Emerging Tax Issues: Implications of Globalization and Technology

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Introduction

In recent years many tax administrators have begun to fear that the twin phenomena of globalization and technological advancement are eroding tax bases. This concern merits serious consideration because taxes are the principal source of revenue that governments use to finance public expenditures that promote economic growth, stability, and equitable income distribution. Although a government may borrow to finance expenditures that exceed present revenues, in the long term, public borrowing is repaid through future tax revenue. Therefore, it is crucial for governments to cope with these new tax revenue challenges effectively.

By diminishing the importance of national borders, globalization has created new multinational, tax-jurisdictional gray areas that make it easier for taxpayers to avoid or evade taxes. Concurrently, new technological advances are making it easier for multinational corporations to manipulate national tax structures to corporate advantage. Many developed countries have adopted tax reforms in the past few decades to counter these very problems. In order for developing countries to rise to these same challenges, it is important to learn from the example of developed nations and to assess the effect of globalization and technology on their own unique tax programs.¹

This brief reviews taxation practices in developed and developing countries and then provides tax authorities of developing countries some guidelines for coping with globalization and technological advancements.

Key Issues

With globalization and technological advancement, factors of production move across borders more freely. Goods and services are traded in a greater volume all over the world. Given the freedom of

¹ In order to help tax administrators better cope with such new challenges, the Asian Development Bank and the ADB Institute made these issues the focus of the 12th Tax Conference, which they jointly hosted in Tokyo in October 2002. Tax officials from 25 Asian and Pacific countries attended the conference to share their knowledge and learn from international experiences. This brief draws on the findings of this conference.
movement, capital, labor, raw materials, and intermediate and final goods and services tend to move to and be consumed in lower-tax countries. As globalization and technological advancement accelerate, many tax jurisdictions compete among themselves by reducing tax rates or introducing tax incentives to attract investors and mobile, skilled laborers. European Union (EU) members have long suffered from harmful intra-EU tax competition. The EU has therefore continually striven to develop policies and mechanisms that would reduce harmful tax competition—the so-called “race to the bottom” problem. EU tax authorities have been actively designing and legalizing tax harmonization to curb tax competition.

Multinational corporations (MNCs), which have a special interest in expanding their operations globally, can penetrate and become important players in developing markets because local companies have limited capital to compete. However, developing countries have limited knowledge of MNC mechanisms and operations. Since countries in the Organisation for Economic Co-operation and Development (OECD) are home to many MNCs and since the OECD is considered the global authority on the operations of MNCs, tax authorities of developing countries can minimize revenue loss by learning about OECD guidelines such as those governing transfer pricing. MNCs tend to manipulate transfer prices among their subsidiaries to minimize their overall tax liabilities.

In response to trade competition from outside the region, many developing member countries (DMCs) of the Asian Development Bank are seeking to establish, expand, and deepen regional trade arrangements (RTAs). Joining an RTA generally reduces DMCs’ short-term tax revenue, since these countries rely heavily on international trade taxes. To compensate for such losses, tax authorities should introduce or improve the collection of buoyant and broad-based taxes such as value added tax (VAT) and general sales tax. VAT is especially important because it is difficult to evade while tax bases of other taxes are shrinking due to globalization and technological advancements.

Globalization and technological advancements reduce both the efficiency and equity of tax systems by complicating tax collection and creating new ways for avoiding or evading taxes. They also allow taxpayers to raise income outside of conventional channels without tax authorities’ knowledge. To raise and maintain taxpayers’ morale and to make them aware of their responsibilities, rule-based tax laws and practices must be honored. Good governance and good tax practices are all-around improvements that governments can use to
bolster their revenue collection in the face of globalization and technological advancement.

**Taxation Trends in the European Union**

Examine recent taxation trends in the European Union can shed some light on the future of taxation among DMCs. Although no group of DMCs have committed to forming an economic grouping that would be as deeply integrated as the EU, many DMCs have entered into RTAs that have a mandate to reduce trade barriers among member countries.

In terms of taxation, the EU seeks to harmonize taxes among member countries in order to avoid the race to the bottom among tax administrations. To realize this goal EU member countries have increasingly come to rely on multilateral rather than bilateral tax agreements. Multilateral agreements normally require that signatories adopt compulsory rules or recognize an international governing body. Most governments are less willing to relinquish sovereignty over direct taxes than indirect taxes. In Europe, the EU has harmonized indirect taxes, such as sales tax, more successfully than direct taxes, like corporate income tax. This should be good news to developing countries because sales tax is generally easier to administer and collect than income tax. Although the EU has not yet successfully harmonized direct taxes, discussions about harmonizing corporate taxes are ongoing.

The EU has long experimented with various policy responses to the intensifying globalization and technology advancement. The EU experience suggests that DMCs will have to shift away from bilateral toward multilateral tax agreements. In preparation for the shift, regional tax policymakers should discuss the possibility of regional cooperation and harmonization of tax policies.

**Transfer Pricing**

Although developing countries are advised to concentrate primarily on indirect tax reforms, direct tax in the form of corporate income tax remains one of the most important revenue sources for DMCs. Furthermore, as MNCs are increasing their presence in the region, DMCs face the growing risk of losing tax revenue to MNCs that manipulate transfer pricing. Transfer pricing refers to the setting
of prices for transactions among multinational enterprises that are subsidiaries of a multinational corporation, where the prices are not subject to market determination. MNCs often manipulate transfer prices among subsidiaries in different tax jurisdictions to minimize overall corporate tax liabilities. For example, two trading partners who are subsidiaries of the same MNC may evade corporate income tax using the following tactic. The purchasing subsidiary might overstate the price of a product sold by the selling subsidiary when the selling subsidiary is subject to a high tax rate and the purchasing subsidiary is subject to a lower tax rate.

The OECD has adopted international tax rules that address the problem of transfer pricing by enabling tax authorities to adjust transfer prices using the Arm’s Length Prices (ALP) principle. The ALP principle states that if conditions made between associated enterprises in their commercial or financial relations differ from those that would have been made between independent enterprises, then profits that would have accrued to one of the enterprises may be included in the profits of that enterprise and thus be subject to taxation. The ALP principle is designed to eliminate tax distortions by treating all enterprises as separate entities regardless of their relationship.

Although applicable to most transactions, the ALP principle has its shortcomings. Since multinational enterprises take advantage of economies of scale, transactions among their subsidiaries are often genuinely less costly than transactions between nonrelated entities. Multinational enterprises also undertake transactions that independent entities would never make. These factors make it difficult for tax authorities to apply the ALP principle. To make matters worse, tax authorities normally do not audit such transactions until several years after this occurrence and it is difficult to get relevant information about market prices of transactions between independent entities. To cope with these problems, the OECD recommends specific guidelines for tax authorities to assess Arm’s Length prices that are flexible but based on specific methods that are compatible with the transaction. Applying these guidelines yields a range of prices that would require a compromise between taxpayer and tax authorities. For a DMC, this happy medium is naturally an outcome of adopting and adapting established rules from developed countries before the DMC perfects its own rules. As of now, DMCs can immediately adopt and implement these OECD-originated guidelines to reduce revenue loss due to tax avoidance by MNCs.
Value-Added Tax

In order to make the most of economic globalization, many DMCs have entered into regional trade agreements or joined the World Trade Organization. Such trade groupings require countries to reduce overall dependency on international trade taxes. To compensate for lost international-trade tax revenue many countries have sought to increase revenue derived from indirect sales taxes and one effective method for achieving this goal is replacing turnover sales tax with value added tax. Turnover sales tax doubly taxes consumers and is easily evaded. VAT, however, eliminates double taxation, promotes business competitiveness, and is more compatible with a liberalized trade regime. Within ASEAN, VAT collection has been very responsive to economic growth. Many DMCs such as Cambodia, Thailand, and Viet Nam have relied primarily upon VAT revenue to compensate for revenue lost due to tariff rate reductions.

Since VAT requires systematic bookkeeping and accounting, tax authorities that wish to adopt VAT must carefully design rules, laws, and administrative procedures to facilitate a smooth transition. They must also disseminate adequate information so that all parties will know how to fulfill VAT requirements. VAT should be introduced during the slowest time of the business year to minimize transitional problems. Governments must monitor prices fixed by large businesses to prevent them from using the introduction of VAT as an excuse to raise prices unreasonably.

The implementation of VAT is complex. Some governments choose to exempt small businesses and financial institutions from VAT and instead impose business turnover taxes. Thailand, for example, exempts from VAT goods that are inelastic and necessary for the poor, such as unprocessed food, unprocessed agricultural products, medicines, and textbooks.

In spite of VAT’s clear advantages, some countries in the Asian and Pacific region, including the Philippines and Thailand, have encountered problems administering VAT because economic circumstances are continually and rapidly changing. For example, certain transactions that are not subject to or are difficult to assess for VAT have increased dramatically in recent years. These include international business transactions, trade in services, and electronic commerce. Since VAT was originally designed for application to the sale of goods in closed economies, such developments present new challenges to tax administrators. Policymakers must, therefore, constantly monitor the economic environment and adjust VAT
administration accordingly. The adjustments include tax base coverage, tax rates, payment measures, and tax exemptions.

**Good Governance and Anticorruption**

In a world where taxpayers are increasingly capable of capitalizing on international tax loopholes with the aid of state-of-the-art technology, governments cannot overemphasize the importance of maintaining well-governed tax administrations that are free from corruption. Several international financial institutions, including the ADB, have recently adopted good governance policies. Many countries worry, however, that international organizations might use these policies to intervene in domestic political affairs. In spite of the sensitive nature of this issue, certain aspects of good governance, such as transparent and comprehensive legal structures, undoubtedly promote better tax administration.

Good governance is the effective and efficient management of national social and economic resources and, by extension, effective and efficient tax administration. Good governance helps ensure that lawful taxes are paid so that public services are adequately funded. Corruption in tax administration can be prevented by adopting tax laws that are clear, concise, and comprehensive and by applying sensible penalties to punish all parties involved in tax wrongdoings.

**Conclusion**

In designing tax reforms, tax authorities in developing countries should be aware of taxation trends and practices in both developed and developing countries. The experiences of developed countries can serve as a model of probable future tax trends and thus enable tax authorities to prepare for the long and medium term. In the short term, developing countries can also quickly adapt and implement complex tax regulations and guidelines that developed nations have already designed and tested, such as transfer pricing rules. Beyond this, developing countries can also learn other valuable lessons from the recent experiences of developing nations. Such peer experience is especially relevant because all developing economies share the common tax problems of large informal sectors and low ratios of taxpayers to total population.
In coping with the erosion of tax bases caused by globalization and technological advancements, tax authorities in developing countries must adjust tax policies and administrations to minimize revenue loss. First, tax administrations should rely more heavily on indirect than on direct taxes, while moving from bilateral toward multilateral tax agreements. Favoring indirect taxes, like value added tax, helps to broaden the tax base, reduces overall tax rates, and thus lightens individual tax burdens and distortions. By resorting more to multilateral tax agreements, countries can efficiently reduce the likelihood of double taxation and tax competition among different tax administrations. Second, to prevent multinational corporations from avoiding taxes by manipulating transfer prices, tax authorities should adopt a form of the arms-length-pricing principle, such as that used by the OECD. Essentially, this is one example of a legal reform designed to prevent taxpayers from avoiding taxes by manipulating difference in tax rates among different countries. Third, developing countries that have not already done so should replace turnover sales tax with value added tax. Because VAT is broad-based, governments can lower the tax rate and thereby reduce the overall excess burden. Fourth, developing countries must implement effective good governance and anticorruption programs in the realm of tax administration in order to reduce tax leakages.

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