Anticipating Tax War in the ASEAN Economic Integration Era
Competition Might be Worse Off Following the Implementation of the ASEAN Economic Community

The Indonesian government plans to expand, simplify, and extend the duration of tax holiday policy up to 20 years to boost foreign investment. This might provoke tax competition with neighboring countries, and trigger race to the bottom among ASEAN countries, especially after the implementation of the ASEAN Economic Community (AEC) later this year.

In the region with integrated economy such as European Union or the one that is less integrated such as Africa, race to the bottom phenomenon had taken place. Tax war will bring all the countries in a lose-lose situation, while the super low tax will result in potential loss of state revenues. For Indonesia, this means that the target achievement of 16 percent tax ratio according to Naivacita (Nine Priorities) will be harder to achieve. Therefore, coordination and agreement between ASEAN countries to avoid using excessive low tax instrument to invite investors are urgently needed.

Tax Holiday, Investment, and Tax Revenue

The Indonesian Government plans to broaden the implementation of tax holiday to nine industry, extends the duration up to 20 years, and simplifies the application process. While in the previous policy, tax holiday can only be issued through consultation with the president, now it can be provided only through the Minister of Finance decree. The purpose is very clear: to bring the investors in.

Tax holiday is not a new policy in Indonesia, but over time, the results were far below expectation. In the 1970s when tax holiday policy was enacted, there was no significant investment coming to Indonesia. Instead, when the policy revoked in 1984 and there was no special tax incentives policy, Foreign Direct Investment (FDI) increased rapidly (Nainggolan, 2004).

Research from Banga (2003) in 17 Asian countries including Indonesia concluded that tax incentives had no significant impacts on the increase of FDI inflows. Research from Dewi (2012) also concluded that tax holiday does not significantly influence the investment decision. Even without tax holiday, Indonesia already has many potential resources to attract the investors.

On the other hand, tax holiday facility most likely can be exploited by “deceitful” companies to avoid taxes. Old companies might create a “new” company to gain tax holiday facility. This can be carried out particularly by abusing weak tax administration in the developing countries such as Indonesia or by employing sophisticated concealment techniques, which have been proved in the tax evasion cases of a number of multinational companies (OECD, 2014).

Tax holiday could also potentially eliminate a huge amount of state revenues. Findings from a study in 20 developing countries indicate that the exemption of corporate income tax can eliminate potential tax revenue of around
Table 1
Tax rates in ASEAN Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Corporate Income Tax (%)</th>
<th>Value added tax (%)</th>
<th>Personal Income Tax (%)</th>
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<tbody>
<tr>
<td></td>
<td>Min.</td>
<td>Max.</td>
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<td>22</td>
<td>10</td>
<td>5 35</td>
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Source: ASEAN Briefing, 2014

Figure 1
Corporate Income Tax Rate (%) EU, 1995–2014

Source: Taxation trends in the European Union, 2014 (modified)

To date, tax rates in ASEAN countries are greatly varied. Personal income tax rates ranged from 0 percent in Brunei to 37 percent in Thailand, while corporate income tax rates ranged from the lowest 17 percent in Singapore to the highest 40 percent in Myanmar. Value added tax ranged from 0 percent in Brunei and Myanmar to 12 percent in Philippines (see Table 1). Extreme variation of tax rates range will motivate tax reduction for countries with higher tax rates.

Tax competition had already taken place prior to the implementation of the ASEAN Economic Community (AEC). In 2006 (a year before the AEC blueprint was published) until 2015, all ASEAN-6 countries have been lowering their corporate income tax rates. This reduction is not going to stop since the Philippines is planning to lower their corporate income tax to 20 percent by 2019, while Malaysia will reduce the tax rate to 24 percent in 2016, and Vietnam will lower corporate income tax to 20 percent. These reductions will likely trigger other countries to take similar actions.

In fact, competition among countries in ASEAN to attract foreign investment by providing tax incentives had been started even more than a decade ago, until recent years. Back in 1996, in the competition to lure investment from the General Motors, the Philippines offered corporate income tax exemption for 8 years and Thailand offered similar exemption, with an additional 15 million dollars grant for training facilities. In 2001, to appeal investment from Canon, Vietnam provided corporate income tax exemption for 10 years, but the Philippines competed Vietnam by changing its regulation and gave corporate income tax exemption from 8 to 12 years. Recently, in 2014, in order to entice Samsung’s investment, Indonesia offered the exemption of corporate income tax for 10 years while Vietnam offered 15 years.

0.5 percent of the gross domestic product (GDP). If these findings are applied in the context of Indonesia, it means that potential loss of revenue from tax reaches more than IDR 50 trillion, which is equivalent to the budget of government’s one million house program (subsidized housing program for the poor).

Tax Competition towards the Implementation of ASEAN Economic Community

It is clear that tax holiday does not necessarily attract investment while it potentially reduce state revenue. Furthermore, this policy can also trigger tax competition with the neighboring countries. The possibility for such competition to take place would be greater, especially because the increasing economic integration with neighboring countries through the ASEAN Economic Community can push the spillover effect faster.
Tax competition in the European Union

ASEAN should learn from tax competition phenomenon that has led to race to the bottom among the European Union countries. The race in the region started with Ireland. In 1998, as the result of Ireland’s policy in lowering tax rates to a very drastic and surprising level, other EU member countries then followed the race, thus Ireland is dubbed “the sick man of Europe”. Since 1998, tax rates among EU countries had been dropped significantly (see Figure 1).

In 2011, the average corporate tax rates in the EU was 23 percent, over ten percent decrease from 1998 rate which was 34 percent. After 2011, tax reduction rate still decline, but not as rapid as in the previous period, since the tax rates have already been quite low and there have already a number of collective efforts to prevent harmful tax competition by taking an action of tax harmonization.

Due to the concern of the European Commission and some OECD member countries regarding such “unhealthy” competition, they took a number of efforts to harmonize taxes. Member countries then signed the Common Corporate Tax Base (CCTB) agreement, which is not only meant for tax harmonization, but also to reduce the complexity and compliance costs, including the transfer pricing problems.

Race to the Bottom in Africa

Research from the International Monetary Fund (IMF) concluded that race to the bottom in terms of tax competition also proved to be occurred in Africa. Another research from the IMF mentioned that in 1980, as many as 40 percent of African countries offered tax holiday, the number then doubled to 80 percent in 2005. With such tight competition, findings in Africa proved that there is no relationship between tax holidays and foreign investment.

Even with almost zero tax incentive, the amount of foreign investment will not necessarily increase (see Figure 2) in African countries. From the data in Figure 2, it appears that the reduced tax rate will increase FDI at first, but in the end while tax rates continuously lowered, the FDI was also declined.

In conclusion, the IMF admitted that race to the bottom does take place in Africa. This is quite surprising, because the institution is known for its conservative views that favor low tax rates. This indicates the harmful tax competition in Africa, which is worrying this conservative institution. Even with numerous bad impacts, there is no serious action from the African countries to organize tax harmonization in order to prevent race to the bottom.

Conclusion

From research findings that have been mentioned previously, it is clear that tax holiday does not necessarily increase foreign investment. Tax is actually just one of many determining factors for investment. Businessmen from China, for instance, mentioned that complicated bureaucracy is the major problem in Indonesia before infrastructure and electricity, after which is tax rates. It is not much different from the survey conducted by AT Kearney and a survey of Japanese businessmen (JETRO) who invest in Indonesia.

Research from Dewi (2012) also concluded that without tax holiday, Indonesia is actually an
attractive country to invest. Therefore, the government must focus on the major determinants that affect the investment climate and the entire surrounding problems that need to be fixed. With fourth largest population in the world, rapidly growing middle class, the openness of the society, along with rich natural resources and natural beauty, Indonesia is too attractive to be ignored.

As a matter of fact, the government does not need to put excessive effort in attracting FDI. The classic research from Sritua Arief (1993) reminded that within ten years period, FDI which focused on domestic market will generate total profits that will be repatriated to their country of origin in greater sum than the initial capital invested (net capital outflow). Export-oriented FDI which imported all materials and components from companies within the same group (intra-trade) have more or less similar disadvantageous impact.

In the context of the integration of ASEAN Economic Community, lessons are learned from the experience of European Union and Africa. It is clear that an increasingly integrated region might promote harmful tax competition. To anticipate “race to the bottom”, coordination and agreement among countries to avoid low tax instruments is required. When the race to the bottom took place, ASEAN countries and their people are the ones that will suffer the most.

Based on various data and research that have been presented above, we propose the following recommendations:

1. Head of State and Ministers of Finance of ASEAN member countries need to agree on the agenda to avoid excessive tax instruments in the ASEAN economic integration (AEC) implementation.

2. The Indonesian government needs to prioritize bureaucratic reforms with targets and strict supervision to support the business climate. The government has stated that the nation’s investment is focused on infrastructure and energy, but as long as the bureaucracy remains complicated and invisible cost remains high, the investment climate remains disappointing no matter how low the tax rate is.

3. The Indonesian government needs to establish research and innovation budget allocation of at least 2 percent of the GDP to support domestic business, innovation, production, and science in order to develop economic and social potential by the country itself.

Written by Setyo Budiantoro, Executive Director Perkumpulan Prakarsa (sbudiantoro@theparakarsa.org)

Endnote

[5] Ibid.