Mobilizing Taxes for Development

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In this publication, "$" refers to United States dollars.

Developing Asia faces significant spending pressure as it transitions toward more sustainable and inclusive growth. The wake of the COVID-19 pandemic amplified the public fiscal pressure as it lowered tax revenues and increased public spending. Now is the appropriate time to administer fiscal consolidation strategies tailored to country-specific circumstances—with tax policy playing a vital role. Timely implementation of changes in the tax system and strong leadership and political will at the highest levels of government—in tandem with efforts to strengthen tax administration and improve taxpayer morale—will yield tax reform success.

FISCAL PRESSURES ON THE RISE

Developing Asia faces significant spending pressure as it transitions toward more sustainable and inclusive growth. Even before the COVID-19 pandemic, achieving the Sustainable Development Goals (SDGs) by the target year 2030 necessitated the region to spend an additional $1.5 trillion annually, equal to 5% of gross domestic product (GDP) (UNESCAP 2019). Moreover, additional spending needs are typically larger in the poorest countries (Gaspar et al. 2019). A stark illustration of this trend is spending needs for climate finance: the Pacific region, with just 0.1% of regional GDP, accounts for over 1.1% of the current total climate finance in the entire region to meet the nationally determined contribution target of 2030 (ADB 2023). On the other hand, the wake of the pandemic likely widened the fiscal shortfalls as the collapse in activity lowered revenue even as spending needs increased (Benedek et al. 2021).
Weaker revenue and higher spending erased fiscal surpluses or expanded deficits. The outbreak of COVID-19 hurt the economy and pushed up the expenditure demands. While the general government revenue in emerging and developing Asia dropped from 25.0% of GDP in 2019 to 23.6% in 2020, total expenditure increased from 30.7% to 32.6% in the same period, resulting in the higher government outstanding debts at 73.3% of GDP in 2022 compared with 58.9% in 2019. In some economies, debt has reached uncomfortable levels and is projected to rise further in the coming years (Ferrarini, Giugale, and Pradelli 2022). Many governments will require fiscal consolidation to ensure fiscal sustainability (Blanchard, Felman, and Subramanian 2021; Favara, Minoiu, and Perez-Orive 2021; Kose et al. 2021).

For most governments, taxes are the primary source of revenue and largely define the public spending envelope over the medium and longer term. Government spending normally exceeds tax revenue, with the balance made up from borrowing and nontax revenue, thus spending rises with tax revenue in developing Asia and elsewhere (Figure 1). Within developing Asia, the correlation is much weaker among Pacific Island economies. This reflects the high cost of providing government services to dispersed populations and unusually high nontax revenue from fisheries, foreign fishing vessel licenses, and official development assistance (Cabezon, Tumbarello, and Wu 2015). The average public spending in developing Asia—including Pacific Island economies—equals about 27% of GDP, comparable to developing regions, but far below the Organisation for Economic Co-operation and Development (OECD) countries (Figure 2).

Developing Asia needs to mobilize tax revenue to finance the additional public spending for inclusive and sustainable development. Governments must draw on the full range of public and private financial resources to meet vast spending demands. However, both state-owned operations revenue and private financial flows can be unreliable. For most governments, taxes are the primary source of revenue and stand alone as the best option to expand government resources reliably. A central challenge for governments is to raise additional revenue without sacrificing the economic growth vital to reduce poverty further and raise living standards.

![Figure 1: Tax and Selected Expenditure, 2015–2019](image)

Higher taxes are associated with higher government spending on education and health, but not on defense.

GDP = gross domestic product, OECD = Organisation for Economic Co-operation and Development.


1 IMF. World Economic Outlook October 2021 online database (accessed 6 November 2023).

2 While public expenditure is beyond the scope of this brief, improving spending efficiency is an important additional avenue for expanding fiscal space and achieving better outcomes.
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Personal income tax
Corporate income tax
Other goods

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by international standards, with a lower revenue share of
personal income tax. For instance, the tax-to-GDP ratio for those
economies remains below an often-applied minimum threshold of
about 15% (Gaspar, Jaramillo, and Wingender 2016). Developing
Asia could increase tax revenue from a prepandemic average of
about 16% of GDP by 3–4 percentage points. 4 The region relies
heavily on value-added tax (VAT) and on other consumption
taxes, including excises (Figure 3). 5 On average, sum of the
revenues from those taxes account for a little under half of the tax
revenue in regional economies. These shares are comparable to
those in other regions; and corporate income taxes in developing
Asia account for about 21% of tax revenue—a little higher than in
other developing regions and double the share in OECD countries.
On the other hand, personal income taxes in developing Asia
account for 13% of tax revenue—much lower than in OECD
countries, where these taxes make up over a third of tax revenue.

REVENUE MOBILIZATION AND REFORM
AT STAKE

ADB analysis suggests significant room for raising additional tax
revenue in South and Southeast Asia (ADB 2022). Tax capacity
is the theoretical maximum tax revenue an economy can mobilize,
given its characteristics; and tax effort is the ratio of actual tax
revenue to tax capacity. 6 High tax effort indicates actual tax

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Sources:
IMF. World Economic Outlook October 2021 online database. https://www.imf.org/;
ADB estimates.

5 VAT was introduced widely throughout the region since the 1980s and 1990s.
collection close to tax capacity and thus less potential to increase revenue. Low effort indicates more room for higher revenue by raising tax rates, broadening tax bases, or improving compliance. New indicative tax capacity estimates suggest that developing Asia can increase tax revenue on average by the equivalent of 3.6% of GDP, which is significant given the current low tax (Gupta and Jalles 2022).

New indicative tax capacity estimates suggest that developing Asia can increase tax revenue on average by the equivalent of 3.6% of GDP, which is significant given the current low tax (Gupta and Jalles 2022). Tax effort is low, and the potential to increase taxes is substantial in Southeast Asia, particularly in Malaysia and Thailand. In contrast, tax effort and actual revenue are relatively high in the People’s Republic of China (PRC), the Republic of Korea, and some Pacific Island economies (Figure 4). Substantial subregional variation exists in tax capacity and tax effort, which underscores the need for economy-specific approaches to increase revenue.

Making tax progressive is critical to fix the excessive inequality. Central to a progressive tax system is personal income tax with marginal rates that impose proportionately higher tax liability on higher earners. A key challenge in increasing personal income tax revenue in developing economies is prevalent self-employment, as a dearth of third-party information hinders enforcement (Jensen 2022). The average top marginal rate of about 27% is much lower than 40% in OECD countries, but this obscures enormous variation within the region. India, Papua New Guinea, and the PRC have top marginal rates comparable to or higher than the OECD average, while many Central Asian economies apply a flat tax rate of 10%–13% (Gupta and Jalles 2022).

Property taxes are potentially progressive, efficient, and difficult to evade. As shown in the table on page 5, progressive income tax may not be sufficient to reduce inequality in some economies. In economies where the distribution of wealth is highly skewed and the return on capital is disproportionately higher than the wages, a combination of a progressive income tax with some sort of capital tax is essential to keep inequality below acceptable levels. A big challenge for implementing a general wealth tax is the mobility of assets, but real estate property is less mobile and thus cannot readily be shifted. Also, property taxes can bolster subnational governments’ revenue that can be used to cover the increasing costs for public services in the cities under rapid urbanization, which is a challenge in some parts of developing Asia (Bahl and Bird 2018; McCluskey, Bahl, and Franzsen 2022). Most economies in developing Asia levy property taxes, but these generally raise little revenue—on average equal to a few tenths of a percentage point of GDP (McCluskey, Bahl, and Franzsen 2022). Governments must improve property valuation to capture the rising value and enable growth in the tax base.


Corporate income tax revenue faces multiple pressures of erosion in developing Asia as well. Governments motivated by a desire to attract internationally mobile capital and maintain competitiveness have steadily reduced corporate income tax rates across the region over the past few decades. Such rates are typically 20% across developing Asia, down from 30% in 2000 and a little lower than Latin American and OECD averages (Figure 5). Apart from the international competition in lowering the statutory tax rate, tax incentives are frequently overused to increase business investment on the grounds that higher investment will ultimately increase tax revenues, which a study found is not the case (Kronfol and Steenbergen 2020). Additionally, expanding activities of multinational enterprises allow them to exploit the weakness of international tax framework. Because of profit shifting and tax avoidance over cross-border transactions, 4%–10% of corporate income tax revenue is lost globally, with larger losses in developing countries (Crivelli, De Mooij, and Keen 2016).

Environmental and corrective health taxes can contribute directly to the SDGs by correcting behavior and raising additional revenue. Some Asian economies have some types of environmental taxes, including taxes on polluting fossil fuels. However, in 2018, revenues from energy, pollution, and transportation taxes in a sample of economies in developing Asia were only 0.8% of GDP, far lower than the 2.3% in OECD countries. Corrective health taxes, mainly on alcohol or tobacco consumption, have also become more common in developing Asia. These taxes can discourage the consumption of harmful products and save significant socioeconomic costs by suppressing early mortality from unhealthy diets. The proportion of deaths from noncommunicable diseases in developing Asia has risen substantially—from 52% in 1990 to 77% in 2019 (Figure 6). In low- and middle-income economies, these corrective health taxes can also raise up to 0.6% of GDP in additional tax revenue (Lane 2022).

Costly tax expenditures need to be reviewed and tightened, especially for VAT and corporate income tax. Tax expenditures are widely used in developing Asia and cause significant revenue losses. The forgone revenue in a sample of economies in developing Asia was substantial, equal on average to 2% of GDP or 14% of tax revenue (ADB 2022). VAT exemptions may benefit the poor, but they often benefit the wealthy even more because they consume more, making exemptions generally inefficient improvers.
of equity. For corporate income tax, temporary tax expenditures are often introduced in a cyclical down term and repeatedly extended for a longer period. Temporary stimulus measures should be allowed to expire, tax deferrals should be restructured, and stimulus tax cuts gradually removed. Government should simplify tax exemptions and streamline rate structures before raising the tax rates, as it improves taxpayers’ compliance.

CONCLUSION

Developing Asia emerges from the COVID-19 pandemic with weakened public finances. While private finance has a crucial role to play, achieving the SDGs for a greener and more inclusive future requires vast public spending. More efficient public spending can free up additional fiscal resources, but additional revenue mobilization via taxation is essential to augment fiscal space across the region. Fundamental tax reform warrants appropriate timing of the implementation, strong leadership, and political will at the highest levels of government; and it is best done in tandem with efforts to strengthen tax administration and improve taxpayer morale.

REFERENCES


