A Member
VNU UNIVERSITY OF ECONOMICS & BUSINESS

Towards Sustainable ASEAN Development:

Improved Business Environment is the Key to FDI, Not Tax and Land Incentive Competition

Hanoi, Nov 11, 2020

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Economic Inequality, Social Spending and Fiscal Stretch in ASEAN

■ Economic Inequality

- 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.

Gini Index in ASEAN Countries, 2000- 2017

Country	**Income Gini index**		**Income share held by poorest 40%**		**Income share held by richest 10%**		**Wealth Gini index**
	2000-2009	2010-2017	2000-2009	2010-2017	2000-2009	2010-2017	2016*
Philippines	46.9	45.5	13.8	14.5	36.8	35.6	83.9
Malaysia	45.9	42.1	13.6	15.4	34.5	32.1	82.0
Singapore	n. a	39.8	n. a	n. a	n. a	n. a	73.3
Indonesia	33.5	38.9	21.0	17.7	27.1	31.2	83.7
Myanmar	n. a	38.1	n. a	18.6	n. a	31.7	n. a
Thailand	41.3	37.6	16.3	18.0	32.2	29.3	85.1
Cambodia	n. a	36.6	n. a	n. a	n. a	n. a	70.0
Laos	34.0	36.4	20.4	19.1	28.2	29.8	84.9
Vietnam	36.3	36.3	18.7	18.5	28.6	28.1	74.5

Note: *Income Gini indices for Cambodia and Singapore, wealth Gini Indices for all ASEAN countries are collected from WEF (2018). The others are from WB (2020). A Gini index of 0 represents perfect equality, while an index of 100 implies perfect inequality. This table is sorted by income Gini Index in a 2010-7 period. No data available for Brunei.

Source: UNDP (2020)

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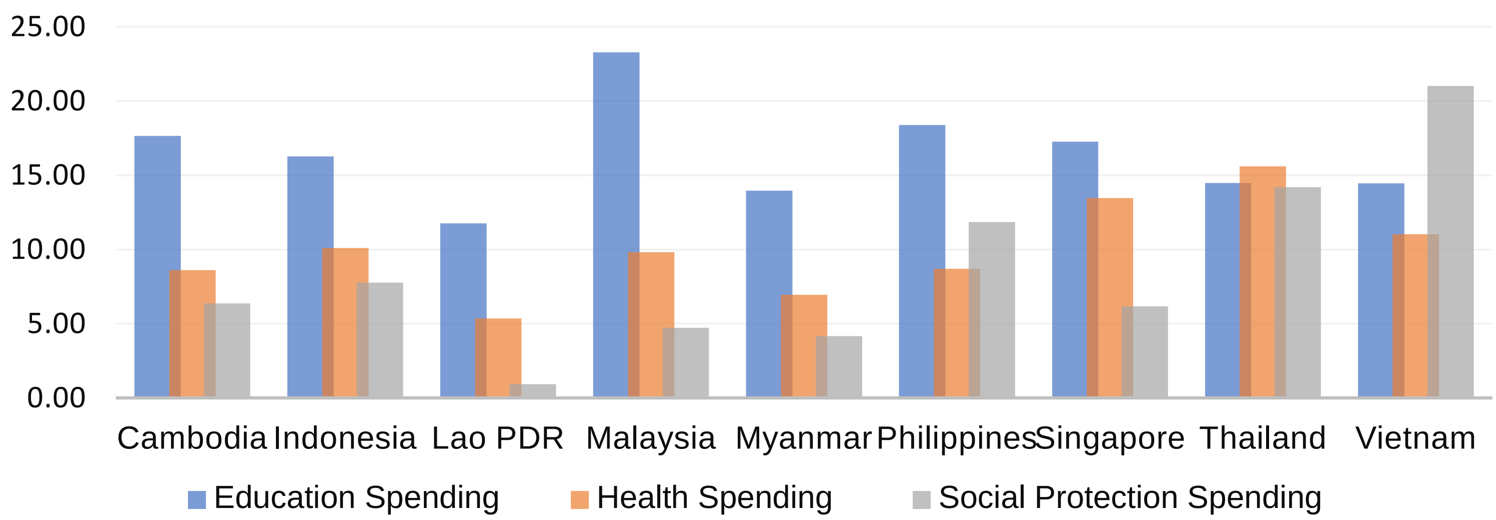
Economic Inequality, Social Spending and Fiscal Stretch in ASEAN

Social Spending

- Most countries in the region fail to invest sufficiently in essential public services such as healthcare, education, and social protection are the most effective ways to fight poverty and inequality.

Social Spending in the ASEAN region as a % of Government Budget, 2020



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

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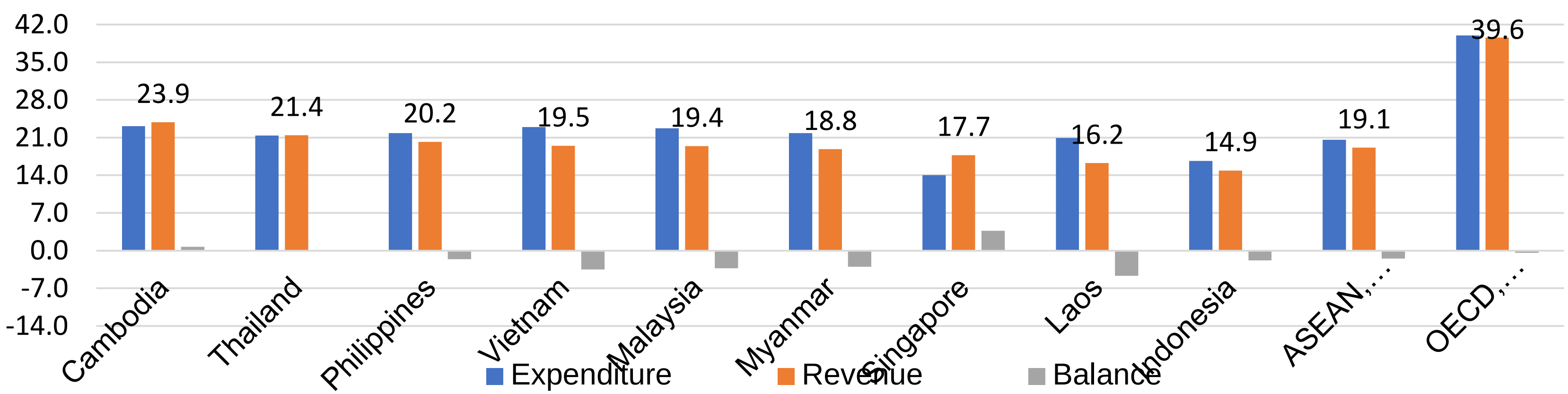
Economic Inequality, Social Spending and Fiscal Stretch in ASEAN

Fiscal Stretch

- 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.

Estimated Budget Indicators in ASEAN Countries, 2018



Source: World Development Indicators - WB (2020)

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The Race to the Bottom on Tax and Non-tax Incentives in ASEAN

- **Tax Competition in ASEAN**
  - Budiantoro (2015) shows 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 FDI.
  - 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 $15m.
  - In 2001, hoping to win investment from Canon of Japan, Vietnam offered a CIT 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.

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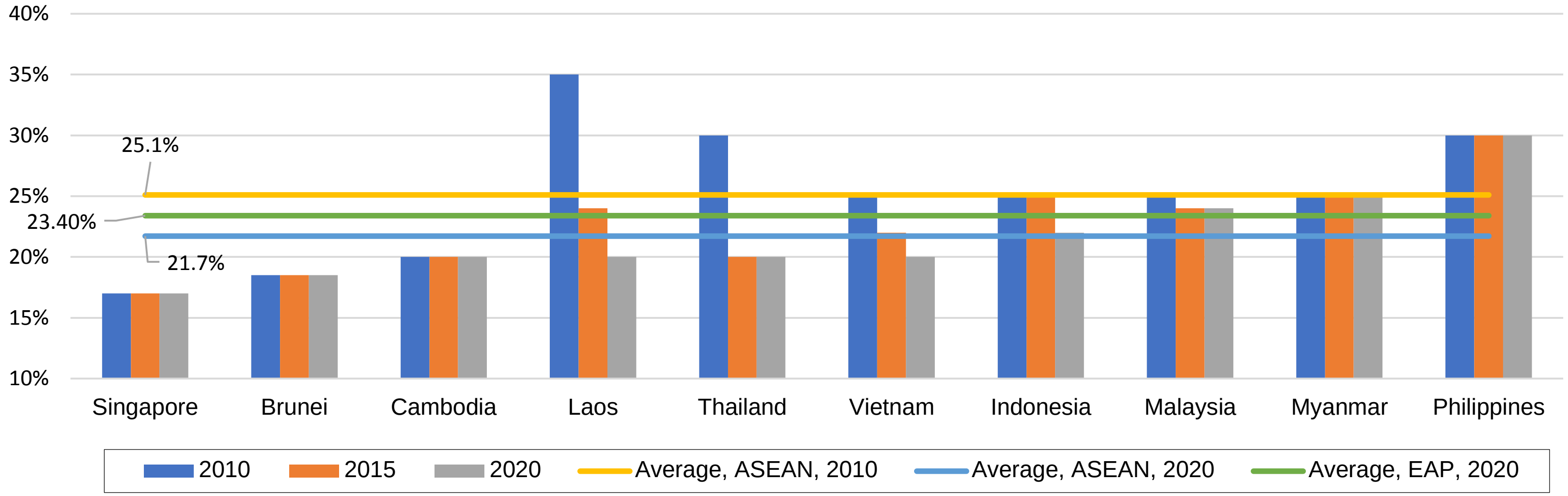
The Race to the Bottom on Tax and Non-tax Incentives in ASEAN

■ Standard Corporate Income Tax

- ASEAN countries set their own standard corporate income tax rates: The highest tax rate at 30% (the Philippines), the lowest at 17% (Singapore).
- The average corporate income tax rate in the ASEAN countries tends to decline over the past decade, from 25,1% (2010) to 21,7% (2020). This rate in 2020 is 1.7 percentage points lower than one in selected countries of the EAP region.

Standard CIT Rates in ASEAN Countries, 2020 (%)



Source: Trading Economics (2020)

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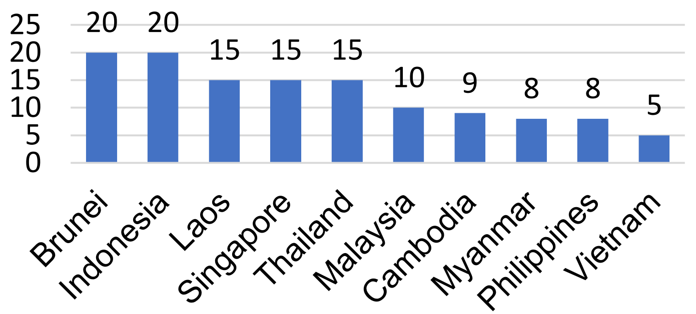
The Race to the Bottom on Tax and Non-tax Incentives in ASEAN

Tax Incentives

- Overuse of tax incentives, especially tax holidays and tax preferences, can draw developing countries into a race to the bottom, as neighbouring countries try to outdo each other in generosity in their efforts to attract investors from industrialized countries.
- The process of shifting production from China to the ASEAN region may worsen this competition between countries, as they seek to attract FDI inflows to further their own interests in boosting economic development, without seeing the wider regional picture.
- In attracting sustainable FDI to promote economic growth, good governance plays a decisive role over the long term (Globerman & Shapiro, 2002). Meanwhile, tax incentives lead businesses to minimize the amount of taxes they pay rather than expanding their production (Shukla et al., 2011).

Maximum period of tax holidays in ASEAN, by host country, 2020 (No. of year)



The CIT rate and preferences in ASEAN, by host country, 2020

Country	General CIT rate	CIT rate after preferencing (at the highest preferential level)
Brunei	18.50%	n.a
Campuchia	20%	0%
Indonesia	22%	0%
Laos	20%	5%
Malaysia	24%	0%
Myanmar	25%	12.50%
Philippines	30%	5%
Singapore	17%	5%
Thailand	20%	0%
Vietnam	20%	10%

Source: The authors' review

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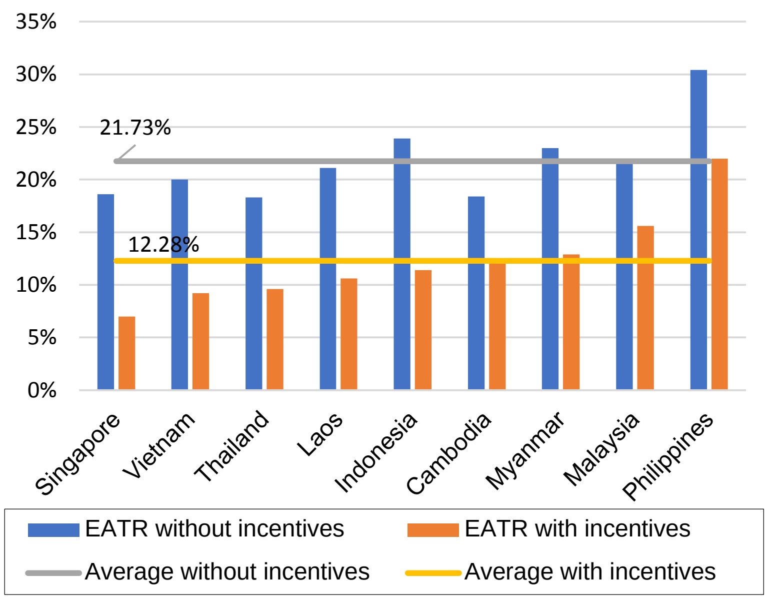
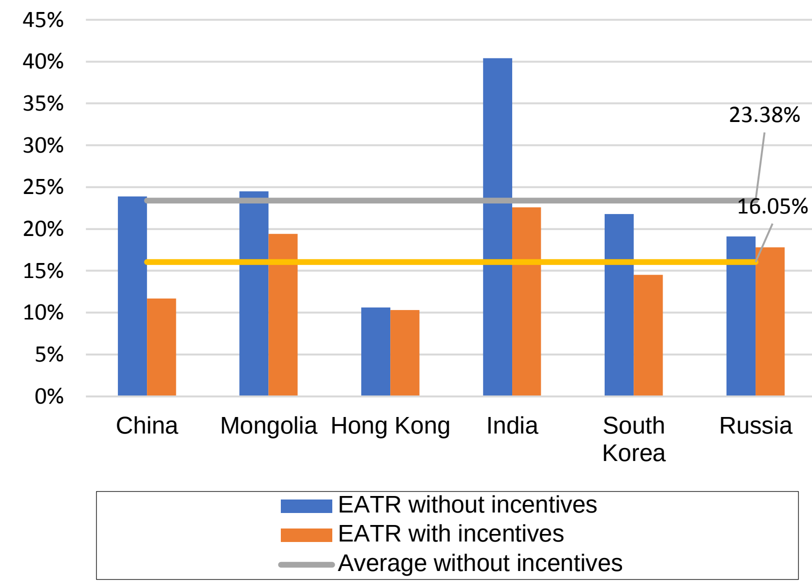
■ Effective Tax Rates

➢ Taking into account the tax holidays of up to 20 years and other enormous profit-based incentives offered to multinationals by some countries, the effective CIT rate is on average 9.4 percentage points lower (2015).

Average effective tax rates (AETRs) with and without incentives (%)



ASEAN countries



Selected Asia-Pacific countries

Source: Wiedemann and Finke (2015)

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The Race to the Bottom on Tax and Non-tax Incentives in ASEAN

Cost of Corporate Income Tax Incentive

Country	Category	Type	Content
Brunei	Economic Inefficiency	Case study	A secrecy jurisdiction in the business ecosystem known as the Brunei International Financial Centre.
Cambodia	Tax expenditure from CIT	Value	6% of GDP.
Indonesia	Profit shifting	Case study	- Potential tax losses from coal mining company Adaro Indonesia (AI): $14m each year from 2009 to 2017. - 27 tax disputes between Indonesia and the Netherlands: a substantial loss of $26.5m.
Laos	Untransparent Mechanism	Case study	Concession investments negotiated case by case and no details of the final concession agreement.
Malaysia	Tax expenditure from CIT	Case study	- 62.4% of 1,251,190 companies registered with the Inland Revenue Board, but only 7.8% subject to tax. - No or low effective rates on income from geographically mobile financial and other service activities.
Myanmar	Redundant incentives	Case study	Incentives in exploitation of natural resources (offshore gas, minerals, and forestry) where the country has comparative advantages in this field (Oxfam, 2017).
Philippines	Tax expenditure from CIT	Value	1% of GDP.
	Tax expenditure from CIT	Case study	$22.17bn given away to a select group of 3,150 companies between 2015 and 2017.
Singapore	Profit shifting	Case study	Special purpose vehicles (SPVs) utilized by MNCs for tax evasion and tax avoidance through tax treaties.
Thailand	Redundant incentives	Case study	- 81% of investments would have been made even without incentives. - At least 70% of the investments that benefited from incentives would have been made without them.
Vietnam	Tax expenditure from CIT	Value	- 7% of state budget revenue in 2016 (VATJ, 2019). - 1% of GDP (OECD, 2019a).
	Redundant incentives	Case study	85% of investors said that tax incentives were not necessary (James, 2014).
	Economic inefficiency	Case study	Unfair investment environment for domestic companies compared with foreign-invested ones.

Note: Detailed sources in text. We provide selected sources in the table for source clarifications and ones not included in text. In tax expenditure, there are two subgroups: (i) values and case studies on tax expenditure; and (ii) case studies on redundant tax incentives.

Source: Authors' review

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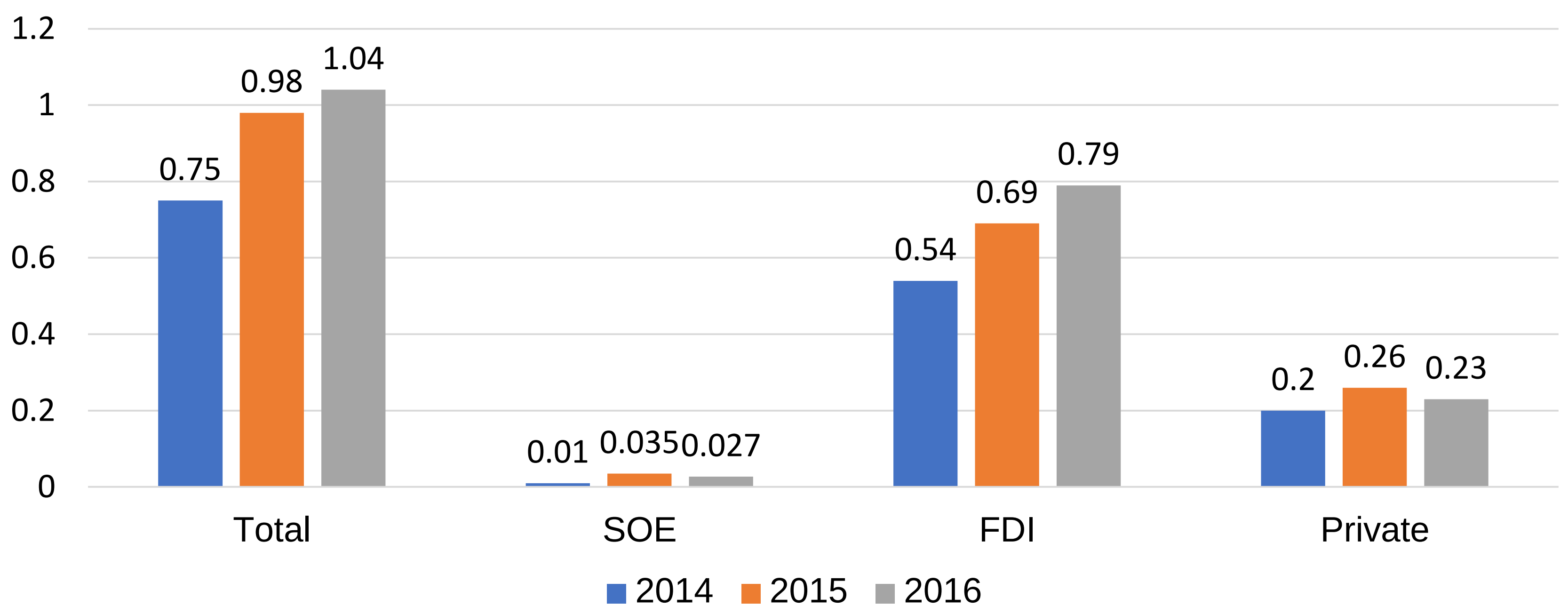
The Race to the Bottom on Tax and Non-tax Incentives in ASEAN

- **Cost of Corporate Income Tax Incentive**

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



Source: GSO (2018)

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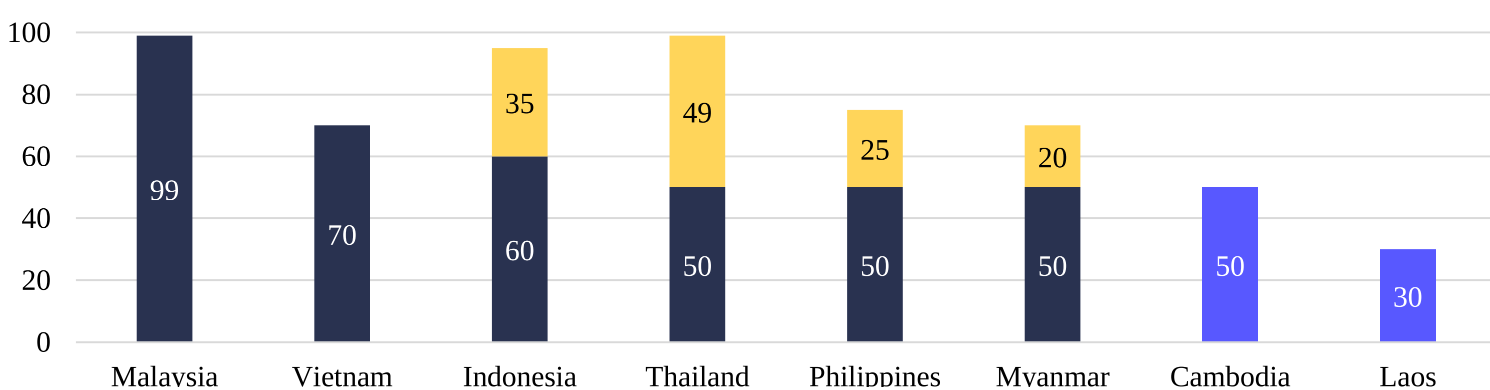
The Race to the Bottom on Tax and Non-tax Incentives in ASEAN

■ **Non-tax Incentives:** Land incentive

- There exists a competition among ASEAN countries in land incentives of various forms. Malaysia leads the region in terms of initial leasehold periods, with a 99-year lease without extension. Thailand and Indonesia also offer long leasehold periods, which are 99 years and 95 years respectively, including extension. Cambodia and Laos offer the shortest initial land-lease periods, but foreign investors in these countries for extension which is decided on a case-by-case basis.
- Rent exemption and reduction are also available in specific areas of some ASEAN countries and vary according to the socioeconomic status of the areas.
- Due to the difficulties in quantifying land incentives, there is no clear evidence to confirm that land incentives have any significant effect on FDI inflows.

Maximum length of land lease (including extension) in ASEAN countries (years)



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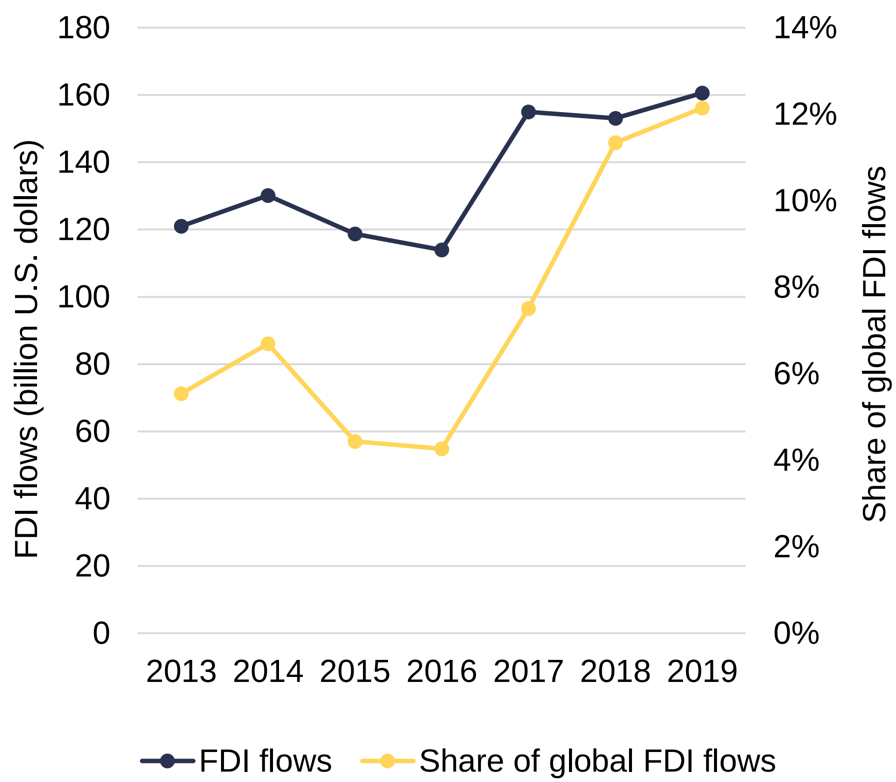
FDI flows in ASEAN Countries

- ASEAN witnessed a surge of 36.04% in FDI flows in 2017 after a slight drop from 2014 to 2016. Despite an insignificant fall in 2018, FDI flows rose again in 2019, reaching the level of $160 billion.
- In relative terms, ASEAN's share of global FDI flows had continually grown since 2016, despite a slowdown from 2018 to 2019. In 2019, the region contributed more than 12% of global FDI flows.
- However, UNCTAD (2020) forecasts that the COVID-19 pandemic will negatively affect foreign investment decisions in ASEAN countries.

FDI flows in ASEAN, 2013-2019



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

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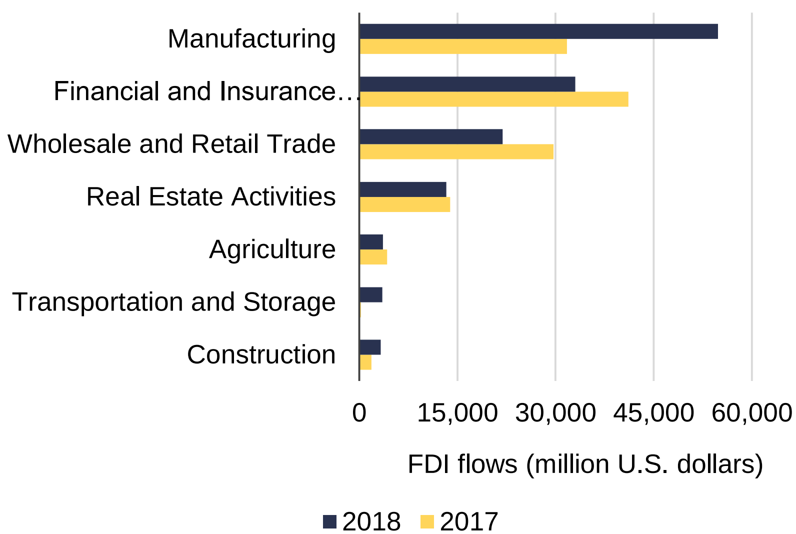
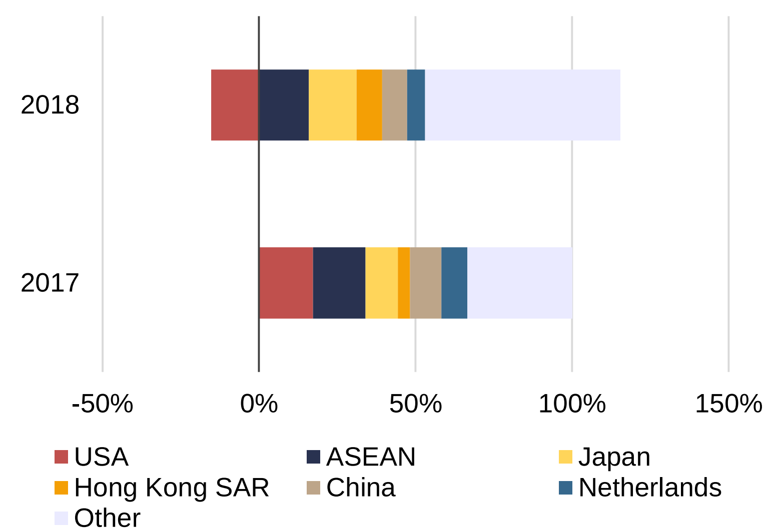
FDI flows in ASEAN Countries

- The upward trend of FDI in the manufacturing sector was one of the main engines of the expansion of FDI inflows into the region. FDI inflows in the manufacturing sector rose from $31.73 billion in 2017 to $54.82 billion in 2018, representing 35.81% of flows into ASEAN in 2018.
- The most important source of FDI in ASEAN is intra-ASEAN investments, which represented 16.71% of ASEAN's flows in 2017 and 15.90% in 2018.

Major FDI sectors in ASEAN, 2017-2018



Investor home countries, 2017-2018



Source: ASEANStatsDataPortal (2020)

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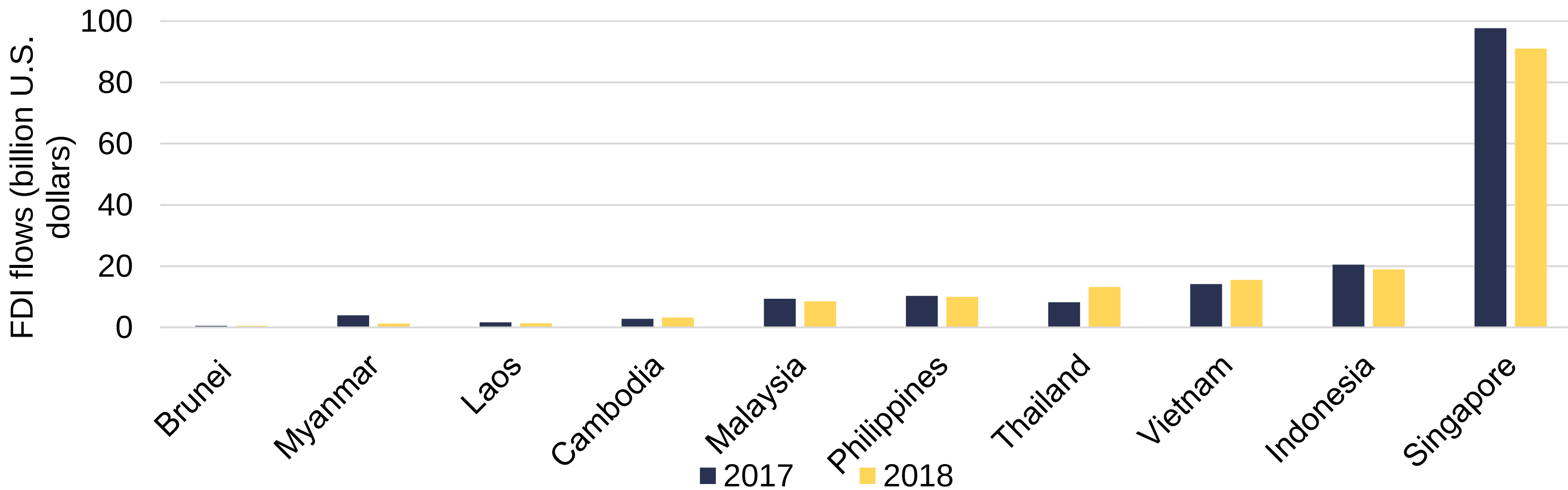
FDI flows in ASEAN Countries

- From 2017 to 2018, six of the ten countries in the ASEAN bloc experienced a decline in FDI flows, in contrast with the other four. A rise of 60% in FDI inflows allowed Thailand to surpass Malaysia and the Philippines.
- Singapore received 50% of the total FDI capital. However, Singapore is considered to become an intermediary investor in attracting phantom FDI and reinvesting into other countries so that MNCs can enjoy low CIT rates (Damgaard et al., 2019; Garcia-Bernardo et al., 2017).

ASEAN's FDI flows by country, 2017-2018



Source: World Bank (2020)

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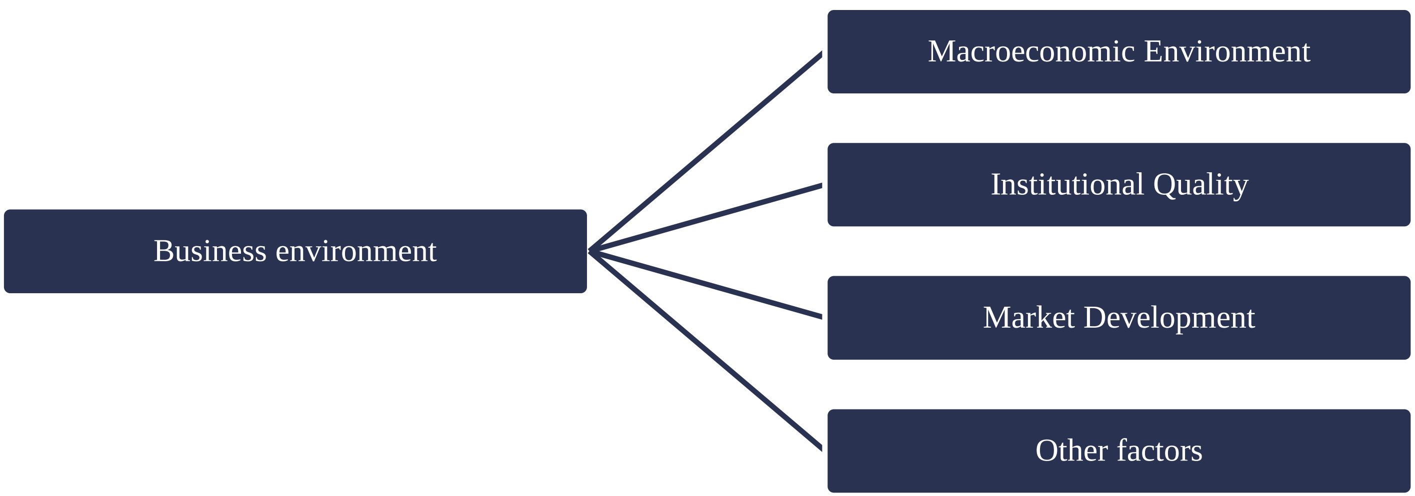
Summary of FDI flows into ASEAN countries, by industry and investor home countries, 2017-2018

Country	Top 3 industries			Top 3 investor home countries		
	Industry	FDI flows		Investor home country	FDI flows	
		2017	2018		2017	2018
Brunei	Manufacturing	493	700	Hong Kong SAR	465	655
	Financial and Insurance Activities	-102	75	Japan	755	99
	Mining and Quarrying	-478	75	ASEAN	547	71
Cambodia	Financial and Insurance Activities	948	1,057	China	628	807
	Manufacturing	319	421	ASEAN	601	776
	Real Estate Activities	369	364	Hong Kong SAR	355	341
Indonesia	Manufacturing	9,615	11,338	ASEAN	10,190	11,157
	Wholesale and Retail Trade	4,555	5,262	Japan	3,913	5,679
	Agriculture, Hunting, and Forestry	3,614	3,116	China	1,994	3,398
Laos	Construction	413	710	China	1,305	1,043
	Electricity, Gas, Steam, …	678	200	ASEAN	170	198
	Primary	391	197	Japan	68	53
Malaysia	Services	4,860	4,064	USA	-	1,616
	Manufacturing	1,465	3,841	Hong Kong SAR	1,604	1,583
	Construction	465	173	Japan	-	1,204
Myanmar	Transportation, Storage…	18	1,032	ASEAN	2,601	2,097
	Manufacturing	666	847	China	560	462
	Primary	731	651	Hong Kong SAR	160	355
Philippines	Manufacturing	1,182	1,095	ASEAN	726	1,070
	Financial and Insurance Activities	141	454	Hong Kong SAR	108	272
	Real Estate Activities	248	294	China	29	199
Singapore*	Financial and insurance services	861,257	927,890	USA	243,688	214,280
	Wholesale and retail trade	279,367	272,010	Cayman Islands	105,150	158,710
	Manufacturing	181,736	221,650	British Virgin Islands	90,555	95,511
Thailand	Manufacturing	1,132	4,828	Japan	3,132	5,251
	Financial and Insurance Activities	3,375	4,182	Hong Kong SAR	971	2,189
	Real Estate Activities	1,799	2,257	ASEAN	1,814	1,671
Vietnam	Manufacturing	6,238	7,250	Japan	3,384	3,875
	Real Estate Activities	1,200	2,891	Republic of Korea	2,820	3,720
	Wholesale and Retail Trade	961	1,605	ASEAN	2,538	2,790

Business Environment and FDI flows in ASEAN Countries

- Business environment is a key determinant of FDI location choices in developing countries. The business environments in ASEAN countries differ markedly in factors such as economic freedom, ease of doing business, governance quality, infrastructure, and labor quality.

Business Environment and its Components



Source: Author's Classification

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Business Environment and FDI flows in ASEAN Countries

- Empirical evidence from previous studies suggests that FDI attraction is sensitive to some business environment indicators.
  - Economic freedom is identified as the most important determinants of FDI (Ghazalian and Amponsem, 2019).
  - Hoang and Bui (2015) indicate that the size of internal market, represented by GDP, is one of the main factors that encourage FDI inflows into ASEAN.
  - Gopalan, Rajan, and Duong (2019) highlighted the importance of infrastructure development in pulling Greenfield FDI inflows into China and the ASEAN bloc.
  - Goodspeed, Martinez-Vazquez, and Zhang (2011) pointed out a positive relationship between the infrastructure quality ranking and the FDI inflow, implying FDI's sensitivity to the infrastructure quality of the host country in both developed and developing countries.
  - Bénassy-Quéré, Coupet, and Mayer (2007) add information, banking sector, easiness to enter the market, and legal institutions as factors that significantly and positively affect the amount of FDI received.
  - Wei (2000) argues that corruption is a deterrent to foreign investment.
  - Kaufman et al. (1999) finds that political instability and violence, government effectiveness, regulatory burden, rule of law, and graft have significant effects on FDI flows.

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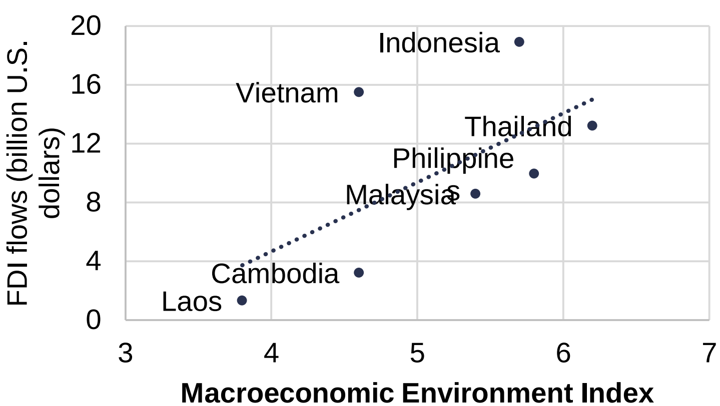
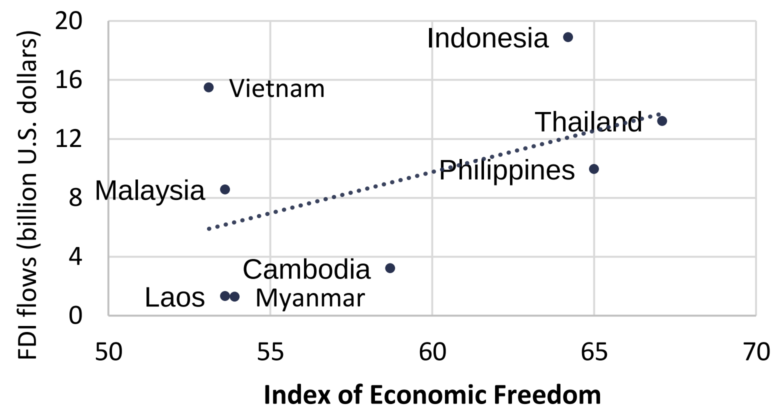
Business Environment and FDI flows in ASEAN Countries

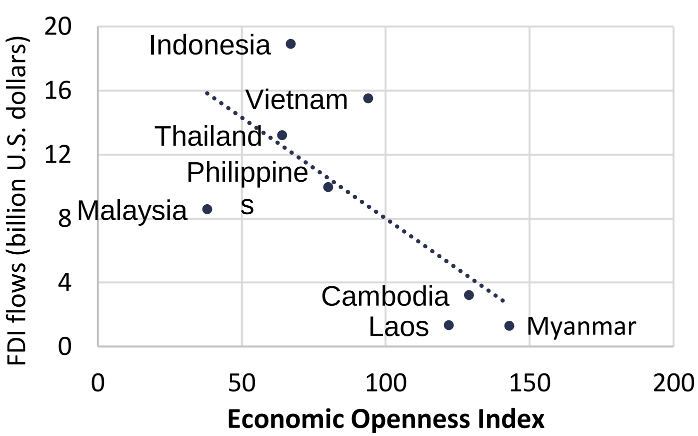
- **Macroeconomic Environment and FDI flows in ASEAN Countries, 2018**



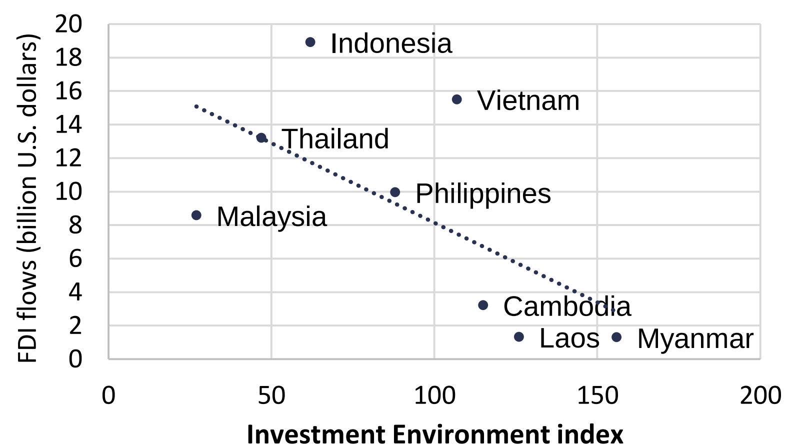
Source: WEF (2017)



Source: Heritage (2020)



Source: Legatum Institute (2019)



Source: Legatum Institute (2019)

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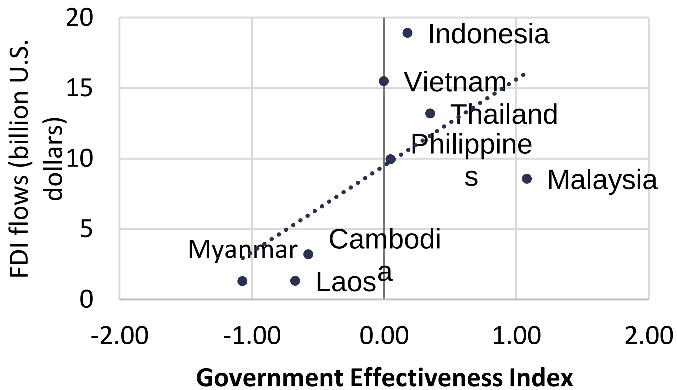
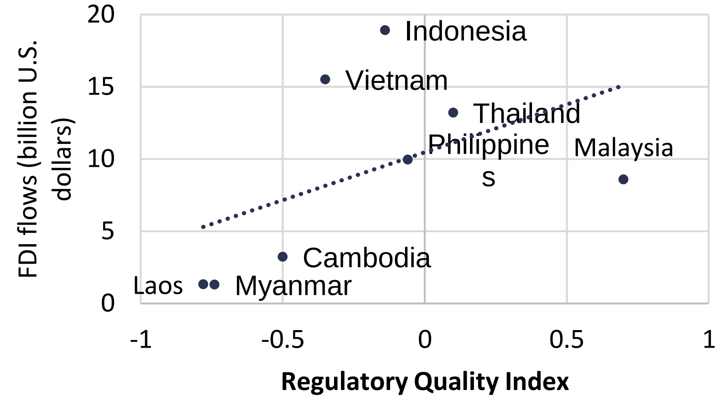
Business Environment and FDI flows in ASEAN Countries

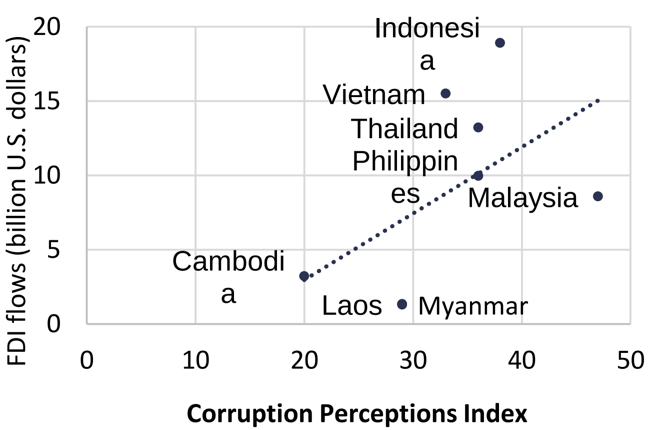
- **Institutional Quality and FDI flows in ASEAN Countries, 2018**



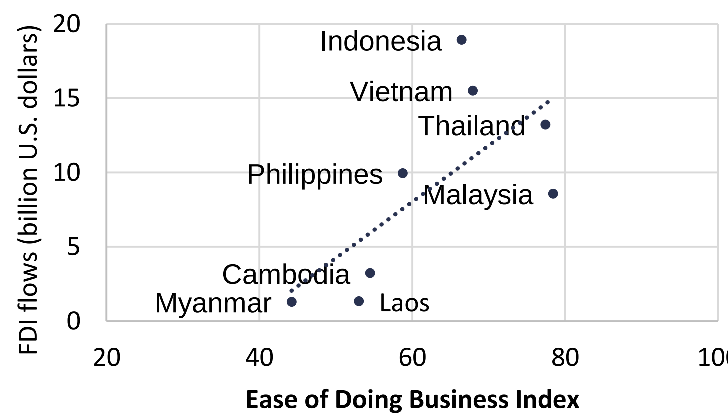
Source: World Bank (2020)



Source: World Bank (2020)



Source: Transparency International (2020)



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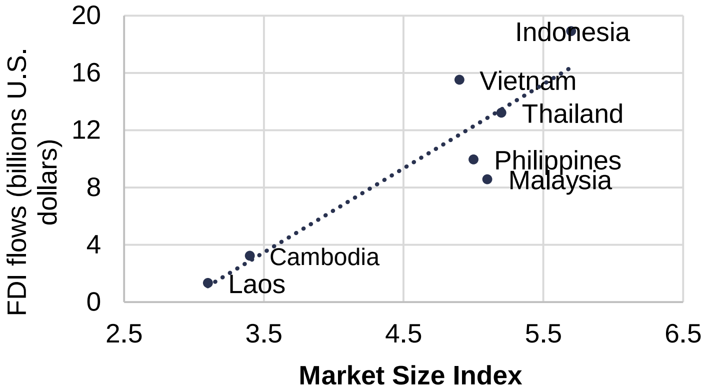
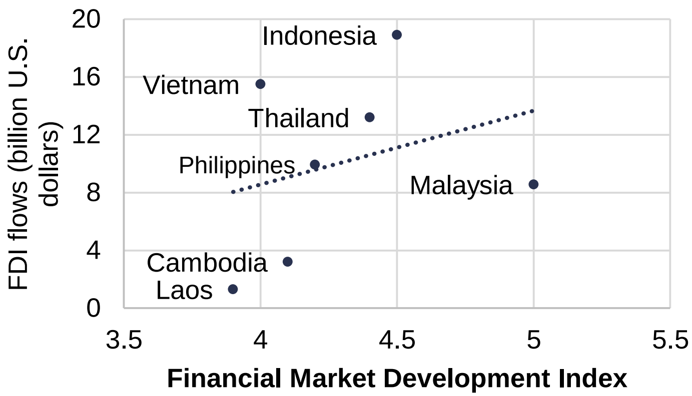
Business Environment and FDI flows in ASEAN Countries

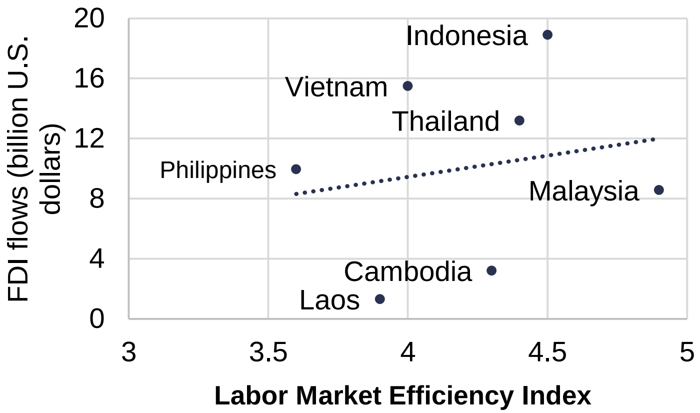
- **Market Development and FDI flows in ASEAN Countries, 2018**



Source: WEF (2017)



Source: WEF (2017)



Source: WEF (2017)

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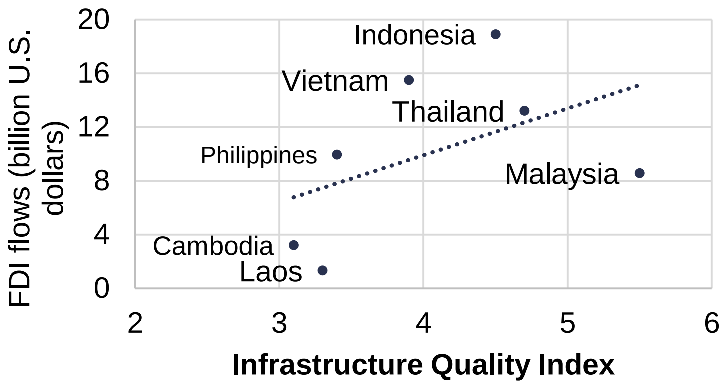
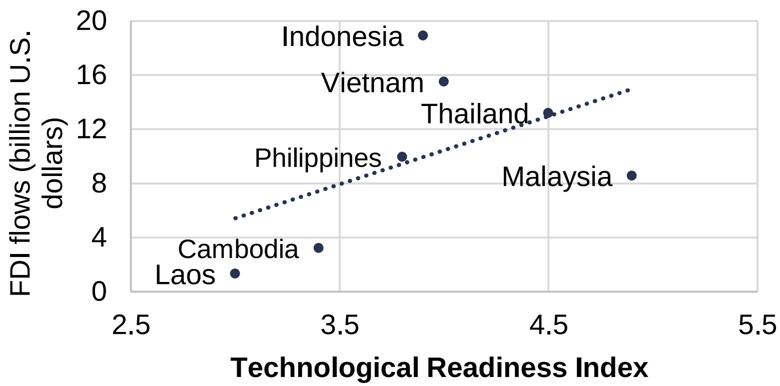
Business Environment and FDI flows in ASEAN Countries

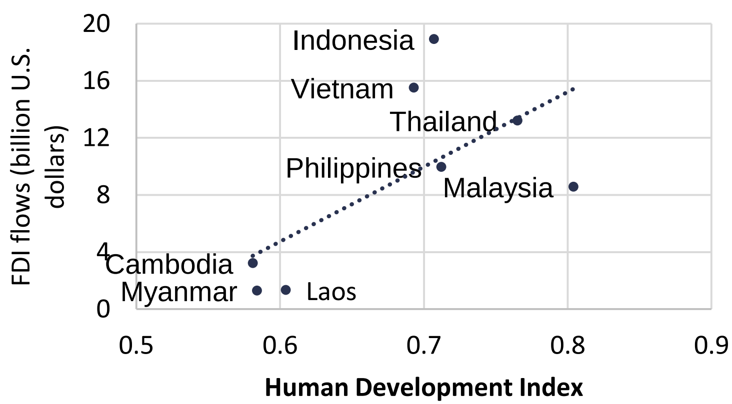
- **Other factors and FDI flows in ASEAN Countries, 2018**



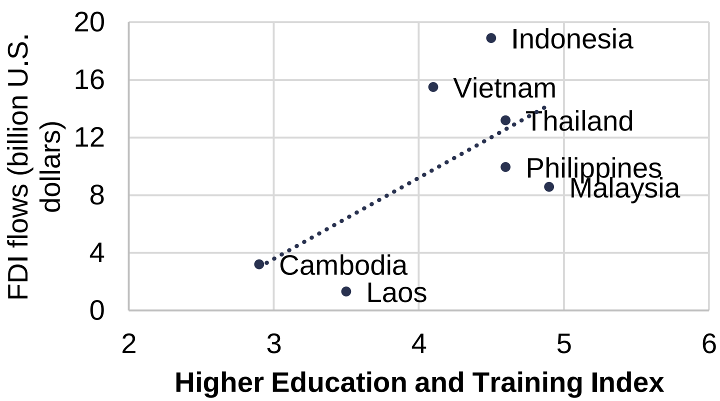
Source: WEF (2017)



Source: WEF (2017)



Source: UNDP Human Development Reports (2020)



Source: WEF (2017)

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Business Environment and FDI flows in ASEAN Countries

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.

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Business Environment and FDI flows in ASEAN Countries

- **Discussion:**
  - Most of other factors have positive linear correlation with FDI flows. In which, economic openness, ease of doing business, market size, and human development have the strongest positive linear correlation with FDI flows.
  - ASEAN countries are often divided into two separate groups, one of which has both favorable business environment and high FDI flows (Indonesia, Malaysia, Philippines, Thailand and Vietnam) and the other has both unfavorable business environment and low FDI flows (Cambodia, Laos, and Myanmar).
  - Significant efforts to enhance the investment climate are needed for the latter group of countries to increase the amount of FDI attracted. Human development in Cambodia, Laos, and Myanmar is still lacking, which is an obstacle for these countries to attracting FDI into manufacturing industries that are often labor-intensive.
  - Besides, the poor business environment conditions in Cambodia, Laos, and Myanmar, particularly institutional quality, explain why these three countries receive large inflows of Chinese FDI. Chinese multinationals are not only indifferent to poor regulatory quality but also tend to invest in countries with the same level of corruption as that of their home country (Shan, 2018).

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Recommendations

- **Recommendation 1:** Draw up a whitelist and a blacklist of tax incentives
- **Recommendation 2:** Stop the competition in providing site incentives
- **Recommendation 3:** Agree on a minimum tax standard across the ASEAN region
- **Recommendation 4:** Establish rules for the good governance of investment incentives
- **Recommendation 5:** Agree upon improving business environment, focusing on the key factors

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Recommendations

- **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.
    - 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. These incentives should be monitored for their effectiveness and abuses such as super deductions, or super tax credits should be avoided.
  - 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.

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Recommendations

- **Recommendation 2:** Stop the competition in providing land 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.

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Recommendations

- **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.

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Recommendations

- **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.

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Recommendations

- **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) administrative burden in 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.

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Thank you for your attention

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