transparency and Exchange of Information and more recently the Inclusive Framework on BEPS.

There are two useful examples that developing countries have shared. First is the need to communicate the domestic benefits as well as external pressures, and to demonstrate how the work can be achieved in practice. Thailand developed a graphic representation of the “road map” for implementing the range of initiatives, which combines an effective planning tool showing how careful scheduling can make the complex implementation appear achievable with a communication and

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<sup>3</sup> ASEAN Secretariat. 2016. *Master Plan on ASEAN Connectivity 2025*. Jakarta: ASEAN.



influencing tool available to all stakeholders. This technique is one that participants continue to use in our strategic workshops to good effect.

Implementing the international standards also relies on top-level political support within the country—and there is much to be said on this subject—but the use of formal strategies and operational plans, which are endorsed by key political figures is very useful. The tax administration of Papua New Guinea has enhanced its effectiveness in such strategic planning over the past 10 years and its planning is linked to the country's long-term national development strategy. The latest version of their strategy now takes on greater strength by adopting the methods of the IMF model for a medium-term revenue strategy, consolidating the linkage to UN SDGs.

The critical element here is including the domestic changes that are required to take advantage of greater transparency and exchange of information. Some countries will need to improve their auditing skills and processes; adopt new legislative powers for auditors and investigators; develop new evidence-based compliance strategies; or even more fundamentally, ensure the taxpayer database is complete, accurate, and consistent.

Addressing these issues in regional strategic workshops has had the advantage of emphasizing the importance of cooperating and collaborating to combat tax evasion. It is perhaps obvious that local or regional examples can have a greater impact in workshops as they demonstrate the real benefits of international standards and how they can be achieved. And these benefits are those which meet the challenges as perceived by regional tax administrations.

## **4.4 Tax Policy Reform for Increasing Domestic Resource Mobilization**

An informal survey of tax policy officials from countries in Asia and the Pacific conducted at one of the workshops indicated that nearly all were able to find fiscal space (underused tax capacity) within their country in corporate and personal taxes, property taxes, and VAT or GST. In some countries, the specific sectors mentioned were the extractive industries, agriculture, and fisheries. Policy options to improve the performance of their tax system include: monitoring tax incentives and exemptions with a view to identifying and removing those that are not cost-effective, bringing more of the informal economy within the tax net, countering tax abuse in the digital economy, reforming taxation of capital gains and environmental taxes, and exploring the scope for increasing certain tax rates. In addition, countries have emphasized the importance of

improved tax administration and collection, enhanced transparency and access to bank and third-party information, as well as better cooperation and coordination between government agencies. Common constraints affecting those policy options include securing political and stakeholder support, capacity constraints within policy units, lack of access to data, lack of coordination and data sharing, and low tax morale.

### **Recurrent property tax**

Recurrent property taxes are underused in most countries and especially so in developing Asia.<sup>4</sup> Although the property tax system varies greatly among countries, they share many common challenges regarding policy design, valuations, and the effective administration and enforcement of property taxes. There is scope for improving the revenue performance of property taxes in the region and ADB is engaged in fostering knowledge sharing among key personnel responsible for property tax policy and administration.

### **Other policy areas**

Reforming environmental taxes as part of a wider policy on environmental protection and green growth is a challenge for the region, which is increasingly seen as urgent and one where regional knowledge sharing is needed. So-called sin taxes are also being implemented or examined by countries in the region. While the aim of taxes on tobacco, alcohol, and sugary drinks is mainly aimed at changing consumer behavior to combat illnesses and the social and economic impact, the revenues raised can also be substantial. There is scope for sharing experiences including cooperation with the producers/manufacturers as well as cooperation with other government agencies focused on health and social issues. The work on designing and implementing an excise tax on sugary drinks in the Philippines is an important real-time example, and tax and health policy workers in other countries in the region are interested to follow its progress.

### **Evidence-based policy making and tax administration**

A focus on tax statistics and international comparisons of tax administration can strengthen policy making as well as improve tax administration. The 2017 edition of *Revenue Statistics for Selected*

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<sup>4</sup> Tax on property is defined as recurrent and non-recurrent taxes on the use, ownership or transfer of property. Recurrent taxes are usually annual taxes on immovable property values. Non-recurrent relates to those taxes on the change of ownership of property through inheritance or gift and taxes on financial and capital transactions.

*Asian Economies* covering seven economies<sup>5</sup> provides a comprehensive multiyear analysis of the performance of the main taxes administered by each economy. The 2018 version has been expanded to cover Asia and the Pacific. Countries not yet included in the series and who wish to contribute to future editions will be supported in developing their statistical reporting.

ADB aims to support countries in improving the effectiveness of tax administration and its comparative series on tax administration provides useful data and analysis for this. Preparation of a third edition is progressing with the aim of expanding country coverage (from 21 to at least 30), introducing an automated survey tool, and providing a richer set of comparative data.

## 4.5 Conclusion

This chapter has focused on a short list of issues. Others that are the subject of ADB's collaborative work include data analysis (from automatic exchange of information and additional domestic information sources), VAT administration and VAT fraud, and tax compliance strategy, and audit and investigation. ADB's work is often in collaboration with at least one of the international organizations which have formed the Platform of Collaboration on Tax (IMF, OECD, United Nations, and World Bank) and that collaboration is continuing.

The knowledge sharing carried out in our strategic workshops needs to be supported by more training opportunities. The participating countries have identified the need for external training on tax policy, reforms VAT administration, data analysis, and tax crime investigation. These are all issues where collaboration among the international partners can add tremendous value.

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<sup>5</sup> Indonesia, Japan, Kazakhstan, Republic of Korea, Malaysia, Philippines, and Singapore.

PART II

# **Country Policy Analyses**

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# 5

## Macroeconomic Effects of the PRC's Fiscal Policy

*Jungsuk Kim, Mengxi Wang, Cynthia Castillejos-Petalcorin,  
and Donghyun Park*

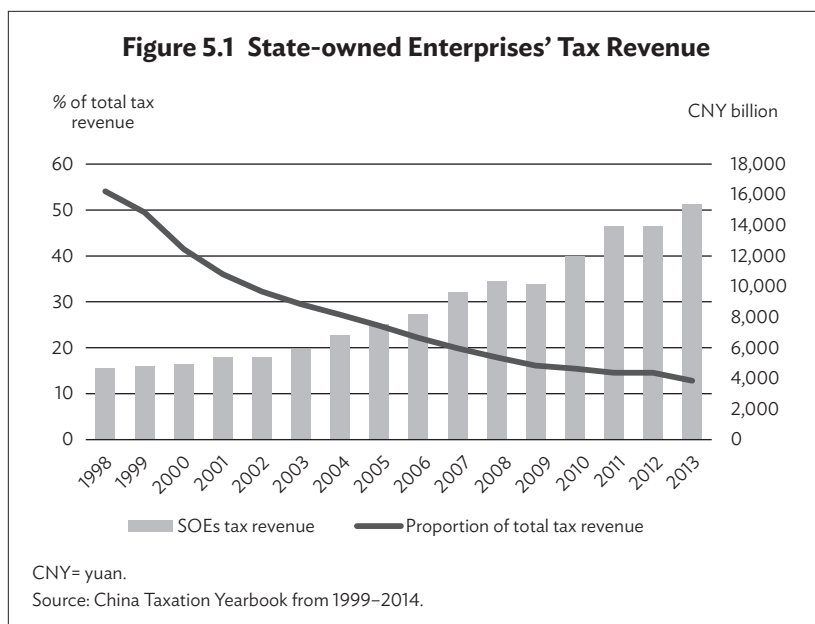
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### 5.1 Introduction

In 1978, after the Cultural Revolution, the People's Republic of China (PRC) opened up and implemented economic reforms, introducing new structural experiments and decentralization. In the last 40 years, the country has achieved a significant economic transformation thanks to its remarkable economic growth rate. The current 13th Five-Year Plan (2016–2020) highlighted the need to achieve sustained economic growth. In addition, the government introduced the “Made in China 2025 Strategy” to step up the new Industrial Revolution by transforming the PRC into an advanced industrial manufacturing leader. The PRC's structural primary balance has remained broadly constant over years of sustained improvement and there is still ample fiscal space to develop.

A major characteristic of the PRC's fiscal structure is the existence of state-owned enterprises (SOEs). They cover important sectors such as petroleum, electricity, telecommunications, transportation, natural gas, and public services. Since they are controlled by the government, they affect fiscal policy as they engage in many fiscal or quasi-fiscal activities. As such, SOEs have undergone major restructuring to ensure profitability and reduce losses. For example, the denationalization process of SOEs was split into two stages: The first phase (1997–2001) covered the privatization of small and medium-sized SOEs, and the second phase (2002–2009) covered the reconstruction of the share stock system of the large-sized SOEs and joint ventures with foreign companies.

Given the commercial nature of SOEs, they have been a main source of tax revenue. However, although the amount of revenue coming from them has increased over the years, their share of total tax revenues has decreased, implying that more and more private companies are



contributing to overall tax revenues, which is to some extent, a direct indicator of the success of denationalization (Figure 5.1).

In addition, the functional boundary between the central and local governments in the PRC is unclear after their reform from a long-run, highly centralized system, and there is considerable room to develop and improve,<sup>1</sup> despite decentralization of power and transfer of profits since the founding of the new PRC. While there is adequate fiscal space, central government expenditure is very limited; therefore, local governments bear the heavy burden of social spending and competitive development, including building infrastructure to attract capital and job opportunities. In 1994, the tax-sharing system was reformed by introducing tax returns and transfer payments so that the central government could determine local receipts by using a formula on general transfer payments to reflect equalization and specific transfer payments. Local governments are responsible for turning over a certain percentage of their tax revenues to the central government according to the fiscal policies at different times.

<sup>1</sup> Wray, R., and Y. Lommen. 2013. Monetary and Fiscal Operations in the People's Republic of China: An Alternative View of the Options Available. ADB Economics Working Paper Series No. 380. Manila: Asian Development Bank.

## 5.2 Economic and Fiscal Developments in the PRC

Table 5.1 presents the fiscal and monetary policies stances implemented at various periods since 1976 to comply with the mandate of supporting growth while ensuring fiscal sustainability.

**Table 5.1 Phases of Fiscal Stances**

Time	Fiscal Policy	Monetary Policy
1976–1981	Tightened	Tightened
1982–1983	Loosened	Loosened
1984–1992	Tightened	Tightened
1992–1996	Moderately tightened	Moderately tightened
1997–2002	Proactive	Proactive
2003–2008	Prudent	Moderate
2008–2014	Proactive	Moderately loosened

Source: Ministry of Finance, the PRC. <http://www.mof.gov.cn/zhengwuxinxi/zhengcefabu/> (accessed 1 December 2017).

The preliminary economic reforms of the late 1970s were geared toward the adoption of new measures under the new economic policy of readjustment and consolidation. The ultimate targets were increasing steel and petroleum outputs to 60 million and 250 million tons, respectively, and implementing 120 large projects in metals, minerals, and gas. This program achieved remarkable success, which supported the comparatively complete industrialization process. However, the program triggered high inflation. In response, the government implemented some measures to immediately “adjust, reform, reorganize, and improve” the national economy, focusing on the restructuring of the fiscal system, which delineated the roles of the central and local governments on revenue;<sup>2</sup> and included a sharp reduction in government

<sup>2</sup> The central government provided a certain base figure including the expected total receipts and total expenditures of a locality plus one of three alternative figures: a proportion of local revenue to be submitted as surplus; a proportion of adjusted income to be received by the local government; or a fixed amount of subsidy from the central government, which encouraged the initiatives of both levels of governments.



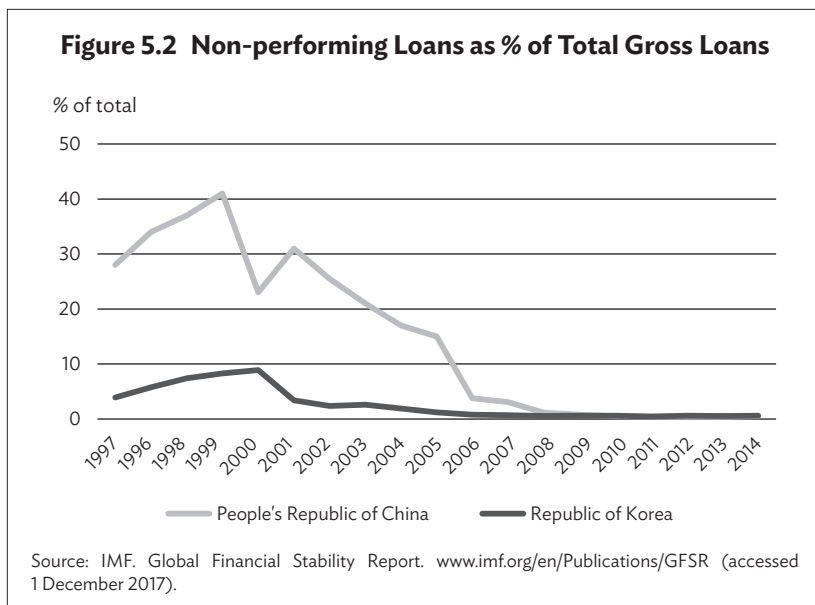
expenditures, particularly those related to capital construction and public institutions. This reduced the gross domestic product (GDP) growth rate from 7.8% to 5.2% during 1980–1981.

By 1985, the economy had recovered from the temporary downturn. However, the fiscal deficit problem emerged, which was quickly remedied by the People's Bank of China (the central bank) by printing more currency, which was not a viable solution. Therefore, the government drastically cut down central government expenditures by terminating grant-in-aid toward specific non-performing SOEs that were saddled with long-term losses. Spending on administration and management in 1990 shrank from 42.2% of the total to only 7.3%. Moreover, a new tax-profit substitution program was established as a link between the central and local governments. The main distinction of this system was that the central-local division of budgetary receipts was now based on different kinds of taxes rather than on profits from state enterprises.

Recognizing the value of solid economic development, the government moved to begin opening up the economy. The economic reforms were designed mainly to address the bottleneck of underdeveloped infrastructure. The government emphasized the importance of technical innovation and 845 medium- and large-sized infrastructure projects were completed and put into production. During this period, the new revenue enhancement system was formed, with value-added tax as its main element, including a 13% and 17% tax rate. Major improvements were also made by individuals and enterprises through the unified income tax code. In addition, the separation of profit from tax was rationalized and regulated so that sharing profits and risks was given priority rather than profit maximization.

During the 1997–1998 Asian financial crisis, the government decided to keep the exchange rate stable and drive domestic consumption by increasing investment to protect its economic gains. This rendered monetary policy ineffective and placed fiscal policy at the forefront as the most important tool to respond to the economic recession. A massive CNY1,280 billion fiscal stimulus package was released through extra bonds and special treasury operations to build social infrastructure and capital for state-owned commercial banks. Debt-to-equity swaps were introduced at that time, which partly mitigated the crisis, and four asset management companies including PRC Orient, PRC Great Wall, PRC Cinda, and PRC Huarong were tasked to provide policy lending.

As a result, the non-performing loan ratio declined dramatically from its peak of 29.8% of total loans in 2001 to less than 1.0% in 2013 (Figure 5.2). Since the government decided to cancel state-owned enterprises' self-owned circulating funds in July 1983, the state-owned commercial banks had to bear all the risks. Four asset management companies had



the responsibility to remove non-performing loans generated by state-owned commercial banks; the companies transformed their roles to allot dividends to creditors, which indicated longer repayment time but was less stressful. The total amount reached about CNY1.4 trillion, enough to help enterprises in the short term, but further restructuring of the SOEs was needed to ensure long-term viability. In 2010 and 2012, PRC Cinda and PRC Huarong accomplished shareholder reforms and introduced more investor-friendly strategies, and then went public in Hong Kong, China in 2013 and 2015, respectively. The cash recovery rate of this reform was about 21% (Table 5.2). This was a major milestone for the commercial transformation of four of the largest asset management companies, toward avoiding liquidity problems and financial panic in the future.

Although the PRC's economy did not suffer significantly during the 2008–2009 financial crisis given its abundant foreign reserves and underdeveloped financial system, considerable fiscal adjustment was needed for a smooth transition during and after the crisis. There was a sudden reduction (of about CNY3 billion) in the issuance of government bonds, the majority of which had largely been used to support rural development of areas such as the central–western provinces' restoration of the old industrial base in the northeast; and ecological construction

**Table 5.2 Removed Non-performing Loans and Cash Recovery Rate from PRC Asset Management Companies (until 31 March 2006, in CNY 100 million, %)**

Asset Management Company	Face Value of Removed NPL	Face Value of Cash Recycling	Assets Recycling Rate	Cash Recovery Rate
PRC Orient	1,419.9	328.1	27.16	23.11
PRC Great Wall	2,707.8	278.3	12.70	10.28
PRC Cinda	2,067.7	652.6	34.46	31.56
PRC Huarong	2,468.0	546.6	26.50	22.15
Total	8,663.4	1,805.6	24.20	20.82

PRC = People's Republic of China, NPL = non-performing loan, CNY = yuan.

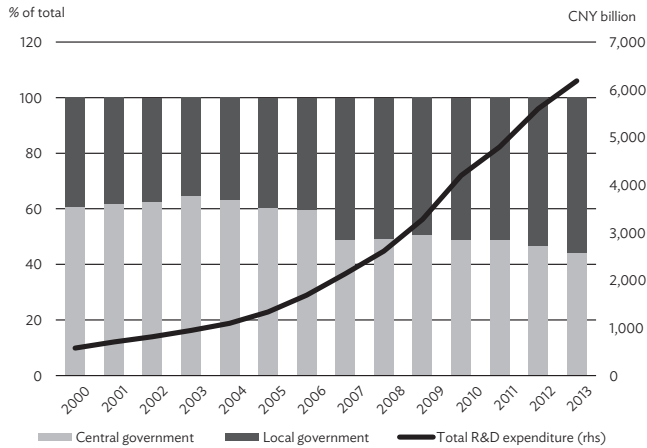
Source: Yuan, Y., and Y. Zhu. 2016. *Exploring Domestic Non-Performance Asset Management Corporation Characteristics*. Financial Institutions of Credit Rating Working Paper.

and environment protection. Following guidance from the government, social investment was also shifted to support infrastructure construction in the backward regions. To strengthen the PRC's competitiveness after its entry into the World Trade Organization, the country developed high-tech industries, which prompted the government to raise research and development (R&D) funding to more than 1.5% of GDP, and reinforced the country's scientific and technological innovation capabilities, thereby speeding up technological progress (Figure 5.3).

The share of R&D in total government expenditure increased continuously, with local governments noticeably expanding their spending shares, which have surpassed the central government's share since 2007. Besides, government expenditure in R&D remained stable at about 21%, while expenditure for sci-tech enterprises exceeds 70%.

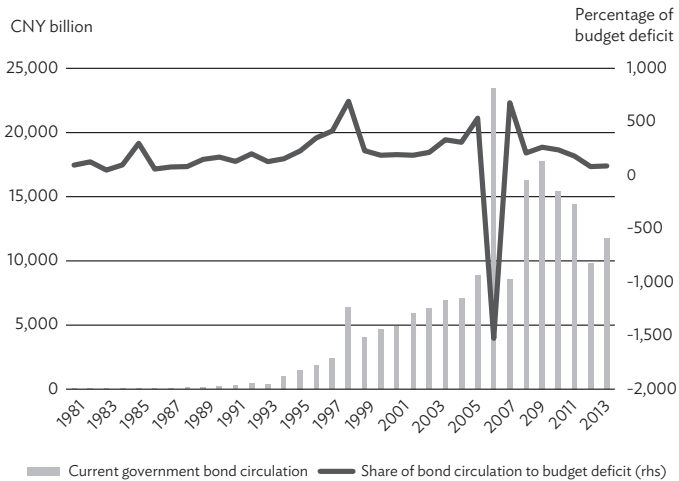
By the time the global financial crisis (GFC) hit, the PRC had attained over 10% GDP growth since 2003, but inflation had also gone up simultaneously. The exuberance in economic growth led to a credit and investment boom, and the high volume of foreign capital flows created demand expansion and an unprecedented active market. However, there was distrust in the market among investors and consumers as a result of the GFC, which forced the government to pursue a more proactive expansionary fiscal policy that changed the economic structure. Massive amounts of bonds were issued to provide financial support for sustainable economic development, and at the same time, issuance of municipal bonds was permitted with the approval of central government (Figure 5.4). In 2009, the new value-

**Figure 5.3 R&D Expenditure by Type of Government**



CNY = yuan, R&D = research and development, rhs = right hand side.  
 Source: PRC Science & Technology Statistics Data Book, 2000–2013.

**Figure 5.4 Government Bond Circulation and the Budget Deficit**



CNY = yuan, rhs = right hand side.  
 Source: PRC Government Bond Yearbook, 1981–2014.

added tax reform, one of the largest tax reforms, cut down total revenue by about CNY1.39 billion.<sup>3</sup> By 2014, the government spent about 2.1% of GDP on R&D, which transformed the coastal regions from being “the world’s factory” to R&D hubs.

A quick assessment of the achievements of the PRC’s fiscal policy during the past four decades indicates a mixed performance. The policy succeeded in financing state investment quantitatively, but failed to assure its appropriate utilization, leading to periods of economic chaos in the process of marketization. One unique function of the PRC’s fiscal policy was to accelerate the socialization movement, which saw the disappearance of individual proprietorship, which eliminated many small-scale services and retail trades. The outlook for the near future is that fiscal policy, together with monetary policy, will be used to prevent spiraling inflation via targeted and direct government controls when necessary.

### 5.3 Literature Review

The research about the dynamic effects of fiscal policy is divided into three parts: First, Cholesky identification assumes matrices  $K$  are down-triangle matrices, which means fiscal variables and output variables do not have structural influences on each other.<sup>4</sup> Second, sign restriction identifies policy shocks using sign restrictions on impulse response, which has been applied to monetary policy impacts.<sup>5</sup> Third, Romer (1994), Ramey and Shapiro (1997), Edelberg et al. (1998), and Blanchard and Perroti (1999) use methods that distinguish between automatic and discretionary policy, and estimate the elasticity of tax on output using

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<sup>3</sup> Liu, Xing, and Shi. 2009. Fiscal Policy Adjustment and Reform in 2008. *Review of Economic Research* 2248.

<sup>4</sup> Fatás, A., and I. Mihov. 2013. Policy Volatility, Institutions, and Economic Growth. *The Review of Economics and Statistics*. *MIT Press* 95(2):3 62–276; Favero, C. 2002. How do European Monetary and Fiscal Authorities Behave? IGIER Working Paper No. 214.

<sup>5</sup> Uhlig, H. 1997. Bayesian Vector Auto-regressions with Stochastic Volatility. *Econometrica* 65(1): 59–73; Mountford, A., and H. Uhlig. 2002. What are the Effects of Fiscal Policy Shocks? CentER Discussion Paper No. 31.

external information.<sup>6</sup> This has been further developed by Blanchard and Perotti (2002).<sup>7</sup> This chapter will follow the third method for the purpose of exploring the relationships and the transmission channel of fiscal policy variables.

There are numerous studies that explore the PRC's fiscal policy. Qin et al. (2006)<sup>8</sup> came up with a basic macroeconomic model and briefly described eight key equation structures of the block, including government expenditure, etc. The Fiscal Science Research Institute (2009) focused on the fiscal risks of local government revenue, and found that to a certain extent, fiscal transfers significantly promote the construction of local infrastructure but are not sustainable, and the local fiscal system needs to focus on improving local taxes in the future.<sup>9</sup> Lam and Wingender (2015) have explored how revenue reforms can properly contribute to more inclusive and sustainable growth in the PRC and propose that improving the progressivity of labor and taxes, introducing a recurrent property tax, and finishing the transition to a comprehensive value-added tax could help promote growth, boost revenues, and reduce the deficit.<sup>10</sup>

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<sup>6</sup> Romer, P. M. 1994. The Origins of Endogenous Growth. *The Journal of Economic Perspectives* 8(1): 3–22; Ramey, V. A., and M. D. Shapiro. 2007. Costly Capital Reallocation and the Effects of Government Spending. NBER Working Paper No. 6283; Edelberg, W., M. Eichenbaum, and J. Fisher. 1998. Understanding the Effects of a Shock to Government Purchases. NBER Working Paper No. 6737; Blanchard, O., and R. Perotti. 1999. An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output. NBER Working Paper No. 7269.

<sup>7</sup> Blanchard, O., and R. Perotti. 2002. An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output. *The Quarterly Journal of Economics* 117(4): 1329–1368.

<sup>8</sup> Qin, D., M. A. Cagas, G. Ducanes, N. Magtibay-Ramos, P. Quising, X.-H. He, R. Liu, and S.-G. Liu. 2006. A Small Macroeconometric Model of the People's Republic of China. ERD Working Paper No.81. Manila: Asian Development Bank. Economics and Research Development.

<sup>9</sup> Fiscal Science Research Institute of the Ministry of Finance. 2009. The Trends in Chinese Local Government Debt and Related International Experiences from a Fiscal Risks Perspective. *Macroeconomy* 179(1).

<sup>10</sup> Tax on property is defined as recurrent and non-recurrent on the use, ownership, or transfer of property. The recurrent tax is mandatory and is imposed on the owners (in some cases on the lessee or user) of the property in the various tax jurisdictions; it is a stable source of income for the public budgets of modern market-based economies. Lam, W.R., and P. Wingender. 2015. China: How Can Revenue Reforms Contribute to Inclusive and Sustainable Growth? IMF Working Paper No. 15/66. Washington, DC: International Monetary Fund.

## 5.4 Empirical Analysis

### 5.4.1 Empirical Framework

In this section, we describe the data and empirical framework used for our analysis.

For developing countries such as the PRC, quarterly data are difficult to find, even in the statistical yearbook. All variables are in natural logarithms unless stated otherwise. For the identification of the fiscal policy shocks, the variables in the government expenditure model with respect to fiscal policy shocks are central government expenditure, local government expenditure, net tax, fixed asset investment, and gross national income (GNI). We follow Perotti (2002) to build a model including net tax, but without the division of the government into central and local government.

SVAR model can be formed as below:

$$Y_t = A(I + A_1L + A_2L^2 + \dots + A_pL^p)y_t = A \epsilon_t = B e_t \quad (1)$$

Perotti (2002) divides fiscal policy into discretionary and automatic policy. Discretionary policy's effectiveness is measured by the size of the multipliers and automatic stabilizer's effectiveness is measured by the magnitude of an exogenous shock that fiscal policy can smooth out. The formula to calculate net tax<sup>11</sup> is:

$$\begin{aligned} \text{Net tax} &= \text{Revenues} - \text{Transfers}; \\ \text{Revenues} &= \text{Tax revenues} + \text{Non-tax revenues}; \\ \text{Transfers} &= \text{Social security transfers to households} \\ &\quad + \text{Other transfers to households} + \text{Subsidies to firms} \\ &\quad + \text{Transfers abroad} \end{aligned}$$

The orthogonalization matrix  $P_{\text{SR}} = A^{-1}B$  is then related to the error covariance matrix by  $\Sigma = P_{\text{SR}}P'_{\text{SR}}$  in the short-run SVAR model.

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<sup>11</sup> Perotti, R. 2002. Estimating the Effects of Fiscal Policy in OECD Countries. European Central Bank Working Paper Series. Frankfurt: European Central Bank. Perotti divides fiscal policy into discretionary and automatic policy. Discretionary policy is where effectiveness is measured by the size of the multipliers, while automatic policy is where effectiveness is measured by the magnitude of an exogenous shock that fiscal policy can smooth out.

The variables in the investment model are investment in infrastructure, manufacturing, and R&D, net tax, and GNI. One of the reasons we chose these three variables is that because of the aggregate nature of production functions, the exact contribution of infrastructure to productivity remains limited as the production function approach does not cover all welfare aspects of infrastructure supply. For example, the impact of infrastructure investments on consumers is not taken into account. Furthermore, the production function approach can hardly be used to give an ex-ante evaluation of specific projects. Undoubtedly, industrial development has played an important role in the economic growth of developing countries including the PRC; and thereafter, investment in manufacturing indirectly influenced productivity performance. In addition, Romer (1986) came up with endogenous growth model, in which technological innovation is created in the R&D sectors combining human capital and knowledge, which is at the heart of economic growth.<sup>12</sup> In the PRC's case, investment in infrastructure is calculated by adding investment in the management of water, conservancy, environment, and public facilities; transport, storage, and post; production and supply of electricity, heat, water, and gas, services to households, repair and other services; education; culture, sports and entertainment, and public management, social security and social organizations between 1991 and 2014 from the data collected from the Statistical Yearbook of the PRC of 2016 and 2003. All endogenous variables will be also regressed in three sub-periods: before 1998, 1998–2007, and 2008–2014. This allows us to compare the effect of fiscal policy in different fiscal episodes.

In the third structural model, external debt is divided into short-term and long-term, and the other variables are government expenditure and government revenues. Favero and Giavazzi (2007) emphasized the importance of including the debt feedback effect when estimating the effects of fiscal policy shocks.<sup>13</sup> The identified system is:

$$Y_t = \sum_{i=1}^n A_i Y_{t-i} + \sum_{i=1}^n B_i (d_{t-i} - d^*) + u_t \quad (2)$$

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<sup>12</sup> Romer, P. 1986. Increasing Returns and Long-Run Growth. *The Journal of Political Economy* 94(5): 1002–1037.

<sup>13</sup> Favero, C., and F. Giavazzi. 2007. Debt and the Effects of Fiscal Policy. Research Department Working Papers of Federal Reserve Bank of Boston, 7(4). Boston: Federal Reserve Bank of Boston.



$$d_{lt} + d_{st} = \frac{1 + i_t}{(1 + \Delta\pi_t)(1 + \Delta y_t)} [(d_{lt-1} - d_l^*) + (d_{st-1} - d_s^*)] + \frac{g_t - t_t}{y_t} \quad (3)$$

where  $Y_t = (g_e \ g_r)$ , the variable in the matrix are government expenditure, government revenue,  $d_{lt}$  is long-term debt to GDP ratio,  $d_{st}$  is short-term debt to GDP ratio, and  $d_l^*$  and  $d_s^*$  are unconditional mean values.

Generally speaking, in terms of impulse response functions, fiscal multipliers reflect the impact of fiscal variables on GDP or GNI, or  $\frac{\Delta Y_t}{\Delta X_t}$  where  $X$  is government expenditure or tax value. However, Davig,

Leeper, and Walker (2010) point out that current fiscal policy will affect future fiscal policy, which means that the ordinary impulse response cannot accurately capture the impact on the economy.<sup>14</sup> Therefore, Perotti (2004) applies the SVAR model to calculate the cumulative impulse response and cumulative multipliers as  $\frac{\sum_{i=0}^k \Delta Y_{t+k}}{\sum_{i=0}^k \Delta X_{t+k}}$ , which can

be interpreted as the ratio of the cumulative value of GDP or GNI to the cumulative value of government or tax.<sup>15</sup> In addition, Mountford and Uhlig (2009) have developed a new method assuming the discount rate as

$\frac{\sum_{i=0}^k \prod_{j=0}^i (1 + \gamma_{t+j})^{-1} \Delta Y_{t+k}}{\sum_{i=0}^k \prod_{j=0}^i (1 + \gamma_{t+j})^{-1} \Delta X_{t+k}}$ .<sup>16</sup> We calculate the multipliers based on three

models,  $\frac{\Delta Y_t}{\Delta X_t} * \frac{Y}{X}$ ,  $\frac{\sum_{i=0}^k \Delta Y_{t+k}}{\sum_{i=0}^k \Delta X_{t+k}} * \frac{Y}{X}$ , and  $\frac{\sum_{i=0}^k \prod_{j=0}^i (1 + r_{t+j})^{-1} \Delta Y_{t+k}}{\sum_{i=0}^k \prod_{j=0}^i (1 + r_{t+j})^{-1} \Delta X_{t+k}} * \frac{Y}{X}$ ,<sup>17</sup>

which represent the multiplier, cumulative multiplier, and discounted cumulative multiplier.

<sup>14</sup> Davig, T., E. Leeper, and T. Walker. 2010. "Unfunded Liabilities" and Uncertain Fiscal Financing. NBER Working Paper No.15782. NBER.

<sup>15</sup> Perotti, R. 2004. Public Investment: Another (Different) Look. IGIER Working Paper No. 277. IGIER.

<sup>16</sup> Mountford, A., and H. Uhlig. 2009. What Are the Effects of Fiscal Policy Shocks? *Journal of Applied Econometrics* 24: 960–992.

<sup>17</sup> Note:  $\Delta Y_{t+k}$  is the response value of output at t+k period, and  $\Delta X_{t+k}$  is the value that the impulse variable response to itself, while  $X/Y$  is the average of the ratio of fiscal variable to output.

## 5.4.2 Empirical results

### Government expenditure model

In terms of fiscal policy, the government expenditure of the PRC is determined primarily by the central government. The central government's fiscal decisions affect the local government's fiscal decisions. We identified fiscal policy shocks using a recursive identification scheme and then estimated a 5-variable SVAR model, imposing restrictions on A and B as indicated below according to the recursive approach, and set the variable sequence as investment ( $i$ ), net tax ( $nt$ ), local government expenditure ( $le$ ), central government expenditure ( $ce$ ), and GDP per capita ( $y$ ). According to Barro (1990), under the assumption of constant returns to scale, government expenditure can change the steady economy growth rate.<sup>18</sup> Decentralization of the government leads to greater autonomy for local governments. Zhang and Zou (1998) adopted the ratio of local government to central government to measure the degree of decentralization and proved that decentralization definitely affects economic growth, although negatively influences provincial development.<sup>19</sup> The Laffer curve implies that the proper tax rate, which leads to the maximization of output determines the trend of tax revenue. The A-B matrix of government expenditure model can be estimated as below:

$$\begin{bmatrix} 1 & 0 & 0 & 0 & 0 \\ -0.33 & 1 & 0 & 0 & 0 \\ -0.25^{***} & -0.08^{***} & 1 & 0 & 0 \\ -0.13^{***} & 0.04 & 0.59^{***} & 1 & 0 \\ 0.04 & -0.02^{***} & 0.13^{***} & 0.06^{**} & 1 \end{bmatrix} \begin{bmatrix} \varepsilon_t^i \\ \varepsilon_t^{nt} \\ \varepsilon_t^{le} \\ \varepsilon_t^{ce} \\ \varepsilon_t^y \end{bmatrix} = \begin{bmatrix} 0.02^{***} & 0 & 0 & 0 & 0 \\ 0 & 0.05^{***} & 0 & 0 & 0 \\ 0 & 0 & 0.01^{***} & 0 & 0 \\ 0 & 0 & 0 & 0.01^{***} & 0 \\ 0 & 0 & 0 & 0 & 0.00^{***} \end{bmatrix} \begin{bmatrix} e_t^i \\ e_t^{nt} \\ e_t^{le} \\ e_t^{ce} \\ e_t^y \end{bmatrix} \quad (4)$$

Note: \*\*\*, \*\*, and \* represent null hypothesis rejected on 1%, 5%, and 10% level of significance

Source: Authors' calculations.

<sup>18</sup> Barro, R. 1990. Government Spending in a Simple Model of Endogenous Growth. *The Journal of Political Economy* 98(5): 103–125.

<sup>19</sup> Zhang, T., and H. Zou. 1998. Fiscal Decentralization, Public Spending, and Economic Growth in the PRC. *Journal of Public Economics* 67(2): 221–240.

In line with Blanchard and Perotti (2002),<sup>20</sup> the net tax elasticity of output in the PRC is  $-0.02$ , meaning that a 1.00% decrease in net tax generates a 0.02% increase in output. Similarly, a 1.00% increase in central government expenditure and local government expenditure leads to a 0.13% and 0.06% increase in output, respectively. However, private investment elasticity to output is insignificant at impact.

The results are reported in Tables 5.3, 5.4, and 5.5.<sup>21</sup> A number of interesting patterns emerge. First, the overall trend indicates that both central and local expenditures, as discretionary fiscal tools, had a positive effect on output in the first quarter, and then faded, approaching zero gradually, while the response of output to net tax appears to be in the opposite direction, indicating an adverse reaction of auto stable fiscal policy on output. Compared to the cumulative multipliers among three different impulse shocks, local government expenditure was more effective in the first quarter; after the third quarter, net tax had a greater impact. Second, before the Asian financial crisis, net tax had a positive effect in the short term, which went against the trend of government expenditure shocks, but the cumulative multiplier of expenditure, especially local government expenditure, was relatively bigger than the other two variables. Third, after the GFC, the cumulative multiplier of local government expenditure was relatively bigger than that of the central government. Fourth, during 2008–2014, central government expenditure had a bigger impact on output, with a much larger cumulative multiplier than local government expenditure or net taxes, implying a dominating role of central government in regulating and controlling economic instability.

The impulse response function for the government expenditure model yields the following findings. Our results provide conclusive evidence that the effects of government expenditure (and tax) multipliers may change over the business cycle, i.e., be larger in recessions than in expansions.<sup>22</sup> These findings appear to be in line with Keynesian arguments in favor of using discretionary government expenditure during a downturn to stimulate aggregate demand. In general, both Blanchard and Perotti (2002) and Mountford and Uhlig (2009)<sup>23</sup> find that tax multipliers are lower than spending ones in the short term, which is in accordance with the theoretical prediction that

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<sup>20</sup> Blanchard and Perotti, *supra*, note 7.

<sup>21</sup> IRF results are available from the authors upon request.

<sup>22</sup> Woodford, M. 2010. Financial Intermediation and Macroeconomic Analysis. *Journal of Economic Perspectives* 24(4): 21–44.

<sup>23</sup> Blanchard and Perotti, *supra*, note 7; Mountford and Uhlig, *supra*, note 5.

**Table 5.3 Multiplier Output Response to a Central Government Expenditure Shock**

Periods	Step	Multiplier	Cumulative multiplier	Discounted cumulative multiplier
Before 1998	1 quarter	0.101	0.050	0.051
	3 quarters	0.076	0.012	0.014
	5 quarters	0.068	0.012	0.009
	8 quarters	0.081	0.030	0.027
1998–2007	1 quarter	0.102	0.012	0.012
	3 quarters	0.016	0.020	0.020
	5 quarters	0.001	0.014	0.014
	8 quarters	0.008	0.015	0.015
2008–2014	1 quarter	0.673	0.269	0.271
	3 quarters	0.156	0.202	0.205
	5 quarters	0.530	0.204	0.206
	8 quarters	1.437	0.089	0.100
1991–2014	1 quarter	0.089	0.022	0.023
	3 quarters	0.052	0.001	0.000
	5 quarters	0.054	0.009	0.008
	8 quarters	0.011	0.008	0.007

Source: Authors' calculations.

**Table 5.4 Multiplier Output Response to a Local Government Expenditure Shock**

Periods	Step	Multiplier	Cumulative multiplier	Discounted cumulative multiplier
Before 1998	1 quarter	0.201	0.041	0.043
	3 quarters	0.025	0.051	0.052
	5 quarters	0.200	0.074	0.073
	8 quarters	0.033	0.068	0.068
1998–2007	1 quarter	0.407	0.066	0.068
	3 quarters	0.148	0.030	0.032
	5 quarters	0.019	0.031	0.032
	8 quarters	0.033	0.027	0.028

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**Table 5.4** *continued*

Periods	Step	Multiplier	Cumulative multiplier	Discounted cumulative multiplier
2008–2014	1 quarter	0.208	0.009	0.010
	3 quarters	0.018	0.010	0.009
	5 quarters	0.080	0.077	0.076
	8 quarters	0.496	0.010	0.011
1991–2014	1 quarter	0.053	0.046	0.046
	3 quarters	0.020	0.020	0.021
	5 quarters	0.023	0.010	0.011
	8 quarters	0.161	0.008	0.006

Source: Authors' calculations.

**Table 5.5 Multiplier Output Response to a Net Tax Shock**

Periods	Step	Multiplier	Cumulative multiplier	Discounted cumulative multiplier
Before 1998	1 quarter	0.013	0.002	0.002
	3 quarters	0.004	0.004	0.004
	5 quarters	0.020	0.003	0.003
	8 quarters	0.026	0.001	0.002
1998–2007	1 quarter	0.301	0.007	0.007
	3 quarters	0.212	0.019	0.019
	5 quarters	0.010	0.007	0.007
	8 quarters	0.005	0.010	0.010
2008–2014	1 quarter	0.316	0.137	0.139
	3 quarters	0.134	0.050	0.052
	5 quarters	0.080	0.068	0.070
	8 quarters	1.260	0.010	0.004
1991–2014	1 quarter	0.006	0.022	0.022
	3 quarters	0.003	0.018	0.018
	5 quarters	0.011	0.025	0.025
	8 quarters	0.018	0.037	0.035

Source: Authors' calculations.

part of the higher disposable income stemming from tax cuts is saved. Moreover, some evidence also suggests that net tax multipliers could be higher than government expenditure multipliers in the long term. Our study proves that the discounted cumulative multipliers of central and local government expenditures are 0.023 and 0.046, respectively after one quarter, whereas the net tax multiplier is 0.025 and 0.035 in 5th quarter and 8th quarter, much larger than 0.008 and 0.007 in the case of central government expenditure, or 0.011 and 0.006 for local government expenditure. In general, during recessions the multiplier should be higher; our study shows that the effect of central government and net tax is significant after the GFC, with a discounted multiplier of 0.271 and 0.139, respectively. It is interesting that the impact of the local government expenditure shock after the Asian financial crisis shows no apparent fluctuation.

### Investment model

In the second 5-variable SVAR model, the responses of GNI to total society investment by sectors are estimated. For the sake of convenience, the variables' names are shortened as GNI to  $y$ , Investment in infrastructure to  $inf$ , Investment in manufacturing to  $mac$ , and Investment in R&D to  $rd$ . The coefficients corresponding to the structural uncorrelated shocks  $\varepsilon_t^{nt}$ ,  $\varepsilon_t^{inf}$ ,  $\varepsilon_t^{mac}$ ,  $\varepsilon_t^{rd}$ ,  $\varepsilon_t^y$  can be obtained in the equation below:

$$\begin{bmatrix} 1 & 0 & 0 & 0 & 0 \\ -0.18 & 1 & 0 & 0 & 0 \\ -0.13 & -16.09^{***} & 1 & 0 & 0 \\ -0.19^{***} & -0.97^{***} & -0.02^{***} & 1 & 0 \\ -0.04^{***} & -0.01 & -0.002^{***} & 0.09^{***} & 1 \end{bmatrix} \begin{bmatrix} \varepsilon_t^{nt} \\ \varepsilon_t^{inf} \\ \varepsilon_t^{mac} \\ \varepsilon_t^{rd} \\ \varepsilon_t^y \end{bmatrix} \quad (5)$$

$$\begin{bmatrix} 0.05^{***} & 0 & 0 & 0 & 0 \\ 0 & 0.02^{***} & 0 & 0 & 0 \\ 0 & 0 & 0.72^{***} & 0 & 0 \\ 0 & 0 & 0 & 0.02^{***} & 0 \\ 0 & 0 & 0 & 0 & 0.002^{***} \end{bmatrix} \begin{bmatrix} e_t^{nt} \\ e_t^{inf} \\ e_t^{mac} \\ e_t^{rd} \\ e_t^y \end{bmatrix}$$

Note: \*\*\*, \*\*, and \* represent null hypothesis rejected on 1%, 5%, and 10% level of significance.

Source: Authors' calculations.

Regarding infrastructure, the coefficient shows a negative sign without being statistically significance. Another interesting finding is

that during 1991–2014, a 1.0% decline in investment in manufacturing led to a 0.002 % increase in GNI. However, a 1.0% increase of R&D investment generated a 0.09% increase in GNI, much higher than in the other sectors.

The results are reported in Tables 5.6, 5.7, and 5.8.<sup>24</sup> First, the response of GNI to only manufacturing appears to be on a declining trend in the first quarter, and then recovers slightly until the fourth quarter, and goes down again thereafter. Regarding innovation of investment in infrastructure and R&D, the response curves peak in the fourth and first quarter, respectively, and show a positive impact. Until the first quarter, the magnitude of GNI to R&D shock is the biggest with the discounted cumulative multiplier of 0.0495, followed by infrastructure with 0.0167, and manufacturing at only 0.0001. Second, before the Asian financial crisis, GNI reacts negatively to the innovation of investment in infrastructure, and in the same period, the output multiplier of manufacturing was much higher than that of the other two sectors. Third, after the Asian crisis, the cumulative multiplier of R&D is much larger than that for infrastructure and manufacturing investment, notwithstanding during 2008–2015. Manufacturing investment also has a relatively high impact on GNI. However, there is a declining effect of R&D on GNI in the last sub-period.

The impulse response functions offer several observations. The government is mainly responsible for driving investment in infrastructure in the PRC, but due to the low efficiency of government investment and crowding-out effects, there is a high likelihood of a negative impact, as shown in our study of the 1991–1998 period. Furthermore, previous studies have already shown in some cases that R&D investment has a negative effect on economic growth. On the one hand, technological progress may increase the unemployment rate. On the other hand, as more attention is paid to intellectual property rights protection, it prohibits knowledge spillover and the efficiency of shared processes at the firm level. Lin Yifu,<sup>25</sup> a well-regarded economist, believes that infrastructure investment may promote economic growth in the long term, thus explaining why the output multiplier of investment in infrastructure increases from 0.019 to 0.0162 during eight quarters in 1998–2007 and from 0.0021 to 0.0246 in 2008–2015. We can also assume that the small multiplier comes from insufficient amount invested in this sector after the recession. The higher R&D multiplier after 1998 either

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<sup>24</sup> IRF results are available from the authors upon request.

<sup>25</sup> Lin Yifu is a leading Chinese economist. He is the founder and first director of the China Center for Economic Research. His main academic theory is called New Structural Economics.

**Table 5.6 Multiplier Output Response to an Infrastructure Investment Shock**

Periods	Step	Multiplier	Cumulative multiplier	Discounted cumulative multiplier
1991–1997	1 quarter	0.0210	0.0179	0.0185
	3 quarters	0.0496	0.0132	0.0117
	5 quarters	0.0745	0.0300	0.0277
	8 quarters	0.3306	0.0448	0.0410
1998–2007	1 quarter	0.0298	0.0016	0.0019
	3 quarters	0.0389	0.0183	0.0178
	5 quarters	0.0049	0.0171	0.0167
	8 quarters	0.0056	0.0165	0.0162
2008–2015	1 quarter	0.0230	0.0024	0.0021
	3 quarters	0.0291	0.0428	0.0417
	5 quarters	0.0177	0.0395	0.0386
	8 quarters	0.0310	0.0244	0.0246
1991–2015	1 quarter	0.0242	0.0162	0.0167
	3 quarters	0.0197	0.0055	0.0047
	5 quarters	0.0113	0.0099	0.0091
	8 quarters	0.0046	0.0111	0.0103

Source: Authors' calculations.

**Table 5.7 Multiplier Output Response to a Manufacturing Investment Shock**

Periods	Step	Multiplier	Cumulative multiplier	Discounted cumulative multiplier
1991–1997	1 quarter	0.6508	0.0022	0.0015
	3 quarters	0.6528	0.0002	0.0004
	5 quarters	0.0390	0.0153	0.0118
	8 quarters	0.0351	0.0410	0.1560
1998–2007	1 quarter	0.0001	0.0009	0.0009
	3 quarters	0.0011	0.0012	0.0011
	5 quarters	0.0005	0.0009	0.0008
	8 quarters	0.0003	0.0007	0.0007

continued on next page



**Table 5.7** *continued*

Periods	Step	Multiplier	Cumulative multiplier	Discounted cumulative multiplier
2008–2015	1 quarter	0.0975	0.1598	0.1591
	3 quarters	0.0017	0.0428	0.0435
	5 quarters	0.0017	0.0254	0.0262
	8 quarters	0.0029	0.0180	0.0187
1991–2015	1 quarter	0.0002	0.0000	0.0001
	3 quarters	0.0014	0.0010	0.0010
	5 quarters	0.0037	0.0012	0.0012
	8 quarters	0.0055	0.0015	0.0014

Source: Authors' calculations.

**Table 5.8 Multiplier Output Response to an R&D Investment Shock**

Periods	Step	Multiplier	Cumulative multiplier	Discounted cumulative multiplier
1991–1997	1 quarter	0.3701	0.0190	0.0199
	3 quarters	0.0256	0.0157	0.0162
	5 quarters	0.0215	0.0122	0.0128
	8 quarters	0.4821	0.0142	0.0350
1998–2007	1 quarter	0.0417	0.0837	0.0845
	3 quarters	0.0232	0.0452	0.0464
	5 quarters	0.0014	0.0374	0.0386
	8 quarters	0.0061	0.0353	0.0365
2008–2015	1 quarter	0.0281	0.2171	0.2185
	3 quarters	0.0563	0.1180	0.1211
	5 quarters	0.0484	0.0625	0.0674
	8 quarters	0.0113	0.0304	0.0364
1991–2015	1 quarter	0.0241	0.0488	0.0495
	3 quarters	0.0144	0.0281	0.0291
	5 quarters	0.0105	0.0196	0.0208
	8 quarters	0.0108	0.0152	0.0166

R&D = research and development.

Source: Authors' calculations.

in the short- or long-term shows its importance in the development of the PRC, which led the government to initiate the Strategic Emerging Industries Plan and the Made in the PRC 2025 in the 12th and 13th five-year plans.

### External debt model

In the third model, we consider the potential debt feedback following Bohn (1998),<sup>26</sup> who comes up with a fiscal reaction function in which  $d^*$  is the unconditional mean of the debt-to-GDP ratio as shown in formula (2). Following Favero and Giavazzi (2007),<sup>27</sup> we constructed a 2-variable SVAR model for the PRC and the Republic of Korea, which includes the government spending-to-GDP ratio and the government revenue-to-GDP ratio, and the effectiveness of debt-to-GDP ratio feedback. We report the coefficients and the standard errors taken from the estimation for the full sample and from sub-samples (Table 5.9).

**Table 5.9 The Effect of  $(d_{t-i} - d^*)$  in the External Debt Model**

	PRC	grev	gexp	KOR	grev	gexp
$(d_{t-i} - d^*)$	1985–1997	-4.2248** (2.0551)	-4.8288** (1.9065)	1985–1997	-0.1022 (0.1101)	0.0215 (0.1581)
	1998–2007	2.0532*** (0.4168)	0.7767 (0.9113)	1998–2007	-0.3233*** (0.1071)	0.3113 (0.5090)
	2008–2014	0.5692*** (0.1464)	-0.0310 (0.5718)	2008–2014	0.1823*** (0.0628)	0.8992** (0.1632)
	All	0.4943*** (0.1072)	0.5060*** (0.1282)	All	-0.0278 (0.0465)	0.0504 (0.0841)
$(d_{t-i} - d_t^*)$	1985–1997	-0.3897 (0.7127)	-0.1145 (0.6612)	1985–1997	0.0080 (0.1633)	0.2066 (0.2245)
	1998–2007	2.7233*** (0.4922)	2.0778* (1.0761)	1998–2007	0.5687*** (0.1223)	-0.4193 (0.5810)
	2008–2014	5.9931*** (0.8895)	2.6420 (3.4733)	2008–2014	0.3028*** (0.1269)	1.9380*** (0.3299)
	All	1.0137*** (0.2900)	1.3978*** (0.3468)	All	-0.0140 (0.0657)	-0.1051 (0.1189)

gexp = government expenditures, grev = government revenues, PRC = People's Republic of China, KOR = Republic of Korea.

Note: \*\*\*, \*\*, and \* represent 1%, 5%, and 10% significant levels, respectively.

Source: Authors' calculations.

<sup>26</sup> Bohn, H. 1998. The Behavior of U.S. Public Debt and Deficits. *Quarterly Journal of Economics* 113: 949–963.

<sup>27</sup> Favero and Giavazzi, *supra*, note 13.

In the PRC, the results covering all the years show that the debt-to-GDP ratio has a significant impact on both government expenditure and revenue. As for the sub-periods, one can infer that after the financial crisis, the short-term debt-to-GDP ratio had a more significant effect on government revenue, but a reduced impact on government expenditure. Both government expenditure and revenue had a significant impact on the long-term debt-to-GDP ratio, especially expenditure, while there were no significant relationships before 1998. In addition, both short- and long-term debt had a more significant impact on government revenue than on government expenditure. This indicates that a stabilizing effect of the debt level of the budget balance worked mainly through the response of government revenues to deviations of the debt from the target level, especially from the long-term debt side.

## 5.5 Conclusion

Fiscal policy in the PRC occupies a crucial position in managing the national economy. The way the government exercises this power varies along with the overall economic situation, such as internal adjustments and coping with external shocks like the financial crises.

After reforming the highly centralized planned economic system, the government of the PRC proceeded to decentralize expenditure management at the various levels of the local government. Tax reforms regarding central and local revenue determined the source of national income and the division of authority. The efficiency and effectiveness of the central government and the policy executive, and the strength of local government forms part of a complementary fiscal management system that can result in better public service and guidance to enterprises, institutions, and citizens, leading to healthier and steadier economic growth. Government expenditure (and tax) multipliers may change over the business cycle, i.e., be larger in recessions than in expansions.<sup>28</sup> In general, both Blanchard and Perotti (2002) and Mountford and Uhlig (2009)<sup>29</sup> find that tax multipliers are lower than the spending ones in the short term, which is in line with the theoretical prediction that part of the higher disposable income stemming from tax cuts is saved. Moreover, some evidence also suggests that net tax multipliers could be higher than government expenditure multipliers in the long term.

In order to address the bottlenecks of underdeveloped infrastructure, the government is mainly responsible for driving investment in

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<sup>28</sup> Woodford, *supra*, note 22.

<sup>29</sup> Blanchard and Perotti, *supra*, note 7; Mountford and Uhlig, *supra*, note 5.

infrastructure in the PRC, but due to the low efficiency of government investment and crowding-out effects, a negative impact is possible, as shown in our study of the 1991–1998 period. Furthermore, previous studies have already shown that in some cases R&D investment has a negative effect on economic growth. On the one hand, technological progress may increase the unemployment rate; on the other hand, as greater attention is paid to intellectual property rights protection, it prohibits knowledge spillover and the efficiency of shared processes at the firm level.

Although the utilization of government bonds remains at a very basic level, and the government still lacks the features of an advanced financial system, it has been proven that, if used judiciously, bonds help finance vital investments. Further, long-term debt can better influence the economy's performance in the long term, and short-term debts are more suitable for influencing economic growth in the short term.

To conclude, if the PRC succeeds in bringing about the intended economic transformation without high inflation, it would be one for the economic history books. Whether the PRC's economy can smoothly navigate the tough situation and maintain steady economic growth with a soft landing remains to be seen. It is therefore essential to develop some specific and efficient fiscal measures to employ and protect the economy from sudden depression.

# 6

## Ongoing Fiscal and Tax Reforms in the People’s Republic of China

*Jurgen Conrad and Jian Zhuang*

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### 6.1 Introduction

In November 2013, the Third Plenum of the 18th Central Committee of the Communist Party of China (CPC) called for wide-ranging reforms to the budget and debt management system, the tax system, and intergovernmental fiscal relations to build a modern fiscal system through sequenced reforms by 2020.<sup>1</sup> This was the start of the most comprehensive and far-reaching fiscal reform initiative in the People’s Republic of China (PRC) since 1994. In June 2014, the Politburo of the CPC passed a plan to deepen fiscal reforms. In line with this roadmap, reforms over recent years have focused on three areas, namely budget management, the tax system, and central–local government fiscal relations. The objective was to implement key reforms by 2016 and “basically complete” the whole reform initiative by 2020.

### 6.2 Budget Management Reform

The objective of the budget management reforms is to make budgets more transparent and strengthen their execution by streamlining department and special purpose budgets, disclosing more details, and strengthening the role of people’s congresses, i.e., parliaments in the process; move to multiyear budgets; improve transfers; strengthen local government debt management; and regulate fees and tax concessions, which have mushroomed at the local level. To support these reforms, the Asian Development Bank (ADB) has provided several technical assistance

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<sup>1</sup> Government of the People’s Republic of China. 2013. *The Decision on Major Issues Concerning Comprehensively Deepening Reforms*. Beijing.

projects in recent years.<sup>2</sup> The projects focused on strengthening of information management systems, adoption of medium-term expenditure frameworks and performance budgeting, tightening of cash management through the development of treasury single accounts, and budgeting for public–private partnerships to ensure they do not become a new, hidden source of local government financing.<sup>3</sup>

Actual reform achievements so far include harmonization and reduction of tax concessions and fees, enhanced disclosure of government budgets and final accounts to the public, and amendments to the budget law effective January 2015, which allow provincial governments to borrow on-budget within centrally controlled quotas, among others by issuing bonds.

Along with the new budget law, the State Council issued several documents to address the root causes of unrestrained local government borrowing, extra-budgetary activities, and weak accountability. For instance, State Council Document 43, adopted in October 2014, laid out a plan to tackle the stock of existing debt and a framework for managing it, starting with classifying the debt stock and delinking local government financial vehicles from local government finances. State Council Document 63, adopted in December 2014, laid down a mandate for governments at all levels to compile and release to the public comprehensive government financial reports. These include not only on-budget revenues, expenditures, and direct debt as in the past, but also a balance sheet of government assets, liabilities, and cash flows. The government's new financial reporting system adopts modified accrual accounting rules, which require all entities with claims on public resources to be shown.

Under the new budget law and associated documents, a national registry of local government debt was created, and the aggregate amount is monitored by the National People's Congress. A program was introduced in 2015 to swap government bonds for local government bank debt. By the end of 2017, more than CNY10.9 trillion (\$1.6 trillion) had been swapped, improving the term structure of local government debt and reducing debt servicing costs to local budgets.

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<sup>2</sup> These include, among others: (i) TA 7568-PRC: Supporting Reforms in Taxation and Budget Management; (ii) TA 7763-PRC: Strengthening Fiscal Policy and Public Finance Reform Over the Medium-term; (iii) TA 8379-PRC: Public Finance Developing Strategy 2020; and (iv) TA 8490-PRC: Public Expenditure Performance Monitoring in Henan.

<sup>3</sup> For a summary of findings and outcomes, see Asian Development Bank. 2014. *Money Matters – Local Government Finances in the People's Republic of China*. Manila: Asian Development Bank.

The 19th National Congress of the CPC in October 2017 found that the framework for a modern budget system has basically been established.<sup>4</sup> However, the Congress also admitted that more work is needed to fully implement the budget law, tighten budget constraints, stop off-budget spending, and strengthen performance management, as well as medium-term budget planning.

Efforts have also been made to create an enabling environment for public-private partnerships (PPPs) and launch PPP pilot projects. The PPP project pipelines built by the Ministry of Finance for projects requiring fiscal support comprised about 7,420 projects worth CNY11.5 trillion (\$1.8 trillion) at the end of the first quarter of 2018. The National Development and Reform Commission has been building an additional pipeline for projects not requiring fiscal support. Institutional capacity and funding for project preparation and implementation monitoring were initially insufficient, and open tenders the exception rather than the rule. Further, the evolving regulatory framework for PPP has remained fragmented and a PPP law is only being drafted under the guidance of the State Council. As a result, state-owned enterprises or former local government financing vehicles<sup>5</sup> were the private partner in more than 70% (by volume) of the 3,324 projects that were at the implementation stage at the end of the first quarter of 2018. Acknowledging these issues,<sup>6</sup> in October 2016, the Ministry of Finance required local governments to report contingent liabilities incurred through PPP projects. If one compares high level policy statements over time, it seems that the importance of PPP has been de-emphasized by policymakers since 2016.

### 6.3 Tax System Reform

Since the reform process and opening up of the economy started in 1978, the PRC has been devoted to establishing an efficient, stable, and sustainable fiscal and taxation system. Assistance provided by ADB has focused on calibrating the rates of the value-added tax (VAT) and rolling

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<sup>4</sup> 人民出版社 (People's Publishing House). 2017. *党的十九大报告辅导读本 (Nineteenth Congress Report Counseling Reader)*. Beijing.

<sup>5</sup> While there is no official definition for local government financing vehicles, they are often referred to as autonomous investment corporations, construction investment corporations, or utility investment corporations set up by local governments to finance investment in infrastructure and social services.

<sup>6</sup> For instance, in the budget speech of the Minister of Finance at the March 2017 National People's Congress.

the tax out across the service sector; introducing an effective property tax system; the pricing and taxation of fossil fuels and other environmental taxes, including emission taxes; and refining consumption taxes, also with the objective to reduce environmental damage, maximizing the effectiveness of tax administration, and reforming direct taxes.<sup>7</sup>

During 1996–2014, growth of tax revenues exceeded that of nominal gross domestic product (GDP), and the tax-to-GDP ratio rose from 9.6% to 18.6%. However, as the PRC's economic and social development has entered a “new normal” since 2014 and progress is being made regarding supply-side structural reforms, this trend was reversed and the tax-to-GDP ratio fell to 17.5% in 2016, significantly below the Organisation for Economic Co-operation and Development (OECD) average (25.1% of GDP). Meanwhile, with fiscal expenditure needs continuing to rise, fiscal surpluses have turned into growing deficits, raising concerns about fiscal sustainability.

One of the most important reasons for the deceleration of fiscal revenues is that the PRC's current tax system still relies heavily on indirect taxes on goods and services,<sup>8</sup> whose year-over-year growth rate declined from 10.3% in 2012 to only 1.0% in 2016, while insufficient use is being made of direct taxes on income. International experience suggests that with increasing income levels, countries tend to move away from indirect taxes (on the production of goods and services) toward direct taxation of income and property, while simultaneously increasing social security contributions to fund better social protection. Although the share of indirect taxes in the PRC's total fiscal revenues has declined slightly in recent years, it still amounted to 53.7% of all tax revenues in 2015. On the other hand, direct taxes such as personal income tax, corporate income tax, and social security contributions account for a relatively small percentage of tax revenues (9.5% in 2014), much lower than the OECD average (20.3% in 2014).<sup>9</sup> There is thus considerable potential to maintain fiscal sustainability in the PRC by increasing the share of direct taxes in total tax revenues.

Another issue is that the redistributive effect of taxes and transfers is still relatively limited in the PRC. Income inequality, as measured by the Gini coefficient prepared by the National Bureau of Statistics, was low in

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<sup>7</sup> Asian Development Bank. 2014. *Money Matters – Local Government Finances in the People's Republic of China*. Manila: Asian Development Bank.

<sup>8</sup> Taxes on goods and services in the PRC are defined as the sum of value added tax, other consumption taxes, business taxes, tariffs, and taxes related to imported products minus refunded taxes for exports.

<sup>9</sup> Organisation for Economic Co-operation and Development. 2016. *Revenue Statistics*. Paris: OECD.



the mid-1980s at below 0.30, but rose to 0.49 in 2008, and has remained about 0.46 over recent years. Fiscal policy appears to contribute relatively little to reduce inequality, as reflected in the difference between Gini coefficients before and after taxes and transfers.

The reforms launched in 2013–2014 relate to a broad range of taxes, including VAT, consumption tax, resource tax, property tax, environmental taxes, and also personal income tax. The achievements so far include replacing business taxes through VAT in all service sectors, which helped to harmonize the tax treatment of services with that of industry (where VAT already prevails), but also led to a reduction in overall tax revenues; increasing taxes on polluting businesses and luxury goods; levying resource taxes on mineral products while transforming them from unit to ad valorem taxes; and piloting a water resource tax. A law on environmental taxes was passed in December 2016 and became effective in January 2018. However, little progress has been made regarding property and personal income tax reforms. Both taxes would potentially substantially increase tax revenues and thus help the government address rising social and infrastructure spending needs without additional borrowing and help reduce income inequality. But both taxes are unpopular, and technically and institutionally demanding.

The PRC already has a range of property taxes, but most are one-off taxes on transactions rather than recurrent taxes. Property taxation was introduced in the PRC in 1951 through the Provisional Regulations on Urban Real Estate Tax. After 1985, more regulations were introduced resulting in five taxes: real estate tax, urban land use tax, land value added tax, cultivated land occupation tax, and deed tax. However, these taxes generate only modest revenue for the government. All five types of property taxes combined accounted for only 24.7% of total local tax revenue in 2016, compared with 73% in the US, and almost 100% in Australia, Ireland, and the UK. As a result, local governments in the PRC rely on other sources of income, such as land leasing fees or borrowing. One of the most important reasons for the low yield of property taxes in the PRC is that the current tax structure focuses on taxing transactions rather than possession of property. So, introducing a recurrent tax on residential property—preferably following a broad-based and low-rate approach—has been a hotly debated topic for years. A recurrent tax on residential property would also facilitate a move toward the densification of cities and away from extensive urban development, which allows cities to sell more and more land, but also requires more infrastructure spending. It would also reduce speculative housing investment, which becomes less profitable if a regular tax on real estate is levied.<sup>10</sup>

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<sup>10</sup> To support property tax reform, ADB provided TA 8728-PRC: Improving Efficiency in Public Service Procurement, Delivery, and Financing in 2014.

To test the possibility of levying a recurrent tax on residential property, the PRC has been undertaking pilot projects in Chongqing and Shanghai since 2011, targeting the introduction of taxation of residential properties nationwide. However, the impact of such pilots is limited so far as both cities opted for low rates with high exemptions, focusing on luxury units in Chongqing and new purchases in Shanghai. For instance, the recurrent property tax in Chongqing was levied on approximately 8,800 housing units in 2011 and 11,000 units in 2012. Despite this slight increase, property taxes continued to yield less than 1.0% of local government revenues, given that the tax was levied on less than 1.0% of all properties. The results are similar in Shanghai, where property tax revenues, albeit larger at CNY9.3 billion, amounted to less than 1.0% of local government revenues in 2012, and with a similarly low coverage ratio. Given these outcomes, the pilots have not yet been rolled out more broadly in the PRC.

There are other constraints that have so far prevented the introduction of a recurrent tax on residential property, including (i) inadequate property and land registration data, (ii) separate land and building registration authorities; (iii) difficulty assessing the market value of land, rural housing, and subsidized housing of government and state-owned enterprises' employees; (iv) lack of independence of property appraisal firms, which remain dominated by subsidiary companies of local governments; and perhaps also (v) vested interest resistance to adopt residential property taxation. The current focus of the central government is to build a nationwide property registration system to ensure accurate assessment and collection of property taxes when they are eventually implemented across the country. Although a new registration system was introduced for real estate transactions in 2015, it is expected to take at least 3 years before information on the existing stock of properties is added.

As for personal income tax, a key issue is that the base for collecting it in the PRC is very narrow. The tax schedule for personal incomes is broadly progressive and comparable to those of OECD economies. However, several factors reduce this progressivity in practice. First, the highest marginal tax rate for personal income (45%) only starts at the very top of the income distribution (about 35 times the national average wage) and consequently applies to few income earners. In contrast, the top marginal tax rates in OECD countries are imposed at around four times the national average wage. Second, the current provisions allow for the deduction of a relatively high basic deduction (CNY42,000 or twice the average national wage). In comparison, the average basic personal allowance in OECD countries is about one-fourth of the average national wage. As a result, less than 20% of workers are liable to pay personal income tax and the share of personal income tax payers in the PRC is only 3% of the total population in 2016. Third, personal

income is not taxed on a consolidated basis, but rather it is based on a multi-category (or scheduler) system where each source of income is taxed according to a different category, each of which follows a schedule that determines the tax rate of the specific category.

The 19th Party Congress in October 2017 reconfirmed that a comprehensive reform of personal income and property taxes is needed, with legislative reforms and the improvement of information systems being the next steps. More specifically, the Congress called for the personal income tax system to become more comprehensive, the tax structure to be optimized, tax deductions to be improved, the tax base to be improved and standardized, and tax collection and administration to be strengthened. Regarding property taxes, the Congress urged the government to proceed in line with the principle “legislation first, full authority, step by step.” Real estate tax will be levied on commercial real estate and personal housing based on the assessed value.

Looking ahead, priorities for the reform of personal income taxation include adjustments to the basic personal allowance, for example, by replacing it with a well-calibrated tax credit. This could significantly broaden the tax base and improve the tax code’s progressivity. Simplifying the income tax rate structure so that the higher rates capture more upper-middle income would have the same impact as would targeted reforms of the schedular system. Regarding recurrent taxes on residential property, along with revenue generation, its redistribution aspects should be considered. A phased approach is therefore recommended with a review at each stage, starting at high-end properties, where the ability to pay should be strong, and gradually moving down to lower income levels. In light of urban–rural income disparities, property tax reform should focus on cities first. Good starting points would be levying property taxes on new units, second units, and in the longer term, all units should be included in the tax base. While exemptions should be minimized, taxation should take into account equity considerations. Therefore, low-income owner-occupiers might have to be exempted at the first stages of reform. Local governments need to have clear authority to collect and enforce property tax payments and should be granted autonomy to set the tax rate. The prerequisites for implementing the property tax is the creation of a methodological valuation system, and training of appraisers to prepare and maintain the property valuation database. In both areas, reforms are already underway.

## **6.4 Intergovernmental Fiscal Reform**

As far as reforms of central–local government fiscal relations are concerned, measures taken since 2014 to put subnational (or local) government finances on a sounder footing were piecemeal initially, but

could become a part of a more comprehensive solution over time. The measures taken so far include: (i) broadening the existing provincial government bond market pilot in May 2014 to help finance budget deficits within issuance quotas controlled by the central government (i.e., discretionary and not rule-based); (ii) amending the budget law effective January 2015 to allow on-budget and disallow off-budget borrowing and spending; (iii) the creation of financing and debt management units in local finance departments; (iv) taking stock of local government on- and off-budget liabilities, which was completed by mid-2015; (v) announcing additional quotas to issue provincial government bonds in 2015, 2016, and 2017 to refinance liabilities of those local government financing vehicles that were acknowledged to perform fiscal functions, and also lengthen the maturity and reduce debt service costs; (vi) establishing an early warning system for local government debt; (vii) outlining a resolution mechanism for local governments in distress; and (viii) increasing revenues from VAT allocated to local governments (as compensation for lower revenues from business tax). The central government also increased general purpose transfers to boost local government finances and decreased conditional transfers, which require matching funds that not all local government can afford. However, overall transfers increased only marginally.<sup>11</sup> Therefore, off-budget borrowing through state-owned enterprises or financing vehicles remain the responsibility of local governments, and revenue allocations remain grossly misaligned. Debt ratios in some provinces have reached over 100% of annual fiscal revenues and over 60% of provincial GDP. A substantial reduction in off-budget borrowing by local governments would impose a degree of fiscal contraction that looks undesirable even from the perspective of the central government, particularly as far as provinces with weak economies are concerned.<sup>12</sup>

In August 2016, the State Council outlined reforms of central-local government fiscal relations over 2016–2020.<sup>13</sup> In all likelihood, this marked the beginning of more comprehensive reforms that focus on reassigning expenditure categories. The State Council

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<sup>11</sup> Fiscal transfers are essential to address financing gaps of local governments. On average, transfers account for 40% of total subnational revenue since 1995 in OECD countries. However, variations range from about 11% of local revenues in Iceland and Switzerland to 70% in the Netherlands and the UK. Fiscal transfers play a critical equalizing role as revenue decentralization can exacerbate regional inequality.

<sup>12</sup> ADB's TA 7763-PRC: Strengthening Fiscal Policy and Public Finance Reform Over the Medium-Term provided several recommendations on rebalancing the fiscal relationship between the central and local governments.

<sup>13</sup> State Council of the People's Republic of China. 2016. *Guidelines on Promoting the Reform of Dividing Financial Powers and Expenditure Responsibilities between Central and Local Governments*. Beijing.

guidelines provided few details on the redistribution of revenues and accompanying reforms of the 36 provincial and 3,000 prefectural and county governments. This created the impression that no aggregate redistribution of revenues from the center to local governments was envisaged at that stage. However, the 19th Party Congress reconfirmed that the objective remains to comprehensively reform the allocation of expenditure responsibilities and revenue assignments across different levels of government, and that central government transfers will be further increased so that access to basic public services across the country can be improved; for this, basic standards have yet to be defined, which could be adjusted over time.<sup>14</sup> The Congress also stressed that the coordination role played by provincial governments should be strengthened, local government initiative should be encouraged, and local tax revenue sources as well as local tax autonomy need to be strengthened.

As reforms progress, unified standards of public service delivery need to be developed before the assignment of expenditure responsibilities at all levels of government. This seems to be an area the government is currently focusing on. Expenditure responsibilities should then be balanced according to economies of scale, possibilities of internalizing costs, and available administrative capacity. Afterward, revenue assignments can be matched with expenditure responsibilities, although adjustments will have to be made over time. A comprehensive reform of expenditure and revenue assignments will take time in any case. Meanwhile, partial reforms might be considered to mitigate existing problems. One example is the recentralization of the delivery and financing of social security services such as pensions, and disability, survivor, and unemployment benefits, either at the provincial or central government levels. Recent policy measures, which assign more responsibility for social security to the central level, are steps in the right direction.<sup>15</sup>

With regard to revenue assignments, international experience suggests that a degree of local government autonomy is vital for the effective functioning of a decentralized fiscal system. The property tax has clear advantages as a local own-resource tax, including the relative ease in determining its origin. Setting this tax aside as an own-resource tax for local governments is in line with the central government's decision to expand the property tax. While the design of the tax

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<sup>14</sup> 人民出版社 (People's Publishing House). 2017. *党的十九大报告辅导读本* (Nineteenth Congress Report Counseling Reader). Beijing.

<sup>15</sup> Asian Development Bank. 2014. *Money Matters – Local Government Finances in the People's Republic of China*. Manila: Asian Development Bank.

code can be decided at the central level, which can also determine maximum and minimum rates, the applicable tax rates should then be set by local governments. Local government revenue autonomy can also be strengthened by allowing the joint use of some major taxes, for instance through piggybacked taxation. A key benefit is simplified tax administration and minimized compliance cost. Here again, local governments could be given autonomy in setting their own rates for the designated taxes, which could be direct or indirect, within ranges set by the central government. This would allow tax competition between local governments in a transparent manner while avoiding a “race to the bottom” through minimum rates. Piggybacked taxes might be most suitable for the provincial level of government and larger cities. Even after increasing tax revenues of local government fiscal resources will continue to vary greatly across a country as diverse as the PRC. The means that central government transfers will still be needed to ensure the delivery of a unified minimum level of public services across the country. For this purpose, the design and size of central–provincial transfers both need to be improved, and fiscal practices at the provincial level require reforms to ensure that the provinces pursue effective equalization policies.

# 7

## Taxation of Small and Medium-sized Enterprises: The Indonesian Perspective

*Wawan Juswanto and Milson Febriyadi*

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### 7.1 Introduction

Small and medium-sized enterprises (SMEs) play a significant role in Indonesia's economic development and labor force creation. From 2012 to 2013, labor force absorption of SMEs grew about 6.03% and the related gross domestic product (GDP) grew 5.8%. SME business growth in Indonesia is relatively high, especially because of information technology use and promotion of creative industries that adopt local characteristics. Thus, SMEs in several business sectors such as fashion, food, advertising, interior design, as well as software and application development, have grown significantly. This is also due to high demand from middle-class society.

### 7.2 National Tax Revenue

With respect to state finances, national income tax receipts reached more than 30% of total tax revenue in the last 5 years. 25% of income tax revenues were obtained from business sectors, while individual taxes contributed 17% of the total. These findings indicate that there is a high dependence on tax revenues from business sectors. In fact, the global trend indicates a composition change of income tax that is currently dominated by personal income tax (Table 7.1). The composition change is partly encouraged by the desire of these countries in supporting investment levels of the private sector amid the global economic downturn seen in 2008–2009.

SME business development brings challenges for Indonesia's tax authorities to explore potential tax revenues. It requires a special approach since SMEs offer potential development prospects for

**Table 7.1 Tax Revenue Structure (Selected Countries)**

	1990	2000	2007	2011	2014
<b>A. Tax on Corporate Income (% total)</b>					
Australia	14.1	20.2	22.9	19.7	16.8
Chile	12.4	11.2	29.4	23.4	21.3
New Zealand	6.5	12.4	14.2	12.9	13.2
Mexico	..	..	14.5	14.9	16.9
United States	7.5	7.9	10.0	7.4	8.4
<b>B. Tax on Personal Income (% total)</b>					
Australia	43.0	37.8	36.6	39.3	41.0
Chile	5.6	7.6	4.8	6.6	7.3
New Zealand	24.7	15.1	18.7	20.8	18.7
Mexico	..	..	15.9	17.3	19.7
United States	37.7	42.2	38.3	38.8	39.3

Source: Authors' calculations using OECD data. <http://www.oecd.org/tax/tax-policy/revenue-statistics-tax-structures.htm>

Indonesia's economy, and this sector also faces structural challenges that can obstruct their transformation into a large-scale formal business sector. The Asian Association of Management Organizations<sup>1</sup> identifies some problems that are often encountered in SME arrangements:

- (1) Poor business environment (e.g., bureaucracy, taxation, and unfavorable property rights enforcement);
- (2) Poor infrastructure (e.g., power plants, industrial estates, and telecommunication);
- (3) Inadequate access to finance (e.g., obtaining loans, securing collateral and third-party guarantees, and lack of alternative sources);
- (4) Low technological capacity (e.g., rapid technological advancement in markets, locating sources of appropriate technology, and acquiring technology to develop attractive products);
- (5) Limited application of information and communication technology for example, business communications, marketing intelligence, and customer development;

<sup>1</sup> Cited in Abe, M., M. Troilo, J. Juneja, and S. Narain. 2012. *Policy Guidebook for SME Development in Asia and the Pacific*. Bangkok: United Nations Economic and Social Commission for Asia and the Pacific, p. 6.



- (6) Intense competition in domestic, regional, and global markets (e.g., trade and investment liberalization, less protectionism, freer movement of goods and capital, lower import duties, cuts in subsidies, and cost pressures).

A study done by the United States Small Business Administration also notes that one of the main challenges faced by the government regarding SME arrangements is regulating taxes.<sup>2</sup> The principle of this policy is oriented toward creating a conducive business environment for early-stage SMEs in a large-scale business sector. However, taxation regulation cannot be partially enforced, putting aside other issues faced by SMEs. In supporting policy transformation of SMEs, a comprehensive policy to address various interrelated issues, not limited to taxation, is required.

Since 2013, Indonesia has implemented a special income tax treatment for the business sector of SMEs. Previously, the micro enterprises sector could choose its obligation of tax calculation based on deemed net profit and annual gross turnover, adjusted to business activities in a particular region. The new provision imposes a 1% tariff of gross turnover for certain SMEs with gross turnover up to IDR4.8 billion during the year.

This chapter has three interrelated objectives. First, it defines SMEs by combining definitions based on a global perspective and alternative approaches used in Indonesia. The highlight of this objective is enhancement of the tax base by incorporating such businesses into the national taxation system. Second, the chapter explores the main parts of Indonesia's SME tax policy. Finally, we gauge the effectiveness of the current SME tax policy and some of the critical challenges encountered during policy implementation. We provide a methodology for verifying the effectiveness of these policies based on potential SME tax revenue and the tax coverage ratio, which can be used as a platform for initiating discussions on SME taxation in Indonesia.

## 7.3 Discussion

There is no standard SME definition used either across countries or between industries within a country. Almost all countries categorize SMEs based on the number of workers,<sup>3</sup> but many use financial indicators

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<sup>2</sup> United States Small Business Administration. 2009. *ABC's of Borrowing Money*. Washington, DC: United States Small Business Administration.

<sup>3</sup> Ayyagari, M., T. Beck, and A. Demircuc-Kunt. 2003. *Small and Medium Enterprises Across The Globe: A New Database*. World Bank Policy Research Working Paper No. 3127. Washington, DC: World Bank.

such as total assets, business turnover, level of investment, as well as levels of sales.<sup>4</sup> Besides the quantitative indicators mentioned above, SMEs can also be categorized by various indicator typologies such as whether or not they are listed, their stage of economic development or innovation, market orientation, use of technology, and corporate life cycle. Indonesia uses annual sales and net assets to classify SMEs into three groups: micro, small, and medium-sized enterprises as follows:

**Table 7.2 Small and Medium-Sized Enterprise Categorization**

Categories	Net Asset	Annual Sales
Micro Enterprise	IDR0–IDR50 million	IDR0–IDR300 million
Small Enterprise	IDR50 million–IDR500 million	> IDR300 million–IDR2.5 billion
Medium-Sized Enterprise	> IDR500 million–IDR10 billion	> IDR2.5 billion–IDR50 billion

IDR = rupiah.

Source: Ministry of Cooperation & Micro, Small, & Medium Enterprise (2012). <http://www.depkop.go.id/berita-informasi/data-informasi/statistik-ukm/> (In Bahasa Indonesia).

Since the promotion of scale-based enterprises is commonly driven by social and political considerations,<sup>5</sup> many policymakers and development practitioners are promoting SMEs as a step toward creating an innovation culture that drives the economy, improves income inequality, and lowers the level of unemployment and poverty for emerging markets. Based on SMEs' contribution of 59.1% to nominal GDP in 2012,<sup>6</sup> SME promotion also aims to incorporate the sector into the national taxation system.

However, one of the problems faced by Indonesia as a developing country is the number of “hard to tax” entities. In 2012, only 9.4 million out of the 17.6 million registered taxpayers filed their income tax returns. The lack of administrative and compliance discipline results in the low rate of tax collection and also the large informal sector in the economy. Hence, there is a vital need to strengthen administrative and compliance discipline to improve tax compliance.

<sup>4</sup> Abe, M., M. Troilo, J. Juneja, and S. Narain. 2012. *Policy Guidebook for SME Development in Asia and the Pacific*. Bangkok: United Nations Publication.

<sup>5</sup> Hallberg, K. 2001. *A Market-Oriented Strategy For Small and Medium-Scale*. International Finance Corporation Discussion Paper No. 48. Washington, DC: International Finance Corporation.

<sup>6</sup> Asian Development Bank. 2013. *Asia SME Finance Monitor 2013*. Manila: Asian Development Bank.

The high administration and compliance costs faced by SMEs support the need for the simplification of tax policy. Both the costs are concentrated in the registration, preparation, completion, and submission of returns; objections and alternative dispute resolution; and audits, inspection, and written queries from the tax authority. For that reason, Indonesia adopted presumptive tax systems that provide special flexibility tariffs for SME businesses. Although this special treatment is beneficial for increasing the tax base, the simplification of tax collection also benefits SMEs, for example, by removing constraints to financial access.

For the sake of efficiency, there is an option to exclude SMEs from the taxation system if the tax contribution of an SME is considered low, while compliance costs borne by the SME are high. However, SME involvement is necessary for national growth and development goals regarding participation in the tax system. Therefore, the issue of SMEs is not only of potential revenue, but also of including micro-enterprises in the taxation system and preventing abuse.

## 7.4 Key Features of SME Taxation

According to the 2008 income tax law, the consideration in giving the final tax treatment is intended to encourage the development of investment, simplify tax collection, reduce the administrative burden for both tax payer and the tax collection office, and also encourage the development of the economy.

Regarding SMEs, Indonesia follows the principle of presumptive tax systems. It provides a special rate of 1.0% final income tax on business income in one year. Although the highest annual sales outcome for SMEs is IDR50 billion (Table 7.2), SMEs eligible for individual treatment are those whose highest annual operating income is IDR4.8 billion. Businesses with income between IDR4.8 billion–IDR50 billion per year, are subject to the general tax regime, and can obtain a 50% tax rate discount from 25% income tax. As shown in Table 7.3, if the entity's income is above IDR50 billion, it is subject to the general tax regime.

The new taxation regime of SMEs started on 1 July 2013. Previously, SMEs were allowed to calculate their tax obligation based on deemed net profit as stipulated in the Director General of Taxes Decree No. 536/2000. The calculation norm is determined from a percentage of gross turnover based on business activity in a certain region, i.e., rural, urban, or provincial. With the presumptive tax regime, eligible taxpayers are taxed at 1.0% of gross turnover rather than on the taxable profits as mandated by the regular regime.

However, the presumptive tax regime for SMEs does not apply to corporate taxpayers that have a permanent establishment, street

**Table 7.3 Example of Calculation of Income Tax for Medium-Sized Enterprises** (in rupiah)

**A. Annual Turnover up to IDR4.8 Billion**

Indicators	Amount	Tax Payable
Annual Turnover	3,000,000,000	
Total Income Tax Payable		30,000,000

**B. Annual Turnover > IDR4.8 Billion < IDR50 Billion**

Indicators	Amount	Tax Payable
Annual Turnover	30,000,000,000	
Taxable Income (Assume 10% Profit Margin)	3,000,000,000	
Amount of Taxable Income with Preferential Tax Rate:	480,000,000	60,000,000
$(4,800,000,000/30,000,000,000)$ $\times 3,000,000,000$		
Amount of Taxable Income with Regular Tax Rate:	2,520,000,000	630,000,000
$(3,000,000,000 - 480,000,000)$		
Total Income Tax Payable		690,000,000

**C. Annual Turnover > IDR50 Billion**

Indicators	Amount	Tax Payable
Annual Turnover	85,000,000,000	
Taxable Income (Assume 10% Profit Margin)	8,500,000,000	2,125,000,000

Source: Authors' calculations.

vendors, or those that operate non-commercially and with income greater than IDR4.8 million after one year of commercial operation. In addition, self-employed professionals such as doctors, lawyers, artists, etc., are also exempt from this provision. Income derived from activities that are subject to non-deductible income are also exempt from this provision.

## 7.5 Policy Evaluation

### 7.5.1 SME Composition

The composition of SMEs in Indonesia is still dominated by micro-enterprise groups. In 2012, more than a half of the output, labor, and SME business units were in the micro-enterprises category (Table 7.4).

**Table 7.4 SME Selected Economic Indicators, 2012** (in %)

Selected Indicators	Micro Ent.	Small Ent.	Medium Ent.
Business Units	98.8	1.1	0.1
Labor	92.8	4.2	3.0
Output	60.6	16.4	23.0
Export (Non-oil & Gas)	9.1	19.5	71.3
Investment	14.0	36.2	49.8

SME = small and medium-sized enterprise.

Source: Ministry of Cooperation & Micro, Small, & Medium Enterprise.

These micro-enterprise groups still face structural challenges regarding global market access. Table 7.4 shows that the proportion of the exports of micro-enterprises is still below 10%. In addition, low levels of investment in micro-enterprises indicate limited access to financing from third parties.

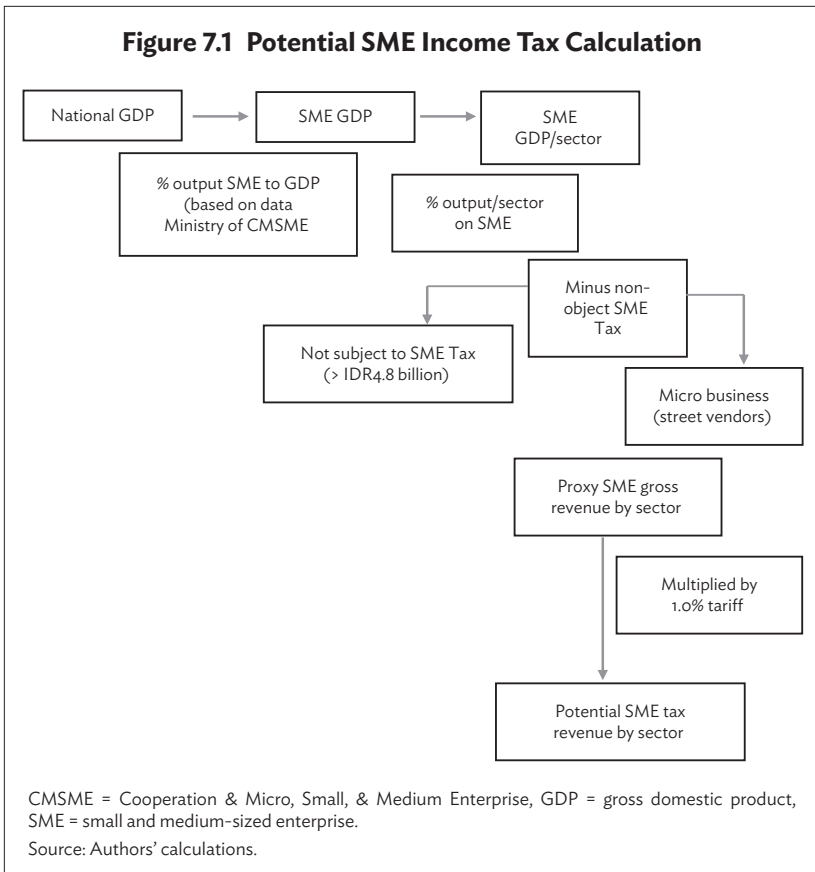
In 2015, SME output accounted for 60% of GDP with a fairly stable business unit growth of 2% per year. In other statistical indicators based on a labor approach, it appears that production of micro and small industry outputs grew steadily over the 2012–2016 period by 5.5% on average.

## 7.5.2 Compliance Rate and SME Taxpayers' Contribution

The evaluation of SME tax policy calls for a measurement of SMEs' tax compliance and participation level in the national tax revenue system (Figure 7.1). First, we calculate the GDP of SMEs by using the estimated proportion of SME output in the national GDP based on the SME output data. Then, by obtaining a proxy income of SMEs by sector, SME GDP data can be duly proportioned per sector and reduced by the business group portion and the income excluded in SME taxation. Finally, by multiplying the proxy income of SME per sector with the 1.0% final SME income tax rate, we can estimate the SME tax potential per sector.

After obtaining potential SME tax revenue by sector, we can calculate the tax coverage ratio by dividing realized tax revenue with potential SME tax revenue. The results reveal the performance of SME tax policy implementation. This mechanism can be used to gauge whether the policy has increased tax compliance from SME groups due to a reduction in compliance and administrative costs.

Furthermore, the evaluation can also assess the level of taxpayer participation and behavior for each year. This study proposes a



mechanism of classifying SME taxpayers into four categories: (a) new taxpayers (TP); (b) previous taxpayers who do not pay tax (NTPt-1); (c) previous taxpayers who pay normal tax (TPNt-1); and (d) SME taxpayers who consistently pay SME tax (SMETP). The taxpayer categories (a) and (b) will show the new tax base; category (c) will indicate the payer regime change from normal tax (t-1) to SME tax (t); and category (d) will show the consistency of SME payers tax per year.

We show changes in economic conditions in the form of lower gross revenues (reflected in adverse changes in category (c) in t periods relative to t-1 period). However, we note that the change could mean there is underreporting/tax avoidance. If the total number of entities in category (d) in year t is lower than the number in categories (a), (b), and (c) categorized in year t-1, it indicates an increase in gross revenue

so that taxpayers in category (d) move to the general regime in year  $t$ . Nevertheless, the change can also mean taxpayers in category (d) have no income in year  $t$ , so they do not pay taxes or are out of the system.

### **7.5.3 Tax Burden and Taxpayers' Eligibility**

Considering that the Indonesian income tax system uses the deemed net profit approach to calculate the taxable income for businesses in certain locations, we should compare the effective tax burden between the normal and presumptive regimes to determine whether the presumptive tax regime is appropriate for all SME categories.

In addition to personal taxpayers, the 1.0% tariff for personal taxpayers with a certain level of gross revenue would pay higher income tax relative to the normal regime since taxable income under the normal regime considers personal tax relief as a deduction. Therefore, policy makers should consider a possible adverse effect such as under-reporting activities, in order to employ a presumptive tax regime rather a normal one.

## **7.6 Conclusion**

Our study has three objectives. First, it defines SMEs by combining definitions based on a global perspective and alternative approaches used in Indonesia. It then explores many key aspects of SME taxation policy in Indonesia. Finally, it examines current SME taxation policy effectiveness and highlights some of the critical challenges faced.

This study also provides an analytical method to examine the effectiveness of SME taxation based on potential SME tax and calculation of the tax coverage ratio. In addition, some tax avoidance schemes used by taxpayers to avoid the normal tax regime should be taken into account by the tax administrator. The current special taxation treatment for SMEs (which may result in tax savings or other monetary benefits) may discourage taxpayers to engage in activities that would bring them under the normal tax regime. In contrast, it may also discourage taxpayers to participate in the presumptive tax regime since it could generate monetary losses for certain profit margin levels.

## **7.7 Policy Recommendation**

An SME tax regime can benefit taxpayers and the tax collection office. It can bring more business entities into the national taxation system and offer strong incentives to calculate potential revenue and to examine

the tax base. From a business-owner's perspective, it can be viewed as preparation to follow the standard income tax regime. However, the SME tax regime is not sufficient to promote SMEs in the economy. Other supportive programs should be added to fulfill the development agenda for SMEs. For instance, the extension of the SME tax regime can be combined with another program such as a microfinance facility. To apply for such a facility, for example, SMEs should be required to show their tax registration form.

To conclude, strong performance of SMEs in recent years is a good reason to promote SME taxation with extensive education as a part of the SME development agenda. The SME tax system should provide a simplified way for calculating, paying, and reporting activities. This can be achieved by strengthening regulations to reward taxpayers who consistently maintain their bookkeeping practice. In contrast, taxpayers suspected of tax evasion activities should be punished.





PART III

# Sharing Practical Experiences

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# 8

## Improving the Training Function in the Tax Authority of the Philippines

*David Tansey*

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### 8.1 Introduction

Many technical assistance projects for tax authorities take the form of reviewing business processes, implementing new information and communication technology (ICT) systems, and providing specialist advisers for complex compliance areas such as the taxation of international transactions.

The Asian Development Bank's (ADB) technical assistance project TA-8354, titled Supporting Capacity Development for the Bureau of Internal Revenue, conducted activities in 2014–2015 to build capacity in the training divisions of the Philippines Bureau of Internal Revenue (BIR) and to deliver new training courses.

This chapter will discuss how improvements to a training function in a developing country's tax administration can be carried out, using the successes and failures of the BIR project as examples where appropriate.

### 8.2 Overview of the Technical Assistance

The assistance focused on rebooting training courses for new recruits, such as the existing 5-day induction course, called the Personnel Orientation Course (POC); and the introductory technical course, called the General Course for Revenue Officers (GCRO), which required half-day attendance over 44 days (Figure 8.1). During the inception mission, the consultants found that only 10% of BIR staff had ever attended either the POC or GCRO.

During the main course of the assistance, the consultants conducted workshops to upgrade the skills of training staff. The topics covered

how to conduct a training needs analysis, how to evaluate the design of a training course, how to develop a competency framework, and how to evaluate application of learning in the workplace. The theory taught in the workshops was applied to real-life work situations; for example, staff were asked to evaluate the design of actual new courses developed for recruits.

Another series of workshops allowed the consultants and BIR staff to collaboratively write a manual, titled the *Learning Management System Toolkit*, which will act as an ongoing resource for existing and future staff training, and draws on best practices in managing the training function.

The BIR was also assisted on the move toward a competency-based human resource system. This involved workshops to identify the major roles in the BIR and the competencies required for each role. A Competency Dictionary identifying and defining all job-related competencies was prepared and was institutionalized by the then BIR commissioner. The process of redesigning job descriptions to incorporate competencies was also started.

The TA project assisted BIR to redevelop the GCRO into a crash course called the Basic Tax Administration Course (BTAC); and update the POC, which covers conditions of employment for BIR staff, performance evaluation, the Code of Conduct, drug-free workplace, etc. The consultants also developed the “Working with Projects” course, on how to effectively operate as a member of a project team. Under the new training strategy developed, these basic courses will be supplemented by specialized courses relevant to the role that the person will carry out, instead of generic courses as was previously done.

The TA project also involved study tours of the Japanese and Malaysian tax academies. The eventual outcome of the above-mentioned activities is a more highly skilled BIR staff in the training function, which can deliver more effective courses in the areas where staff need to excel in their particular roles. The feasibility of e-learning was also investigated.

The TA project produced a training strategy that can produce a more knowledgeable, professional and skilled workforce, which will, over time, be better placed to raise tax revenues for the government.

### **8.3 Improving Technical Skills**

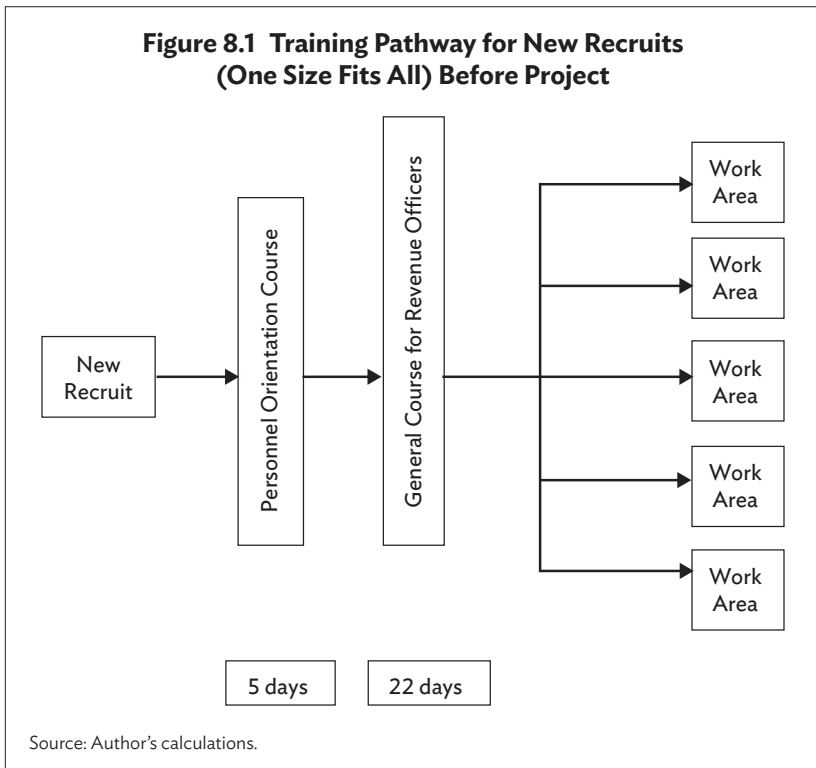
Improvement of technical skills best provides a tangible return on investment in the audit and debt collection areas, where the dollar value per case and per officer can easily be computed, before and after training, in the short and long term.

However, the link between increased technical knowledge and higher revenue levels is hard to measure, because so many other things are changing within the organization and in its external environment.

The economy fluctuates, affecting revenue levels; new and amended laws are made by politicians; and new technologies and systems are developed. Inside the organization, staffing and productivity levels can change; management develops new strategies; and taxpayers demand new service levels. In situations where corrupt staff are eroding the tax base, no amount of increased knowledge will reverse this to increase overall revenue.

Despite these challenges, improvement to overall staff skilling does lead to better-skilled staff, who in the long term can more effectively apply the tax laws, and so maximize the revenue requirements as mandated by the tax laws, all other things being equal.

Under the project, the consultants and BIR training management analyzed the existing pathway provided for training new recruits. In

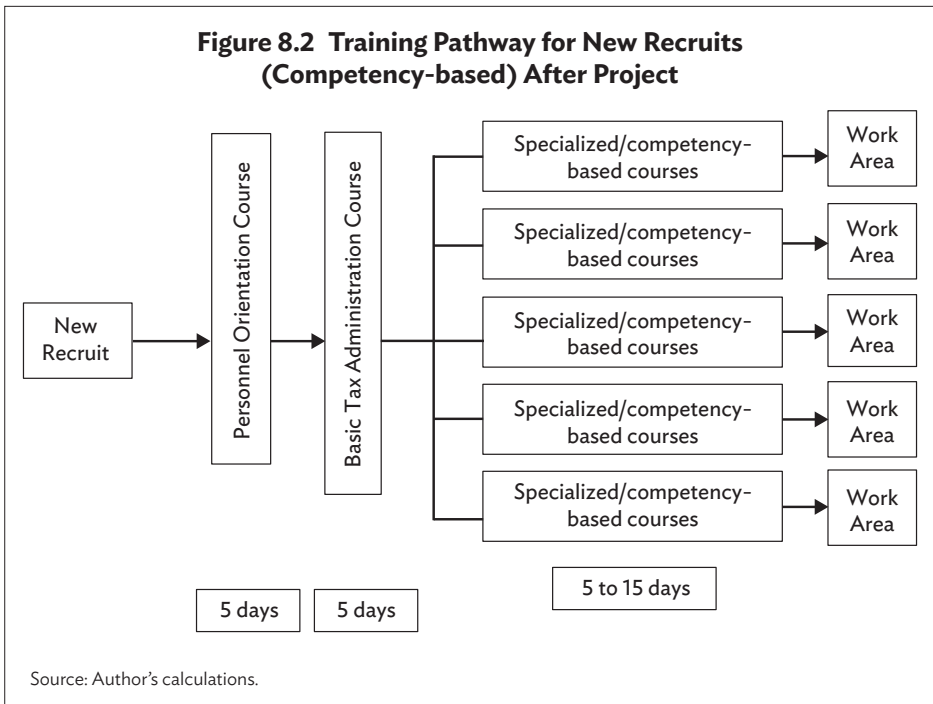


theory, new recruits would go through the POC and GCRO (although, as mentioned, only 10% ever did at any time in their career) and then be placed in a work area where there was a vacancy. They would then undertake any specialized training, if available, relating to their function.

The BTAC takes 5 full days, and is supported by a 600-page textbook, which the participants take away as a resource. The course covers basic technical tax topics, how the BIR manages tax administration, and the “Register-File-Pay” process. The BTAC textbook was based on a narrative conversion of the slides for the GCRO and was developed by training department staff and subject matter experts.

The new training pathway envisages a similar length of time as that which was previously given, but with a more specialized training related to the functions and competencies based on a person’s job description (Figure 8.2).

The concept behind the new curriculum is that each technical officer does not need to study each area of the tax law in detail. They only need to know the basics (and use the text book as a resource if they later need more information in a specific area). They only need to know in detail



those technical areas which they apply in their everyday work. This principle makes the best use of scarce training resources and optimizes the operational officers' time away from the workplace to attend training.

In the BIR, the organization as a whole is assigned an annual revenue target by the Department of Finance. The BIR then breaks this target down by region, office, department, and individual officer. Failure to reach a revenue target by 7.5% on the part of an individual can lead to termination. Meeting the total target can lead to significant bonuses for all staff members. In this environment, the pressure to meet targets means that any time away from the workplace, such as at training courses, is not attractive.

As the project focused on training new recruits, the problem that now faces BIR is that there are many specialized work functions for which there is no training course available. The GCRO could be utilized to provide some detailed training material for some areas, but there are still many gaps.

Each year, an agency should prepare its training plan for the following year, comprising those courses that are demanded by the staff of various departments. Ideally, each staff member should have a Personal Development Plan, listing courses they intend to take in the short and long term. Their plans should tie in with the competencies required as stated on the person's job description.

Agencies should develop Competency Dictionaries, which list and define all types of competencies, technical and non-technical, required for all staff to efficiently carry out their jobs. The development of the Dictionary needs to be done as a precursor to development of the training needs analysis, and then of training plans and courses.

## **8.4 E-learning**

The project also investigated the feasibility of implementing e-learning in BIR. A study found that e-learning would facilitate the delivery of training, especially in remote areas, but would require graduated implementation due to ICT constraints. Attempts to make progress on this front were unsuccessful as the project design called for a national e-learning consultant to assist in this aspect. Several (unsuccessful) attempts to recruit such a person were made.

Future projects of this nature should consider provision of an international e-learning consultant. Developing countries may not have a sufficient pool of such expertise, and those few experts may be fully utilized elsewhere. To the credit of BIR, they paid for private sector e-learning training of some staff and produced a workable e-learning pilot module on their own.



## 8.5 Tax Academy

The BIR had training centers, including computer labs, in Manila, Davao, and Cebu. However, there were no dedicated trainers, and these had to be borrowed from the technical areas where individual revenue targets applied. Ideally, the training function should have a team of dedicated full-time trainers.

The Philippines enacted a law for establishing a tax academy some years ago, covering the BIR, the customs agency, and the agency covering local government finances.<sup>1</sup> In early 2018, the Department of Finance announced that the establishment of the tax academy would proceed, and would be operational in that year.

The study tours provided for under the TA project for BIR staff to Japan and Malaysia were crucial in providing the staff with information and inspiration about how those two countries equip their tax officers with the knowledge, skills, and attitudes to effectively carry out their duties.

In Japan, the National Tax College (NTC) is modelled on a university campus, with lecture theatres, dorms, cafeterias, sporting facilities, and related infrastructure.

“NTC trains new recruits who have graduated from high school and universities so that they can carry out the duties expected of them as tax officials as well as provides important job training programs for tax officials who are already working in the field, enabling them to keep pace with the most recent changes. Furthermore, NTC engages in academic surveys and research on taxation while providing international training programs for overseas tax officials mostly from Asia as part of international cooperation activities.”<sup>2</sup> Figure 8.3 shows the NTC’s training programs.

In Malaysia, the tax academy is not a separate entity, but part of the training division of the Inland Revenue Department. In addition to training Malaysian staff, the funding model involves provision of training to tax officials of other countries.

Both study tours included visits to operational areas of the Japanese and Malaysian tax offices. Other models for tax training include the partial outsourcing to a university, as the Australian Taxation Office did when it funded the ATAX Faculty at the University of New South Wales, which started offering specialist tax degrees in 1990, delivered by distance education.

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<sup>1</sup> Republic Act No. 10143 of 2009. An Act Establishing the Philippine Tax Academy, Defining Its Powers and Functions.

<sup>2</sup> <http://www.nta.go.jp/ntc/english>

## 8.6 Improving Integrity

The training function can be a gateway into an organization to promote messages of anti-corruption, desired behavior, and ethics. These messages can be included in induction courses and annual refresher courses and incorporated into management training and other existing courses.

One of the priority areas for specialist training as stated by the then BIR commissioner was on the Statement of Assets, Liabilities, and Net Worth (SALN), which is an annual form each employee is required to complete as an integrity measure. The SALN will be described in detail in this part of the chapter, as it is important to document its use in reducing corruption, for other countries that are facing integrity issues.

The SALN is a form used to determine the net worth of a person. If a person accumulates net wealth greater than their salary and other declared income, and cannot explain the increase in wealth, this indicates that the person may be in receipt of illegal income such as bribes and kickbacks, and an investigation would be triggered. The transparency of the SALN is intended to ensure that the public can place trust in their officials, and that those who break the law are held accountable.

The Philippines Republic Act No. 6713, Code of Conduct and Ethical Standards for Public Officials and Employees dated 20 February 1989 mandates the SALN. Section 8 of the Act states:

“Public officials and employees have an obligation to complete and submit declarations under oath, and the public has the right to know, their assets, liabilities, net worth, and financial and business interests including those of their spouses and of unmarried children under eighteen (18) years of age living in their households.” The declaration must include all real and personal property, investments, liabilities, business interests, and financial connections.”<sup>3</sup>

The Civil Service Commission provides detailed guidelines on how to complete the SALN, and the required form of the SALN.<sup>4</sup> The SALN must be completed by all politicians up to and including the President, judges, members of the armed forces and police forces, and all civil servants. It must be completed in duplicate, with one copy provided to the agency employing the person, and the other copy to the Ombudsman.

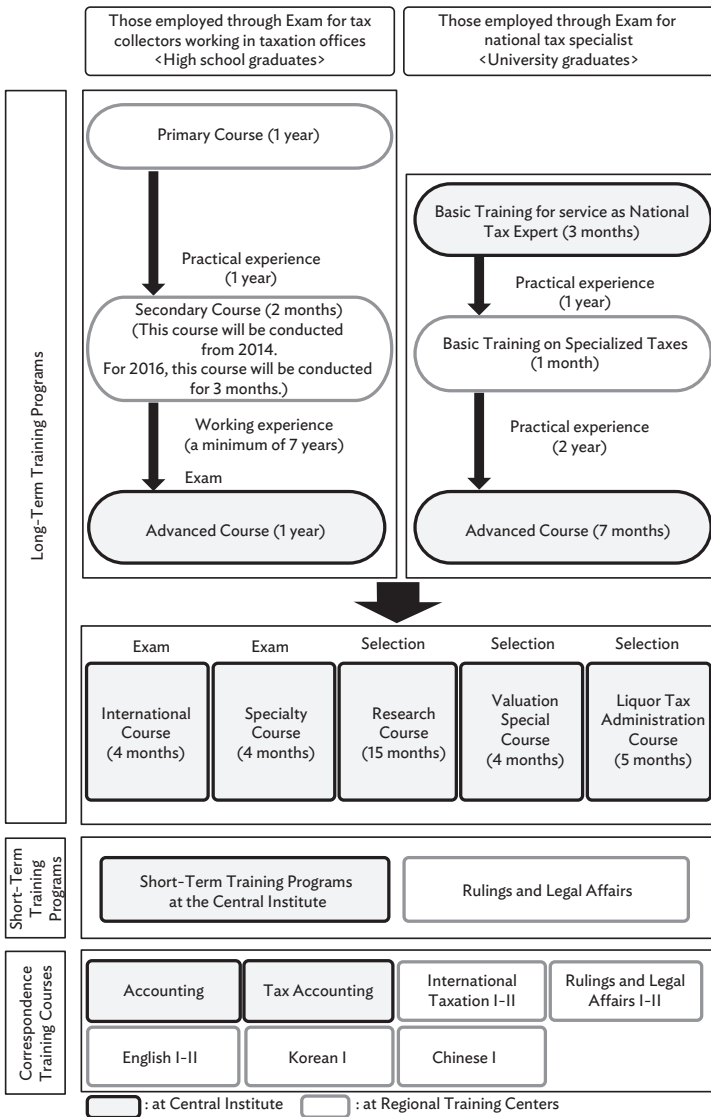
Husbands and wives who are both public officials or employees may file the required statements jointly or separately. In the case of a joint

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<sup>3</sup> All the quotes from the law in this section are from the Republic Act No. 6713.

<sup>4</sup> <http://www.csc.gov.ph/2014-02-21-08-28-23/pdf-files/category/193-statement-of-assets,-liabilities,-and-net-worth-saln-form-for-the-year-2012-and-onwards>

**Figure 8.3 Japan's National Tax College Training Programs**



Source: Author's calculations.

filing, all real and personal property should be included, including both paraphernal (properties exclusively owned by the declarant's spouse) and capital properties (properties exclusively owned by the declarant).

The law also requires disclosure of all relatives holding government positions, up to the fourth civil degree of relationship.

All SALNs are public documents. Any statement filed under the Act shall be available to the public for a period of 10 years after receipt of the statement. After this period, the statement may be destroyed unless needed in an ongoing investigation. Any person requesting a copy of a statement shall be required to pay a reasonable fee to cover the cost of reproduction and mailing of such statement, as well as the cost of certification.

There are safeguards to this public access. It is unlawful for any person to obtain or use any statement filed under the Act for: "(a) any purpose contrary to morals or public policy or (b) any commercial purpose other than by news and communications media for dissemination to the general public."

The Civil Service Commission guidelines for the filling out of the SALN form explain the penalties for failing to file the SALN, or not making a full and true disclosure in the form.

The above cases may be instigated by the superior of the erring employee, a member of the public, or The Office of the Ombudsman (OMB).

The Constitution mandates the OMB to "investigate on its own, or on complaint by any person, any act or omission of any public official, employee, office, or agency, when such act or omission appears to be illegal, unjust, improper, or inefficient."

The Philippines Republic Act No. 6770 (Ombudsman Act of 1989) empowers the OMB to investigate and initiate the recovery of ill-gotten and/or unexplained wealth, and prosecution of the parties involved.

The High Court, in one of the leading cases on SALN, said that the law mandates the "true, detailed and sworn declaration" in the SALN as "the means to achieve the policy of accountability of all public officers and employees of the government."<sup>5</sup>

From the perspective of the BIR, with its 10,000 staff members, the workload associated with administering the SALN is considerable. Each year, 10,000 paper forms must be collected from staff, checked, and returned if completed incorrectly; in some cases, checked against third party information to ensure full disclosure; and in others, investigated further for large increases in net wealth above declared income sources.

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<sup>5</sup> Case GR 167828. 2 April 2007.

Staff must be educated regarding how to fill the form and the need for accuracy. Storage space must be provided for 10 years of forms. Resources must be used on penalizing those cases where the SALN is not complete or is inaccurate, and court cases must be filed in a few cases. All of these resources could otherwise be used to collect taxes.

In a 2007 presentation *The Experience of Asset Declaration in the Philippines*, the Assistant Ombudsman provided statistics showing that in the 2000–2007 period only 203 cases had been taken up for failure to file a SALN or failure to file a full and detailed SALN, and 115 cases were reported for forfeiture, from the total of all public officials from all agencies.<sup>6</sup> The number of people required to file SALNs is about: 1.3 million civil servants (at three levels of government including provinces and cities); 90,000 armed forces; 160,000 police, plus a small number of judges and politicians.

In the Ombudsman’s 2015 Annual Report, only two examples of action against 38 high-ranking officials from all government agencies and tiers of government were related to the SALN.<sup>7</sup>

The BIR publishes statistics on the number of staff charged with graft and other offenses during 2009–2013.<sup>8</sup> Over the period, 189 cases were decided, with 18 staff dismissed. There is no link provided by the BIR between the statistics and discrepancies detected in the SALN, and other sources of internal control cases.

There are a handful of media releases and articles about BIR staff being sacked on the basis of their SALN. A 2014 Department of Finance media release gives us the following report:<sup>9</sup>

“The Revenue Integrity Protection Service (DOF-RIPS), the anti-corruption arm of the Department of Finance (DOF), scored another first in its anti-graft campaign by dismissing a couple working with the Bureau of Internal Revenue (BIR) from the service.

“The dismissal of spouses is a first for DOF-RIPS. In its 10-year existence, DOF-RIPS has filed cases against two spouses from BIR; two spouses from the Bureau of Customs and one spouse from the Bureau of Local Government Finance, but this is the first time that both spouses were dismissed from the service,” [Undersecretary], head of the DOF Revenue Operations and Legal Affairs Group, said.

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<sup>6</sup> <http://www.oecd.org/site/adboecdanti-corruptioninitiative/39367966.pdf>

<sup>7</sup> <http://www.ombudsman.gov.ph/docs/annualreport/Annual%20Report%202015.pdf>

<sup>8</sup> [http://www.bir.gov.ph/images/bir\\_files/old\\_files/pdf/presidential\\_directives\\_idapv2.pdf](http://www.bir.gov.ph/images/bir_files/old_files/pdf/presidential_directives_idapv2.pdf)

<sup>9</sup> BIR Spouses Dismissed from the Service for Unexplained Wealth. 2014. *DOF News Correspondent*. 19 March.

Anecdotally, the majority of BIR staff complete a simple SALN, with income consisting only of their salary and possession of perhaps one property. A person completing the SALN can calculate ahead if they are going to report an unexplained growth in net wealth and likely trigger an enquiry; by underreporting assets, the person is more likely to fly under the radar.

The DOF-RIPS Director stated that one rampant form of SALN fraud was to overstate assets upon joining the civil service, to purport that substantial wealth already existed. Another method is pretending to win the lottery, declaring property as inheritance, and giving partial addresses.<sup>10</sup> Other methods of playing the SALN according to the Assistant Ombudsman are non-declaration of improvements, assets recorded in the names of dummies, lumping of illegitimate assets to intermingle with legitimate assets, and disposal of newly-acquired assets at an inflated selling price.<sup>11</sup>

It is ironic that the net wealth method of indirect income measurement used by some tax authorities (such as the asset betterment statement used in Australia and the United States) is also used to detect corruption in tax officials.

While the SALN administration in the Philippines has an enormous paper-based workload associated with it, and the rate of prosecution is low, it is better to have it than not. Within the existing framework, improvements to the system could be made through automation and data matching with banks, property registries, and other third parties, much like a tax administration does to detect risk in taxpayers.

If such systems' functionality within a tax authority already exists for taxpayers' wealth checks, it could be extended to the financial affairs of tax officials.

In designing a new training course on the SALN, the consultants discussed with the BIR officer responsible for processing them what the common areas of concern were. Many BIR staff who are not accountants may not understand the rules for defining assets and liabilities, valuing assets etc. The new course aimed at correcting the main areas of misunderstanding of the overall BIR staff.

The use of the SALN or its equivalent throughout ADB's developing member countries, which do not have an existing mechanism, should be considered as a possible governance mechanism.

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<sup>10</sup> <http://www.philstar.com/business/2012/07/29/832513/saln-declaration-vital-good-governance>

<sup>11</sup> <http://www.oecd.org/site/adboecdanti-corruptioninitiative/39367966.pdf>

## 8.7 Improving Management Skills

Apart from technical skills, it is equally important to pay attention to “soft skills,” such as communication, leadership, and strategic planning, which are vital to the success of a tax authority. The consultants developed the “Working with Projects” course for BIR, covering how to effectively operate as a member of a project team. The topic was chosen because the BIR was going through a change process at the time composed of numerous projects which impacted staff.

The course is 3 days in length, and can be conducted by in-house staff without need of accreditation in any project management methodology. During the course of the training, participants are introduced to theory of projects, Gantt and PERT charts, and given the Belbin personality test on how they operate as a team member.<sup>12</sup> Participants were required to break up into small groups to complete exercises, and to complete a major assignment.

The major assignment of each group was to give a presentation on a project that was relevant to the workplace and realistic, such as moving to new premises, rolling out new technology, or conducting an education campaign. Each team had a whole day to work on the project, then present it using slides, for critical review by the consultants. The assignment covered project planning, budgeting, staffing, sequencing, execution, and evaluation of outcomes of the assigned project.

There are a variety of possible courses that can make a tax official more efficient, and lead to potential increased revenue, such as: dealing with difficult customers, assertiveness, critical thinking, decision-making, and people management.

## 8.8 Measuring the Effectiveness of New Training Courses

The effectiveness of training courses can be evaluated using a range of sources: participant feedback, anecdotal information, and productivity studies.

Anecdotal information on the new training courses for new recruits was overall positive, as are the participant feedback scores. Training staff in the National Office and the regions reported that the BTAC has led to renewed interest by staff in training. The BTAC is both a “crash course” for those who have had no technical training; and

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<sup>12</sup> See [www.belbin.com](http://www.belbin.com)

a “refresher course” for those who received their technical training years or decades ago.

Feedback scores for participants in the first few batches of the BTAC were extracted from questionnaires at the end of the training, together with a one-hour verbal evaluation by participants. The evaluation questionnaire included attributes such as perceived relevance and application in the workplace. The evaluation shows that most BTAC participants responded to the questionnaire with “Fully” or “Very much so” for most questions. For example, in response to the question “Did the facilitator present the content clearly?” 50% of respondents replied “Fully,” 40% with “Very much so,” and 10% “To some degree.” From this data, a weighted average response can be calculated.

A weighted average of all responses gave an overall rating for the course out of a maximum score of 5.00. The first six batches of the BTAC course held between November 2014 and June 2015 show that participants generally had a high opinion of this course, scoring in the range 4.26 to 4.71. Where the participants gave freeform comments, negative comments tended to focus on the style of the presenter, or the training facilities, rather than the course itself.

The TA project design required that 250 BIR staff be trained in the new courses. At the rate of rolling out the BTAC when the TA project ended, at one batch of 20 participants per month, this target was met in December 2015.

## 8.9 Application to Other Countries

The TA project was appraised as “successful” by the BIR and ADB, within the constraints of the resourcing and scope of the project. The work of the TA project may be supplemented by future projects to continue the implementation of the competency-based framework for the human resources function and training in the BIR, and to develop specialized training courses to match identified competencies. The expectation that e-learning would be a product of the TA project needed to be managed. This can be overcome by providing for a feasibility study for e-learning within the scope of the project.

It is likely that the model used to provide assistance from the BIR can be applied more broadly to the training function of other developing countries, leveraging the learnings from the TA project to produce even better outcomes in the future.

It is recommended that future projects focusing on training look at the following chain of events relating to the human resources function of the tax agency:



- Are job descriptions up to date and accurate? If not, rewrite all job descriptions to modernize them and make them based on competencies rather than duties.
- Develop a competency dictionary and a training plan for the organization based on improving these competencies. Individual training plans should be in place.
- Are recruitment, promotion processes, and performance evaluation based on how competent a person is to carry out the duties, based on the job description?
- Do training staff themselves need development, and should train-the-trainer programs be in place?
- E-learning is a promising technology for training for a dispersed workforce, but requires expertise and technological costs.

In relation to tax technical training, the following should be considered:

- Where resources are scarce, basic training for new recruits should be just that, “basic,” and the building block upon which further specialized courses skill the tax officer in practical work areas.
- Specialized training courses should be devised based on practical needs tailored to the job descriptions.
- Formal structures need to be in place including a single training management administration, dedicated trainers, manuals for training staff and annual training plans.
- The tax academy concept is one method of skilling staff as opposed to in-house training and outsourcing to universities and other suppliers; and should the subject of a formal feasibility study, including a cost-benefit analysis and implementation timeline.

## **8.10 Project Design and Technical Assistance Issues**

The design of a project to improve tax training skills involves first identifying the skills, qualifications, and experience necessary for the multi-disciplinary project team itself.

The team leader should be a tax expert, who has had some background in the training issues of a tax authority, in their home country and developing countries.

The training expert(s) can have a general training background, although some experience in a tax authority would be useful.

If a feasibility study on e-learning shows that it would be practical and efficient, engagement of an international e-learning consultant should be considered. This expert should have sufficient IT knowledge to assist in the establishment of an e-learning function in the tax authority. They should also be able to train the tax officials to a point where they can produce the content of learning modules self-sufficiently after the project ends.

Additional resources should be available for the engagement of short-term experts in specialized tax areas such as banking and finance, international issues, and risk identification. These experts would deliver courses and design ongoing training materials (either traditional or e-learning) and train the trainers in these topics.

The involvement of local consultants is also important, as they understand the culture and environment the international consultants operate in, and can act as go-betweens. There should also be members of the project team who are officials of the tax authority to which assistance is provided, championed by a senior executive of the corporate services area.

## 8.11 Conclusion

Corporate services such as human resources and training within a tax authority are often overlooked when technical assistance is provided, with emphasis on revenue-producing areas such as audit, collection, ICT, or indeed, tax policy areas such as expanding the tax base, rationalizing incentives/exemptions, and changing rates.

There is considerable value to be realized from investment in the training function, in terms of domestic revenue mobilization. The art and the science of the way that this is approached is the key to success. International organizations need to conduct a thorough analysis at the project design stage. Remember the old saying of Francis Bacon: *ipsa scientia potestas est*, or “knowledge is itself power.”

# 9

## Experiences While Working for the Tax System of Maldives

*Natalie Bertsch*

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**Q1. What is the role of the Asian Development Bank (ADB), particularly with respect to public finance and management in developing countries?**

ADB acknowledges the importance of public financial management processes for the adequacy of the budget cycle. The budget, in turn, is a key instrument for public investment in physical and human capital. Without these investments, economic growth and poverty reduction will remain elusive. “Ensuring the effective management of government financial resources and operational efficiency are the key challenges faced by many countries in the region. Revenues must be properly assessed, collected, and administered; budgets must be judiciously prepared and executed; fiscal discipline must be maintained; and procurement, accounting, internal control, and intergovernmental fiscal relations must be well managed. As part of Strategy 2020 and its commitment to the Paris Declaration and Accra Agenda for Action, ADB attempts to redouble efforts to develop national and regional financial management system”.<sup>1</sup>

**Q2. What was your role at ADB?**

I took over the tax administration capacity project with the Maldives Inland Revenue Authority (MIRA) as a project manager in 2012 and remained in that role until 2016 when I went on sabbatical leave. I was responsible for processing additional funding for the project, which I felt was important, as I was highly impressed by the results MIRA was achieving. I consider this to be probably one of the best technical assistance projects I have been involved with. In my opinion, it was a textbook example of a successful technical

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<sup>1</sup> Asian Development Bank. <https://www.adb.org/sectors/governance/financial-management>

assistance project, which should be emulated, if possible, in other jurisdictions.

**Q3. Please briefly summarize ADB's activities with respect to the tax system of Maldives.**

We identified a need for support in the formulation of adequate tax policy and strengthening of tax administration capacity. One important aspect of the tax administration's capacity building was to develop its information technology (IT) infrastructure to simplify payments for taxpayers, with the objective to enhance voluntary tax compliance. We therefore hired a team to support MIRA in providing inputs for tax policy and legislation, under the purview of the Ministry of Finance. These two consultants (one tax specialist, one tax audit specialist) further supported the young and dedicated MIRA staff to translate abstract tax laws into regulation and issue tax rulings one case at a time. The other important task was to enhance MIRA's capacity regarding tax audits, which was a challenge given the absence of official record-keeping by small and medium-sized enterprises in Maldives. Finally, both consultants supported MIRA in developing a very effective awareness campaign to sensitize the public not familiar with the concept of taxation. We also hired an IT team, which supported MIRA in upgrading its IT system, including one for e-taxation and taxpayer customer services.

**Q4. When ADB started to work in Maldives, what issues were identified as problems facing the public finance and tax system of the country?**

Until 2011, Maldives had no general income taxes. Government revenues consisted of import duties, taxes on tourists and banks, land and resort islands, business and other property income, fees and levies, and foreign aid. The revenues of the Government of the Maldives came under intense pressure from the effects of the global economic crisis (2008–2009) and the tsunami (2004). As a result, a broad political consensus around the need for a diversification of the tax base emerged.

**Q5. How have the tax policies of Maldives been reformed? What was ADB's role?**

Against the background of a looming fiscal deficit of 20% of gross domestic product (GDP) in 2009, the Government of the Maldives implemented an ambitious tax reform agenda. A tourism general service tax took effect on 1 January 2011, followed by the business profit tax on 18 July 2011. On 2 October 2011, the tourism general service tax was replaced by an overall general service tax,

which continued to levy a different tax rate on the tourism sector. “In over 20 years working on public sector management reforms across Asia and the Pacific countries, I have yet to see a country other than Maldives, to overhaul and adapt a modern tax system so successfully in such a short space of time. Truly amazing and very proud that ADB was able to contribute to this success story” (Bruno Carrasco, Asian Development Bank).<sup>2</sup>

**Q6. How has the tax administration of Maldives been reformed? What was ADB’s role?**

MIRA was created by the Tax Administration Act, which was ratified on 18 March 2010. Its vision was “to be recognized as a leading professional organization engaged in the collection of revenue in an effective and efficient manner and providing high-quality service to taxpayers.” The bill established MIRA as a separate and independent legal entity. MIRA is led by a visionary Commissioner General of Taxation, Yazeed Mohamed. He is supported by a young, smart, and motivated team. But since Maldives did not have a modern taxation system before, MIRA required international expertise for the efficient application of tax policy. This is where ADB came into play, providing funding and recruiting the required expertise for MIRA. An important element was for the consultants to train staff and transfer knowledge. Today, “MIRA has become the primary center of revenues for the Maldivian government. It has become an admired institution among everyone.” (Ahmed Mohamed, Chair of MIRA).

**Q7. What were the difficulties you encountered during the implementation of the projects?**

To be honest, there were very few difficulties. My main goal was to ensure adequate funding for the long-term consultants since I realized that they had effectively become part of the MIRA team and were considered incredibly useful by both management and the staff itself. The main difficulty was to recruit the adequate consultants on the IT side. MIRA uses a specific tax and revenue management IT system module, for which there are only a handful of experts worldwide. To recruit the right consultant proved difficult.

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<sup>2</sup> Asian Development Bank (ADB). 2017. *Fast-Track Tax Reform: Lessons from Maldives*, p.143. Manila: ADB.

**Q8. How do you think the tax system reforms help the public finances and development of Maldives?**

The tax-to-GDP ratio in Maldives rose from one of the lowest in the region to the highest in South Asia within a few years. This is truly remarkable. The Maldivian government still runs high fiscal deficits, which make domestic resource mobilization even more relevant to finance recurrent costs and pay for necessary capital investments.

**Q9. What do you think are remaining issues? How is the tax system in Maldives going to change further?**

The government's fiscal position continues to deteriorate despite increased revenue collection through MIRA. It has become evident that the existing taxes are not sufficient to meet expenditure needs. To broaden the tax base, new laws such as (i) personal income tax, (ii) tonnage tax, (iii) financial transaction tax, (iv) wealth tax, (v) estate and/or inheritance tax, (vi) emigration tax, (vi) saturated fat and sugar tax, and (vii) municipal taxes should be considered.

**Q10. What lessons have you learned through your experiences in working in Maldives? Are any lessons applicable to other developing countries?**

The project with MIRA reminded me that technical assistance projects can add tremendous value to the development of a country. To have this effect, there are certain requirements, which were present in the case at hand: (i) visionary leadership; (ii) motivated staff eager to learn; (iii) team spirit between MIRA and ADB; and (iv) long-term consultants with the right technical and social skills. Another important lesson learnt is "Keep it Simple." We only employed two long-term consultants, but this was part of the success strategy.

**Q11. What role should the international community including international organizations such as ADB play in improving the public finance and tax system of developing countries?**

The role of international organizations such as ADB is to be at the crossroad of policy dialogue, finance, and international expertise. These instruments need to be carefully calibrated and adapted to the specific concerns in a given jurisdiction. Their role is to listen, discuss, and find solutions as part of a team.<sup>3</sup>

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<sup>3</sup> ADB. *supra*, note 2.

# 10

## Thailand's Tax Policy Agenda and Collaboration with International Organizations

*Patricia Mongkhonvanit*

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### 10.1 Introduction

Globalization has not only led to a borderless world but also a disruption in taxation. Double taxation, especially international double taxation, has been an obstacle in the promotion of cross-border investments, which led to ways of eliminating double taxation. However, there are differences in countries' tax structures; and international tax rules have been evolving at a pace that is slower than that of the commercial world. Therefore, double taxation is no longer a problem, but double non-taxation or very minimal taxation has become a real problem for most, if not all, countries. Tax administrations, including the Revenue Department of Thailand (TRD), are fighting to keep their shares of revenue. However, this is not an easy task. In this chapter, I will share my personal views of the challenges the Revenue Department is facing and also how the Asian Development Bank (ADB) and other international organizations can help.

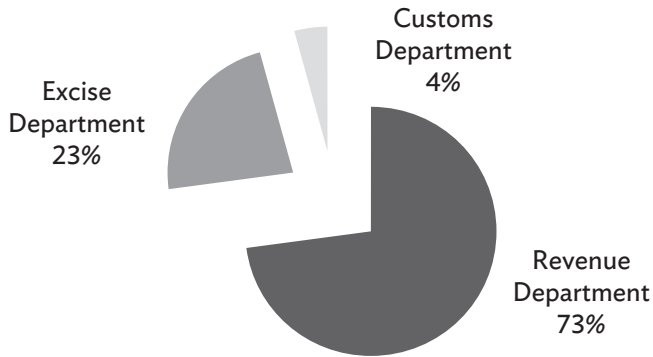
### 10.2 Challenges Faced by the Revenue Department of Thailand

From my personal perspective, I foresee that the TRD is facing challenges from both domestic and international aspects which can be highlighted as follows:

#### 10.2.1 Domestic Revenue Mobilization

Under Thailand's Ministry of Finance, there are three revenue-collecting agencies: the Revenue Department, the Excise Department, and the

**Figure 10.1 Tax Collected by Three Revenue Agencies in FY2017**

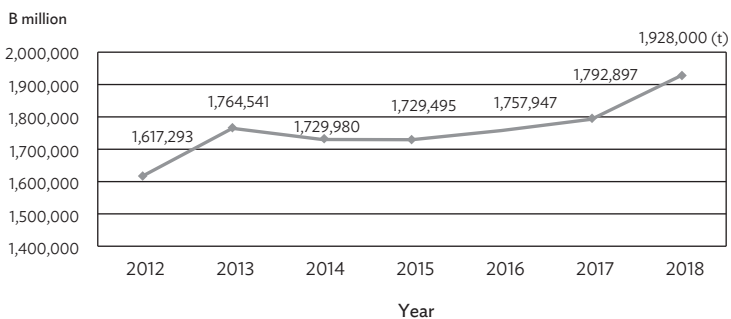


Source: Ministry of Finance of Thailand.

Customs Department. Figure 10.1 shows the ratio of tax collected by these agencies in fiscal year (FY)2017 to total tax collection.

Over the years, government expenditure has been increasing to combat poverty, develop new infrastructure, and provide better education and healthcare. These expenditure requirements cannot be fulfilled without support from the revenue side. The TRD, as the main revenue contributor, cannot ignore the higher revenue tax collection targets set by the government (Figure 10.2).

**Figure 10.2 Tax Collection by the Revenue Department of Thailand (in baht)**



Source: Revenue Department of Thailand.



The European Commission defines domestic revenue mobilization (DRM) as the generation of government revenue from domestic resources, from tax or non-tax sources (royalties, licenses, levies, or other income). On this subject, the commission emphasizes four aspects: (i) better and appropriate tax reform for revenue sustainability; (ii) governance issues regarding effective tax reforms; (iii) promoting increased governmental accountability to strengthen the relationship between tax authorities and taxpayers; and (iv) tax governance on international aspects of taxation.<sup>1</sup>

Thailand has been using tax policy as an important tool for stimulating economic growth and attracting foreign investment. For personal income tax, several schemes have been introduced to help low-income earners, promote savings, and encourage donation. For employment income, the Revenue Code gives tax exemptions for monthly income less than B26,000 (approximately \$812).<sup>2</sup> In addition, tax deductions are given for expenses such as health insurance premiums, interest paid on housing loans, pension and other fund contributions for long-term savings, and investments in long-term equity funds. In 2016 and 2017, there were special tax schemes designed to stimulate short-term consumption. The government allowed tax deductions up to B15,000 (approximately \$470) for the purchase of goods or services that were subject to value-added tax (VAT) of 7%. These schemes were introduced for a short period and without advance notice to avoid deceleration in consumer spending, which would have had an adverse impact on the economy. The schemes were well received by taxpayers, but were criticized by academia as they were believed to foster future consumption. The latest tax scheme<sup>3</sup> boosted 0.05% growth in 2017 gross domestic product (GDP),<sup>4</sup> but resulted in personal income tax losses in 2018.

Regarding corporate income tax, the amended Promotion Investment Act has extended tax holidays from 8 years to 13 years to promote foreign direct investment.<sup>5</sup> In addition, double and triple tax deductions were allowed; for example, triple deductions for

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<sup>1</sup> European Commission. [https://ec.europa.eu/europeaid/policies/financing-development/domestic-resource-mobilisation\\_en](https://ec.europa.eu/europeaid/policies/financing-development/domestic-resource-mobilisation_en)

<sup>2</sup> Calculated based on US\$1=B32 exchange rate. This rate is used throughout the chapter.

<sup>3</sup> The latest shopping tax break scheme was offered during 11 November–3 December 2017.

<sup>4</sup> <http://www.nationmultimedia.com/detail/politics/30331071>

<sup>5</sup> Investment Promotion Act No.4 B.E. 2560 (2017).

research, development, and innovation expenses.<sup>6</sup> In 2016 and 2017, the investment years as announced by the government, any companies making investments during those years were entitled to deduction of extra expenses of 100% and 50%, respectively in addition to normal depreciation.<sup>7</sup>

Aside from tax incentives, another challenge for the TRD is the size of the shadow economy. Schneider, Buehn, and Montenegro have outlined the shadow economy to “include all market-based legal production of goods and services that are deliberately concealed from public authorities for any of the following reasons: (1) to avoid payment of income, value-added, or other taxes, (2) to avoid payment of social security contributions, (3) to avoid having to meet certain legal labor market standards, such as minimum wages, maximum working hours, safety standards, etc., and (4) to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.”<sup>8</sup>

The same research reported that during 1999–2007, Thailand's shadow economy accounted for 51% of the country's GDP, resulting in lost tax revenues for the government.<sup>9</sup> In 2015, the government passed a law stipulating that beginning in 2019, financial institutions must use companies' financial accounting books submitted to the TRD as the main source of evidence when seeking a loan.<sup>10</sup> This stipulation is to make sure that actual income is reported for tax purposes.

In addition, over the past 2 years, the government has announced that Thailand will move toward a cashless society with the aim to not only reduce the country's cash-handling costs, but also to minimize tax evasion.<sup>11</sup> Ad hoc committees have been established to make sure the infrastructure is in place, citizens are informed, and government agencies are prepared. It is encouraging to see some progress on

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<sup>6</sup> Royal Decree No. 598 B.E. 2559 (2016).

<sup>7</sup> Royal Decree No. 604 B.E. 2559 (2016) and Royal Decree No. 642 B.E.2560 (2017), respectively.

<sup>8</sup> Schneider, F., A. Buehn, and C. Montenegro. 2010. Shadow Economies All Over the World—New Estimates for 162 Countries from 1999 to 2007. Policy Research Working Paper 5356. The World Bank Development Research Group Poverty and Inequality Team & Europe and Central Asia Region Human Development Economics Unit. July. p. 7. Washington, DC: World Bank. [http://www.gfintegrity.org/storage/gfip/documents/reports/world\\_bank\\_shadow\\_economies\\_all\\_over\\_the\\_world.pdf](http://www.gfintegrity.org/storage/gfip/documents/reports/world_bank_shadow_economies_all_over_the_world.pdf)

<sup>9</sup> Ibid. p. 26.

<sup>10</sup> Section 8 of the Emergency Decree B.E.2558 (2015).

<sup>11</sup> [https://www.bangkokpost.com/tech/local-news/1043849/ready-to-go-cashless-](https://www.bangkokpost.com/tech/local-news/1043849/ready-to-go-cashless) (accessed December 2017).

this front. Debit card use in Thailand has increased from 4 million transactions in January 2016 to 7.2 million transactions.<sup>12</sup> As of March 2018, all payments paid and received by government agencies will be made electronically. With all the supports from concerned stakeholders, we have to wait and see whether or not the size of Thailand's shadow economy shrinks.

DRM is vital for Thailand. The TRD needs to increase its efficiency not only by broadening the tax base to cover "hard to tax" taxpayers, both those physically existing or doing business online, but also by improving tax collection administration. However, in the medium and long term, holistic evaluation of tax policy reforms is required to create more equitable and efficient tax systems which are simple, broad-based, and fair;<sup>13</sup> and which are also necessary for ensuring fiscal sustainability in Thailand.

## 10.2.2 Legislation Challenges

The Thai Revenue Code needs to keep up with changing global dynamics. Thailand has limited legal tools for combating aggressive tax planning, both domestically and internationally. During the past few years, the TRD has been proposing many tax code amendments to limit loopholes and prevent tax fraud. Some have been successful,<sup>14</sup> and others are still under consideration.

Under the Revenue Code, neither general nor specific anti-tax-avoidance rules, except for transfer pricing rules and regulations, have been introduced. The TRD has proposed that the transfer pricing legal framework be stipulated in the Revenue Code. The draft is awaiting endorsement by the National Assembly and is expected to be enforced in 2018. It will be the first anti-tax-avoidance rule in the Revenue Code.

In addition, aggressive tax planning is being adopted by many means. The most common way is thorough the use of Thailand's Double Taxation Agreement networks for tax benefits. As Thailand is the 98th country to join the Inclusive Framework, the TRD is now under the review of the best practice to be adopted as recommended by Action 6.

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<sup>12</sup> Bank of Thailand presentation to the National E-Payment committee, 22 February 2018.

<sup>13</sup> Speech given by Christine Lagarde, Managing Director of International Monetary Fund, on Revenue Mobilization and International Taxation: Key Ingredients of 21st Century Economies. Abu Dhabi, 22 February 2016.

<sup>14</sup> Thai Revenue Code. Section 37, 37 bis, and 37 ter.

The TRD is also considering developing a concrete legal framework on substance over form, beneficial ownership, and limits on interest deduction.

As Thailand becomes part of the Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum) and Base Erosion and Profit Shifting (BEPS) projects under the OECD Inclusive Framework, considerable work will be required for drafting new legislation, in line with international standards. Laws to facilitate automatic exchange of information and country by country reporting will be TRD's first priority.

Technology is now part of everyone's daily life. Digital content, products, and platform services are offered and used by many. The TRD is working on introducing legislation to impose value-added tax (VAT) on inbound business-to-consumer (B2C), in line with OECD recommendations. As for income tax, it is a challenge to design the best and most effective tax on income for activities arising in Thailand.

One missing section that is crucially needed in the Revenue Code is the authority to access bulk third party information. The International Monetary Fund recommended that the TRD should seek broad information gathering powers from concerned government agencies and the private sector to ensure new sources of revenue from informal sectors and non-compliant taxpayers, while ensuring that there is legislative protection regarding the misuse of data. This is an area in which TRD must push forward to increase compliance as well as efficiency.<sup>15</sup>

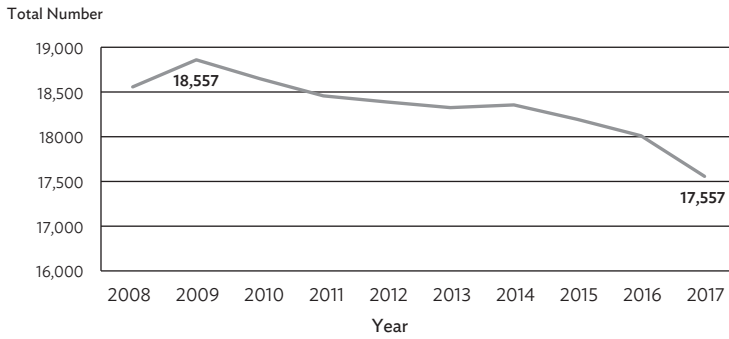
### 10.2.3 Human Resource Challenge

Total tax collection in Thailand has been increasing every year, but the number of revenue officers is dropping every year, due to government policy to reduce the size of government agencies (Figure 10.3). From my personal perspective, this should not be a "one size fits all" policy. The TRD generates the main source of revenue to the country. If compared to corporations, the TRD is a profit-making unit. Downsizing a profit-making unit by using the same criteria as how other units are downsized must be reconsidered. Yet, if the number of staff remains the same, the efficiency of the organization must be proven.

Brain drain is another problem that needs to be addressed. Highly skilled and high-potential officers have been leaving the TRD for private

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<sup>15</sup> International Monetary Fund. 2017. Thailand: Improving Personal Income Tax and Value-Added Tax Administration. IMF Technical Assistance Report. April. Washington, DC: International Monetary Fund.

**Figure 10.3 Number of Staff, Revenue Department of Thailand**

Source: Revenue Department of Thailand.

sector jobs. The reasons vary from exhaustion, too much red tape, not enough challenges, and low remuneration.

The TRD's human resource development needs to be overhauled. Even though its officials receive training from time to time, it is not sufficient. The TRD's capacity building needs to be increased to ensure officials' capability, which requires greater allocation of budgetary resources. The TRD has proposed, without success, establishing a tax academy like the National Tax College of Japan, which provides training programs for all National Tax Agency staff. This enables tax officials to keep abreast of latest business developments including new types of transactions.

### 10.3 Support from International Organizations

International organizations have been supporting Thailand in terms of loans, assistance, and capacity building. During the last 20 years, I would divide the International Monetary Fund's (IMF) technical assistance into three series: 1990s, 2000s, and 2010s. In 1992, Thailand introduced a VAT. After the introduction of this tax, the IMF sent a mission to provide technical assistance in enhancing VAT collection. Those recommendations have been integrated into Thailand's VAT collection system and are still implemented. During the 2000s, an IMF consultant was sent to the TRD with a mandate to establish a Large Taxpayers Office within the TRD. The Large Taxpayers Office would look after large taxpayers, who are small in number but high in tax contribution.

The last series of TA projects were between 2014 and 2017. Assistance during those 4 years covered several aspects of tax administration such as compliance strategies, strengthening core tax administration process, VAT gap analysis, and improving personal income tax and VAT administration. In addition to providing direct TA projects for the TRD, the IMF regularly invited TRD senior officials to attend the IMF–Japan High-Level Tax Conference for Asian Countries to share views and exchange experiences.

The TRD has recently been working closely with the Organisation for Economic Co-operation and Development (OECD) as part of its commitment under the Global Forum and BEPS projects. Aside from that, the TRD has been sending officials to attend training at OECD centers in the Republic of Korea and at the Malaysian Tax Academy. Courses offered by the OECD provide knowledge to Thai tax officials and are beneficial for Thailand's human capital development.

The TRD works indirectly with the World Bank on the Doing Business project, which includes paying taxes. The TRD has also recently requested for technical assistance on how to improve electronic services to increase compliance.

ADB has always provided continued support to the TRD on capacity building. Since 1991, ADB, in cooperation with the Ministry of Finance of Japan, has organized an annual tax conference for developing member countries. The aim of the conferences has been to enhance capacity development on tax policy and administration. During 2008–2011, the conference focused mainly on tax treaties—the model, negotiation, interpretation, and use. However, ADB assistance recently shifted from a broad-based knowledge of tax treaties to more specific ones, such as exchange of information, DRM, and tax policy, which are also beneficial to TRD officials.

The advantage of attending tax conferences and training organized by international organizations is “opportunity,” that is, allowing participants to learn from experts, and exchange knowledge and experience among tax officials. In addition to what is learnt in the conference room, bonds of friendship have been developed outside the room, which are invaluable.

## **10.4. Conclusion**

Challenges in tax administration vary, but there are several common elements. International organizations have been providing assistance to curb these challenges. One-on-one technical assistance is considered to be more in-depth and tailored to meet each country's requirements. Yet, views and experiences from other tax administrators that share similar

challenges and problems are also helpful. In the past, each international organization offered capacity building assistance and/or conferences on a silo basis, which resulted in duplication of topics, schedules, and expenses. Recently, there have been more joint capacity building projects, which I believe are more effective and efficient. Lastly, it is hoped that international organizations, especially ADB, will continue to support regional tax administrations to strengthen cooperation among Asian countries and ensure fiscal sustainability within this region.

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## Tax and Development

### *Challenges in Asia and the Pacific*

*Tax and Development: Challenges in Asia and the Pacific* is an anthology by contributors who have been involved in the activities of the Asian Development Bank (ADB) and the ADB Institute on fiscal policy and taxation in various capacities. While the contributors have different backgrounds, they have worked for one common cause, namely, the development of the Asia and Pacific region with respect to fiscal policy and taxation. The editors believe that this collaborative work provides important insights about taxation and development in Asia and the Pacific.

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The Asian Development Bank Institute, located in Tokyo, is the think tank of the Asian Development Bank. The institute aims to identify effective strategies to improve policy and development management in Asia and the Pacific. We work with an extensive network of partners in the region and globally to influence policies on poverty reduction, inclusive growth, the environment, regional cooperation, infrastructure development, middle-income countries, and private sector development.

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