TOWARDS SUSTAINABLE ASEAN DEVELOPMENT:

IMPROVED BUSINESS ENVIRONMENT IS THE KEY TO FDI, NOT TAX COMPETITION

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OXFAM
VEPR
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Tax & Fiscal Justice Asia

IT IS HIGH TIME FOR ALL ASEAN

MEMBER STATES TO COLLABORATE WITH ONE ANOTHER TO IMPROVE BUSINESS ENVIRONMENT AND AGREE UPON COMMON MINIMUM STANDARDS FOR CORPORATE TAX AND NON-TAX INCENTIVES IN THE REGION TO PREVENT HARMFUL PRACTICES THAT DRAIN ESSENTIAL PUBLIC REVENUE AND CREATE UNNECESSARY TAX COMPETITION AMONG MEMBERS, AND TO ACHIEVE A COMMON GOAL OF BUILDING A SUSTAINABLE AND RESILIENT REGION.

POLICY BRIEF

The health and economic crisis emanating from Covid-19 has posed enormous challenges for sustainable Development in ASEAN region. With economic inequality already high, it is estimated that poverty and inequality will further be exacerbated due to Covid-19. In new analysis published by United Nations University World Institute for Development Economics Research (UNU-WIDER), estimate that with 20 percent contraction of income/consumption Asia Pacific region will add 214.1 million people into poverty at $ 5.50 a day [1].

In June this year Oxfam and Partners published a research 'Towards Sustainable Tax Policies in ASEAN' and recently we have concluded a research paper on the flow of foreign direct investment, business environment and non-tax incentives in the ASEAN region, in both the researches we have found that:

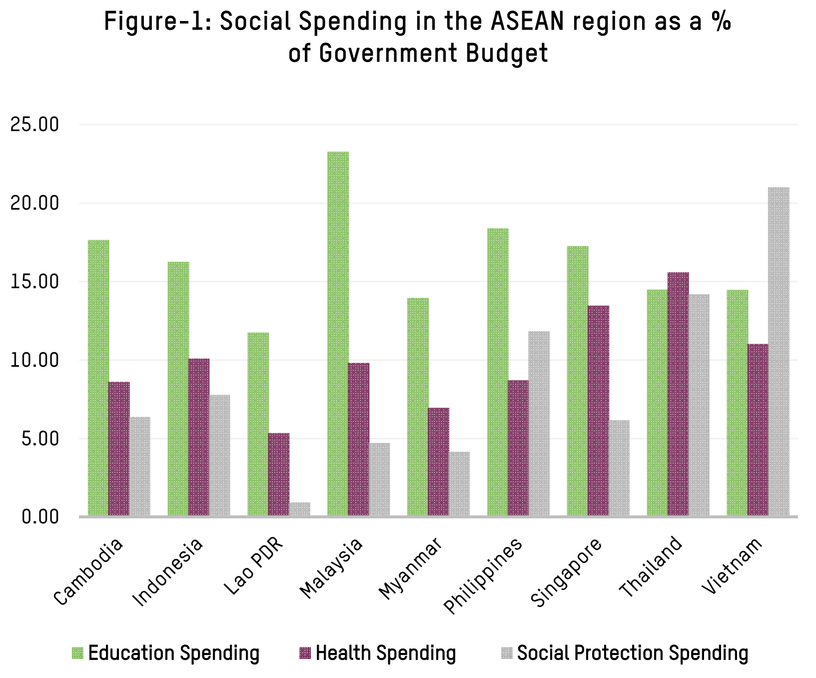
ECONOMIC INEQUALITY WITH INSUFFICIENT SOCIAL SPENDING AND FISCAL STRETCH IN ASEAN

The ASEAN region is experiencing unprecedented economic inequality, as some countries still have the highest poverty levels in the world and most countries in the region are failing to invest sufficiently in essential public services.

In the ASEAN region, an estimated 73.6 million out of 653.9 million people (11.3%) were living in poverty in 2018. ASEAN countries have high levels of economic inequality-the Philippines, Malaysia and Singapore having Gini index 0.45, 0.42 and 0.40 respectively in a 2010-2017 period while Indonesia with 0.39, Thailand with 0.38, Cambodia with 0.37, and Laos and Vietnam with 0.36. Wealth inequality is even alarming with 0.85 Gini index in Thailand and Laos, 0.84 in Philippines and Indonesia, 0.82 in Malaysia, 0.74 in Vietnam and 0.70 in Cambodia.

Progressive tax collection and social spending on essential public services such as healthcare, education, and social protection are the most effective ways to fight poverty and inequality. However, most countries in the region fail to invest sufficiently in those services. For some countries (Cambodia, Laos, Vietnam, Malaysia, and Myanmar), the situation is so critical that the Asian Development Bank has already warned that if they do not mobilize significantly greater revenues in the coming years, the 2030 Sustainable Development Goals (SDGs) will not be met. Figure-1 below illustrates the recent social spending in ASEAN region.

1 *United Nations University. WIDER Working Paper 2020/77. https://www.wider.unu.edu/publication/precarity-and-pandemic*



Source: Fighting Inequality in the time of Covid-19: The Commitment to Reducing Inequality Index 2020

The most worrying aspect is that this lack of spending is being seen at a time when countries in the region already seeing their fiscal space stretched. . Most ASEAN countries have suffered persistent budget deficits for a long period. In 2018 alone, six ASEAN countries had significant budget deficits. On average, the ASEAN region saw a budget deficit of 1.5% of gross domestic product (GDP) in 2018. Budget deficits may go up due to increased expenditure requirement to overcome the current economic and the health crisis created by the COVID-19 pandemic. It is expected that nine ASEAN countries face budget deficits in 2020 with the average one at 4.2% of GDP.

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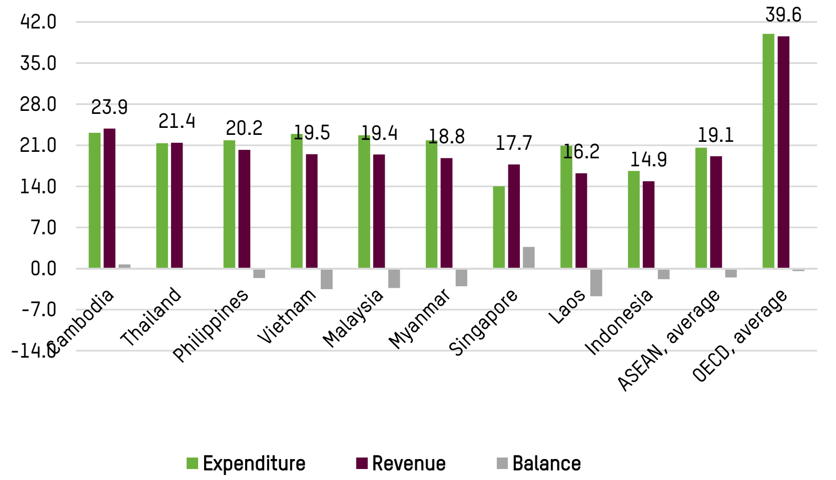
Figure-2: Estimated Budget Indicators in ASEAN Countries, 2018 (% GDP)



In the ASEAN region, levels of revenue collection, measured as a proportion of GDP, remain very low. The average ratio across the region was 19.1% of GDP in 2018, lower than half on average of the OECD countries. These low ratios mean that countries in the region have little budget capacity and are running public deficits, and this gap has consequences for the quality of public services, infrastructure, and levels of good governance.

Even before the COVID 19 pandemic, the situation in ASEAN was already unsustainable. Now the situation is even more dire. Initial estimates from the OECD predict that the pandemic will have significant negative impacts on tax revenues, while at the same time budget burdens will increase due to governments' efforts to introduce supportive packages to help cope with the disease.

There are several reason of low tax revenue mobilizations despite robust economic growth and levels of FDIs. Among other, CIT is the major source of revenue in many members states; however, they are giving up huge amounts of revenue by offering large tax and non-tax incentives to both domestic and foreign investors, damaging the tax bases in the region.

THE RACE TO THE BOTTOM ON TAX AND NON-TAX INCENTIVES IN ASEAN

Tax competition among ASEAN State Members

There has been a long history of tax competition between the Philippines, Vietnam, Thailand, and Indonesia, with the four countries vying with one another for manufacturing investments and using tax incentives as a tool to attract foreign direct investment.

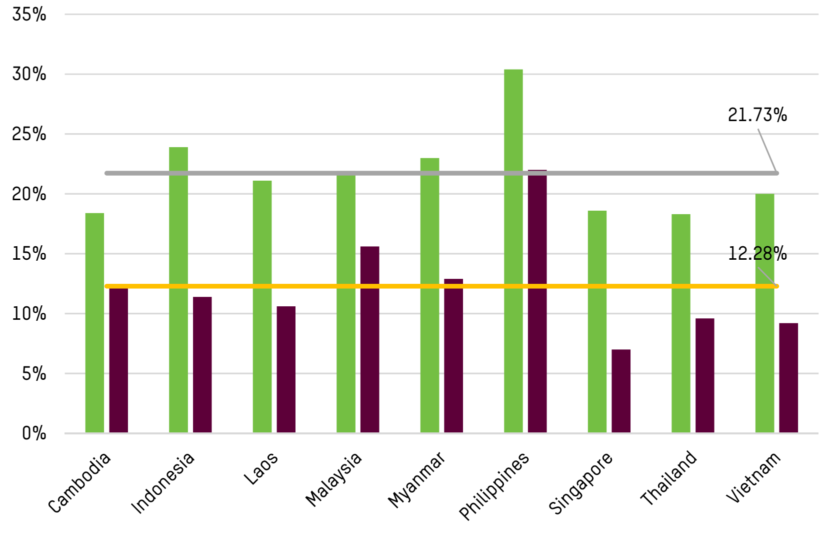
In 1996, competing to lure investment from the US firm General Motors, the Philippines offered a CIT exemption of eight years and Thailand offered a similar exemption, but with an additional amount equivalent to USD15 million. In 2001, hoping to win investment from Canon of Japan, Vietnam offered an exemption of 10 years, but was out-competed by the Philippines, which offered an exemption of 8-12 years. In 2014, in an attempt to entice investment from Samsung of South Korea, Indonesia offered a CIT exemption of 10 years while Vietnam offered one of 15 years.

Just like in many other regions in the world, countries in the ASEAN region are competing with one another in a race to the bottom by reducing their CIT rates and offering aggressive tax incentives to foreign multinational corporations. Across the region, the average CIT rate has fallen over the last ten years from 25.1% in 2010 to 21.7% in 2020.

Over the last ten years, ASEAN's average CIT rate has declined from 25.1% in 2010 to 21.7% in 2020. In addition to CIT cuts, the use of other enormous profit-based incentives to attract FDI, like tax holidays, are prevalent in ASEAN countries. The average effective corporate tax rate in ASEAN is estimated to be reduced by 9.4 percentage points when considering the tax holidays of up to 20 years and other profit-based incentives (Fig-3). Singapore and Indonesia provide the most tremendous tax incentives in the region, with gaps between CIT rates with and without incentives of over 11 percentage points. Also because of that, Singapore has become a tax haven, attracting a huge amount of 'phantom' FDI from the multinationals who seek to reduce tax bills in the host economy[2].

2 *Damgaard, J. and T. Elkjaer. (2017). The Global FDI Network: Searching for ultimate investors. IMF Working Papers No. 17/258*

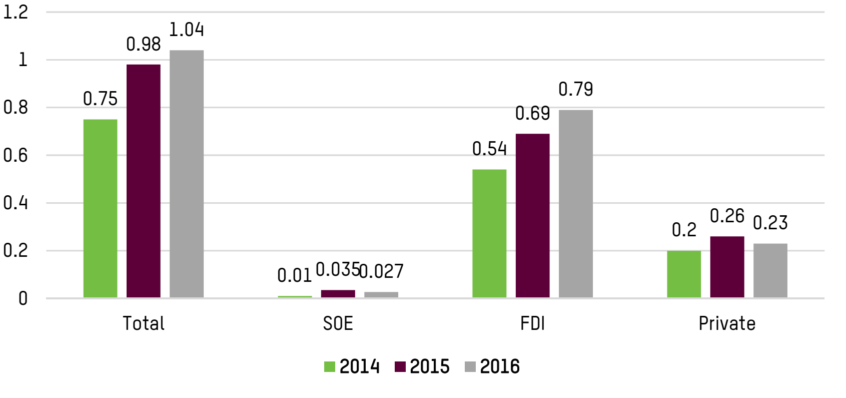
Figure-3: Average effective tax rates with and without incentives in ASEAN countries, 2015 (%)



Source: Wiedemann and Finke (2015)

Furthermore, the costs of redundant fiscal incentives can possibly exceed the benefits of additional FDI. Offering excessive CIT cuts poses a threat to national budget revenues in terms of tax expenditure. Lost budget revenue due to corporate tax incentives was estimated to be 6% GDP in Cambodia and 1% GDP in Vietnam and the Philippines[3]. Philippines gave away an estimated PHP1.12 trillion (equivalent to USD22.17 billion) due to tax incentives and exemptions to a select group of 3,150 companies from 2015 to 2017. In Vietnam, the total revenue impact of tax incentives given to corporate taxpayers in 2016 was VND 46.83 billion (equivalent to approximately $2.06 billion), of which 75.5% was shared by foreign investors.

Figure-4: Incentives on the CIT/GDP in Vietnam, 2014-2016 (%)



Source: GSO (2018)

3 *OECD (2019), OECD Investment Policy Reviews: Southeast Asia. www.oecd.org/investment/oecd-investment-policy-review-southeast-asia.htm (Accessed 6 May 2020).*

Offering tax incentives can produce negative externalities that are detrimental to economic efficiency. The existence of tax incentives is likely to shift the focus of companies from expanding production to minimizing tax bills. An unfair investment environment can also be a consequence of preferential tax policies from which only foreign investors can benefit. In countries with generous tax incentives, there are warning signs of tax avoidance through profit shifting[4]. It is estimated that profit shifting results in losses of at least 6-9 percentage points of potential corporate tax revenues in countries like Thailand, Indonesia, and Malaysia[5]. In Singapore, the use of special purpose vehicles (SPV) is growing, reducing the usefulness of FDI as a measure of real economic activity. These entities open investment opportunities for multinationals, but they can also be utilized for the purpose of tax avoidance through tax treaties that often include excessive tax incentives.

4 VEPR, Oxfam in Vietnam, The PRAKARSA, & TAFJA. (2020). Towards Sustainable Tax Policies in the ASEAN Region: The Case of Corporate Tax Incentives. Hanoi, Vietnam.

5 See more at: https://missingprofits.world/

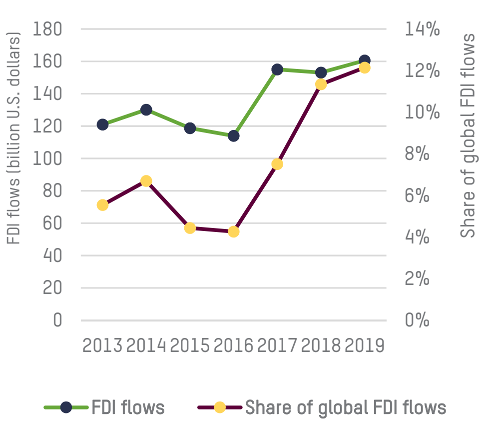
Besides tax incentives, the use of non-tax incentives has been widespread among ASEAN countries and exacerbated the race to the bottom in the region. The competition in providing non-tax incentives is centred on land incentives. This competition in land incentives among ASEAN countries is subsequently enlarging the socio-economic equality, and the non-transparent mechanism of granting land incentives in Cambodia, Laos, and Myanmar is opening opportunities for corruption and rent seeking[6].

Long-term land lease is available in all ASEAN countries, and Thailand even allows foreign investors to own land in some special cases. Vietnam and Laos provide rent exemption or reduction to investment projects in hardship regions or promoted production activities. According to Rolfe (1993), the survey on the attractiveness of investments incentives in the Caribbean region suggests that investors from the U.S. do not show much interest in the above types of non-tax incentives. Land grants rank 17th, training subsidies rank 13th, and financial rank 10th among 20 available incentives in the rankings of attractiveness to foreign investors[7].

BUSINESS ENVIRONMENT IS THE KEY DETERMINANT OF FDI LOCATION DECISIONS

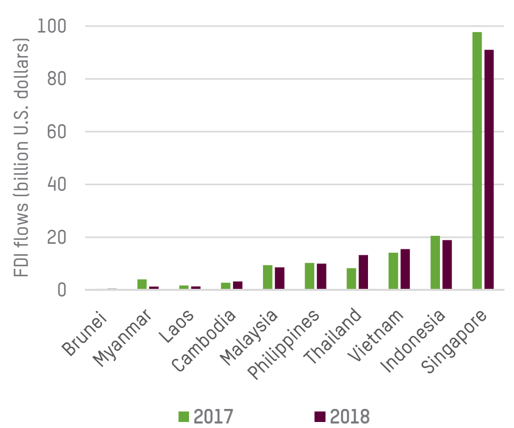
The increasing attraction of ASEAN as a dynamic and competitive location for foreign direct investment (FDI) has recently been apparent. During the period of 2014-2016, ASEAN experienced a fall of 12.5% in FDI flows, suggesting the region's gradual loss of attraction to foreign investors. However, from 2016, FDI inflows into ASEAN rose again with an annual growth rate of 13.65% and ended up at $116 billion in 2019. Notably enough, the share of ASEAN's inflows in the global value has tripled in just three years since 2016[8].

FDI flows in ASEAN, 2013-2019



Source: ASEANStatsDataPortal (2020) and World Bank (2020).

ASEAN's FDI flows by country, 2017-2018



Source: World Bank (2020).

6 *OECD. (2019). OECD Investment Policy Review of Southeast Asia. http://www.oecd.org/investment/oecd-investment-policy-review-southeast-asia.htm*

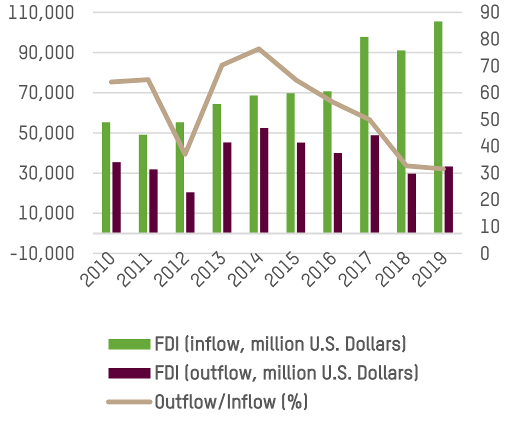
7 *Hoang, H. H. (2012). Foreign direct investment in South-East Asia: determinants and spatial distribution. Centre of Studies and Research on International Development*

8 *The authors' calculations based on World Bank's World Development Indicators.*

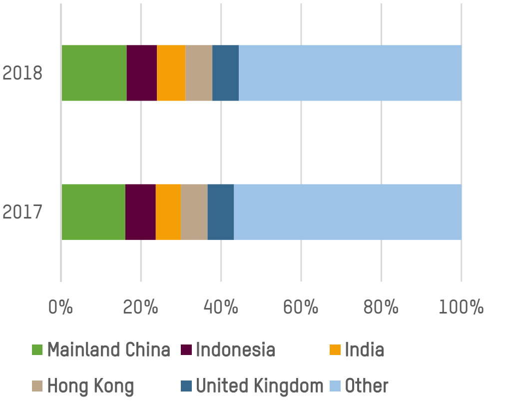
Intra-regional investments had the largest share in the total FDI inflows into ASEAN in 2018, which was around 15.90%. In 2018, more than $15.5 billion of $24 billion of intra-ASEAN investments came from Singapore[9]. By the end of 2018, Indonesia was the largest recipient of FDI from Singapore in ASEAN with a stock of more than $48 billion, followed by Malaysia with $35.4 billion and Thailand with nearly $20 billion. More interestingly, Singapore also possessed both the largest FDI inflows and the highest ratio of FDI to GDP in the region, accounting for more than half of total flows to ASEAN. However, ***a large proportion of FDI into Singapore was 'phantom' FDI,[10] which was soon reinvested in other countries so that the businesses could enjoy enormous tax incentives offered by Singapore***.

In the period of 2010-2018, on average, about 60% of the FDI inflows into Singapore were reinvested in other countries, in which Mainland China was the largest recipient with the share of more than 21% in Singapore's outward direct investment and followed by Indonesia with the share of 10%. ***Singapore's function as an intermediary investor can be damaging to the tax bases of other countries since it gives investors opportunities to avoid paying taxes in the host countries***[11].

Singapore's FDI and OFDI, 2010-2018



Top 5 Singapore's FDI outflow by country, 2017-2018



Note: No available data on FDI outflow by country in Singapore.

Source: Singapore Department of Statistics (2020).

9 Based on ASEANStatsDataPortal

10 Phantom FDI refers to "investments that pass through empty corporate shells. These shells, also called special purpose entities, have no real business activities. Rather, they carry out holding activities, conduct intrafirm financing, or manage intangible assets—often to minimize multinationals' global tax bill." See this definition in Damgaard, J., T. Elkjaer, and N. Johannesen. (2019). The Rise of Phantom Investments. Finance & Development, 56(3), page 12.

11 Damgaard, J., T. Elkjaer, and N. Johannesen. (2019). The Rise of Phantom Investments. Finance & Development, 56(3).

Empirical work suggests that business environment indicators are key determinants of FDI location decisions. UNIDO (2011) finds that economic stability, political stability, cost of raw materials, local markets, transparency of legal framework, and availability of skilled labor play the most decisive roles in the investment location decisions of multinationals in sub-Saharan African countries[12]. Reducing regulatory restrictions on FDI is also a crucial step to increase FDI flows into the region. Human capital, labor quality, and labor productivity in the host country are judged by foreign investors to be relatively important, especially when compared to cheap labor costs[13]. Countries with effective intellectual property rights (IPR) enforcement are more likely to succeed in encouraging FDI, especially FDI that involves knowledge-based assets[14]. Governments, however, should stimulate domestic innovation to fill the technological gaps at the same time as tightening IPR protection so as not to discourage domestic technological diffusion[15]. The quality of infrastructure, particularly the density of high-quality roads, is also among the key factors of FDI decisions[16].

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12 *United Nations Industrial Development Organization (UNIDO) (2011a). "Africa Investor Report: Towards evidence-based investment promotion strategies". Available from https://www.unido.org/fileadmin/user_media/Publications/ Pub_free/AIS_Report_A4.pdf*

13 *Hoang, H. H. (2012). Foreign direct investment in South-East Asia: determinants and spatial distribution. Centre of Studies and Research on International Development.*

14 *Adams, S. (2010). Intellectual property rights, investment climate and FDI in developing countries. International Business Research, 3(3), 201.*

15 *Yi, X., & Naghavi, A. (2017). Intellectual property rights, FDI, and technological development. The Journal of International Trade & Economic Development, 26(4), 410-424. doi:10.1080/09638199.2016.1266380*

16 *Goodspeed, T., Martinez-Vazquez, J., & Zhang, L. (2011). Public policies and FDI location: Differences between developing and developed countries. FinanzArchiv: Public Finance Analysis, 67(2), 171-191. doi:10.1628/001522111X588736*

Results from analyses of correlation between business environment and FDI attraction also indicate positive associations between FDI location decisions and drivers of macroeconomic environment, institutional quality, and market development.

Figure. Selected business environment factors and their correlation with FDI flows

Factors	Linear correlation with FDI flows		Factors	Linear correlation with FDI flows	
	Strong, positive	Moderate, positive		Strong, positive	Moderate, positive
Macroeconomic environment			Market development		
Macroeconomic and Investment environment		✓	*Market size*	✔	
Economic freedom		✓	Other factors		
Economic openness	✔		Infrastructure		✓
Institutional quality			Technological readiness		✓
Governance*		✓	*Human development*	✔	
Ease of doing business	✔		Higher education and training		✓

*Note: * Three dimensions, which are tested separately: Government effectiveness, Corruption perceptions, and Regulatory quality. The correlation is strong and positive if the Pearson correlation coefficient is at least 0.65, is moderate and positive if the correlation coefficient ranges from 0.3 to 0.65.*

Source: Authors' calculations and classification.

In ASEAN, conditions of the business environment varied widely among the Member States. Except for Singapore and Brunei, business environment in ASEAN is comparably inconducive. Given that many business environment factors are major determinants of FDI locations, considerable improvements in those factors are needed for ASEAN countries to attract FDI[17]. Cambodia, Laos and Myanmar are often scored the lowest in terms of business environment factors, especially institutional quality. These countries get negative scores for both government effectiveness and regulatory quality and rank among the world's most corrupt countries, with Cambodia ranking 161st among 180 countries assessed in the world rankings of corruption perceptions.

Other countries in the region, including Indonesia, Malaysia, Thailand, the Philippines, and Vietnam offer relatively conducive environments when compared to Cambodia, Laos, and Myanmar, but they still have a long way to catch up with the world's highest-ranked countries.

17 *Based on Heritage, Legatum Institute, WEF, and World Bank.*

The major share of manufacturing FDI in the total flows into these five countries is attributable to their success in developing skilled and educated workforce.

CONCLUSION AND RECOMMENDATIONS

Despite the importance of ameliorating the business environment, ASEAN governments tend to focus more on competing in a harmful race to the bottom by offering excessive tax and non-tax incentives to attract FDI.

This practice affecting countries capacity to mobilize domestic revenue to finance public spending on services that are essential to fight poverty and reduce inequality and may not necessarily determining the level of FDI flows as discussed above that there are many other priorities for investors than only tax incentives.[18]

Economic and social divergence in ASEAN is increasing due to the needless race to the bottom. Rather than collective good, ASEAN countries tend to prioritize their own interests and compete in attracting FDI by offering redundant tax and non-tax incentives.

The ASEAN Member States need to react at the political level to stop the race to the bottom. No evidence suggests that tax incentives and non-tax incentives especially site incentives are seen by foreign investors as a key factor in their decision-making process. Indeed, tax incentives can even become obstacles in certain cases19.

In view of the above facts, this policy brief makes the following recommendations:

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18 *Based on IMF's Fiscal Monitor Database, no available data in Brunei to calculate its budget deficits*

19 *James, S. (2014). Tax and non-tax incentives and investments: Evidence and Policy Implications. Investment Climate Advisory Services. World Bank Group.*

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RECOMMENDATION 1: DRAW UP A WHITELIST AND A BLACKLIST OF TAX INCENTIVES

The ASEAN should put all tax incentives that should not be allowed in a blacklist, provide a plan to phase them out in the region by a certain date. In parallel with this, the ASEAN should agree on a whitelist in which tax incentives could be allowed and eligible in the region. The blacklist should include foremost profit-based tax incentives, meaning those incentives that offer a low tax rate for profits made, like tax holidays, large tax exemptions, loss carry-backs, and preferential rates. Academics and international organisations like the OECD have already called on the ASEAN countries to stop offering these kinds of incentives due to their harmful nature and marginal positive effects. The white list should include investment-based tax incentives, meaning those incentives focusing on the investment made by the investor. These incentives are proven to be much more productive than profit-based incentives. Although, also these incentives should be monitored for their effectiveness and abuses should be avoided like super deductions, or super tax credits.

There should be a mechanism in place at the regional level to monitor tax policy developments and decide which incentives should be blacklisted or whitelisted. This mechanism should be transparent and inclusive, meaning that both political representatives and technical experts from administrations, civil society and academia are involved.

RECOMMENDATION 2: STOP THE COMPETITION IN PROVIDING SITE INCENTIVES

ASEAN countries need to stop competing in providing land incentives as a means of attracting FDI because of their harm to the local society under the form of land conflict and income disparities. Rent exemption should be phased out from the site incentive packages. The Member

States should also have a regional approach to the economic land concession standards, particularly agreeing on a maximum length of 50-year leasehold period for the region. The governments should authorize rent price adjustment on a quinquennial basis instead of fixing rent prices for the whole lease period.

Instead of offering land incentives, ASEAN countries need to coordinate efforts and budget to develop infrastructure components such as roads and utilities, especially in the industrial and economic zones, for the purpose of FDI attraction.

RECOMMENDATION 3: AGREE ON A MINIMUM TAX STANDARD ACROSS THE ASEAN REGION

To stop the race to the bottom, ASEAN countries need to set a minimum corporate tax rate and ensure not to offer corporate tax incentives below the level of the minimum rate. The appropriate rate is suggested to range between 12.5% and 20%. This would protect countries' domestic tax revenues and stop the existing beggar-thy-neighbour approach to policy making.

RECOMMENDATION 4: ESTABLISH RULES FOR THE GOOD GOVERNANCE OF INVESTMENT INCENTIVES

The ASEAN countries should agree on a rulebook for incentives with clear timeline and recipient selection criteria for each incentive instead of giving incentives to companies arbitrarily. The Member States should also develop a transparent and accountable mechanism for reporting granted incentives to ensure cooperation across the region. They need to incorporate all tax incentives into the relevant corporate tax code and publish annual tax expenditure reports along with their annual budget documents. For the purposes of transparency and good governance, the governments should carry out a cost-benefit analysis before the approval of any tax or non-tax incentive and a mid-term evaluation when incentives have been granted.

RECOMMENDATION 5: AGREE UPON IMPROVING BUSINESS ENVIRONMENT, FOCUSING ON THE KEY FACTORS

The ASEAN Member States should agree on a list of business environment factors that are key to attracting FDI. They should also rank or classify the factors according to the level of significance. The top priorities should be (i) the economic openness, (ii) ease of doing business, and (iii) human capital.

In parallel with it, the countries should make efforts to enhance other indicators of macroeconomic environment and institutional quality such as economic freedom, government effectiveness, regulatory quality, infrastructure quality, and technological readiness.


Oxfam in Vietnam

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