Master Thesis for Economic Growth, Innovation and Spatial Dynamics

Integration, tax competition and harmonization: Should ASEAN be concerned?

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Abstract

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In the European Union (EU) policymakers are faced with many challenges in national corporate taxation policy from globalization, in particular the increasing cross-border mobility of capital. The EU member countries have become a highly integrated single market and this has meant that trade and investment flows are highly sensitive to corporate tax rates. Corporate tax rates have fallen over the last decade in the EU to an average below 30 per cent. This has raised concern and fostered the debate as to whether this should be avoided or solved through harmonizing tax policy. Given that Association of South East Asian Nations (ASEAN) is a fast growing region that is implementing many measures to increase internal integration the EU can be used as a guide in the area of tax competition and harmonization. The paper explores taxation theory and uses empirical evidence from corporate taxation rates over the period of 1998-2006 to determine how regional integration has affected tax competition and harmonization and whether or not ASEAN is heading the same way as the EU. Examining the case of competition and harmonization the paper finds support for ASEAN to reform its corporate taxation policy to reflect more closely the EU's approach to managing the pressures of increased globalisation and regional integration.

Integration, tax competition and harmonization: Should ASEAN be concerned?

Introduction

The research question

Corporate taxation rates in the European Union (EU) have declined steadily over the past decade prompting debate to harmonize tax policy to prevent ongoing decreases and a 'race to the bottom' occurring (Mitchell, 2004). The intensifying situation of tax competition in the EU has been, at least in part, a result of greater regional integration within the Union which has removed barriers to trade and increased capital mobility (Zodrow, 2003). It is argued that this is a cause for concern as it endangers tax revenues and that harmonization can benefit countries even if it does compromise national sovereignty over tax policy. The Association of South East Asian Nations (ASEAN) has emerged as a rapidly growing trade bloc and has significantly increased integration measures after the Asian Financial Crisis of 1997 (Cuyvers & Pupphavesa, 1996). ASEAN was previously formed with a common interest of promoting international investment from outside the region and maintaining strong autonomy over economic, social and taxation policy. However, with the future adoption of the ASEAN Free Trade Area (AFTA) will ASEAN show similar patterns in tax competition and harmonization? And more importantly, is this a bad thing for the evolving ASEAN? The answers to these questions can help predict future taxation changes in ASEAN and by examining the EU case, whether this is the right direction to move in.

The problem defined

Corporate taxation has evolved as a competitive playing field by which countries can win or lose trade and investment. This is no new phenomenon, as Adam Smith recognised a long time ago:

The proprietor of stock is a properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune at more ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour would necessarily be more or less diminished by its removal.

- *An Inquiry into the Nature of Causes of the Wealth of Nations, 1904.*

However the phenomenon that Smith (1904) recognised as capital flight has intensified with globalization and technology driving countries to trade goods and services at increased levels and at a vigorous pace (Lao-Araya, 2003). International markets have become increasingly integrated giving rise to a global market of endless opportunities and competition for capital movement. One of the many manifestations of increased economic integration has been tax competition which has been steadily progressing in the last two decades. A result of this intensified competition to attract mobile capital base (corporations and business) there is a trend towards declining statutory corporate taxation rates and a pressure to harmonize taxation policy.

Tax competition can exist anywhere when people can reduce tax burdens by shifting capital from high-tax jurisdictions to low – tax jurisdictions. In integrated economies corporate tax rates

create an externality as a low rate in one jurisdiction can have negative effects on capital in higher tax jurisdictions (Devereux, 2003). If a country's domestic tax burden is high relative to other countries, the tax base may shift to countries with a less burdensome tax regime, implying outward flows of foreign direct investment (FDI) (Gropp & Kostial, 2001). On the other hand countries can compete to attract inward investment and companies can enjoy higher profits through lower corporate taxation rates. Taxes may also play a major role in firms' decisions about where to declare profits which leads to the issue of transfer pricing, where by international firms with foreign subsidiaries shift profit reported to the subsidiary which operates in the lowest tax jurisdiction (Janeba, 1995). Evidence from the International Monetary Fund (IMF), shows that multinationals spend considerable resources on tax-planning techniques including cross-border transactions to minimize tax liabilities (Gropp & Kostial, 2001).

New technology which can automate foreign banking operations and the establishment of e-service companies has meant new opportunities for companies to avoid high-tax jurisdictions by making it easier than ever for firms to shift profits to affiliates located in low-tax jurisdictions by manipulating transfer prices or inter-affiliate loans and interest payments, or simply moving investments into lower tax jurisdictions (OECD, 1998). The ease at which capital can be moved from high to low tax jurisdictions in today's truly global economy makes it increasingly difficult for governments to remain autonomous when creating corporate taxation policy (Janeba, 1995).

Trade and investment movements affect economic growth and social welfare. Capital brings jobs and prosperity and therefore protecting and attracting capital is of great national concern. Competition and ease of manipulating taxation systems can jeopardise current and future taxation revenue, which, especially in the EU constitutes a large part of Gross Domestic Product (GDP). Assuming that taxes are used in the provision of social goods, a reduction in tax revenue corresponds to a reduction of social welfare (Devereux, 2003). Tax harmonization has therefore been discussed as an option to avoid the ongoing competition placing social welfare at stake. The general definition of tax harmonization refers to aligning taxation systems more similar which would reduce the distortions created by tax rate differentials (Velayos, Barreix, & Villela, 2007). Calls to harmonize corporate taxation rates in the EU to establish minimum corporate tax rate have been disputed strongly since the early 1990s (Teather, 2005). This paper will explore the theoretical and evidence based sides of the harmonization argument to analysis which way the EU will continue in the approach to corporate taxation.

Why is integration in regional trade blocs significant for corporate taxation?

Economic integration is 'any type of arrangement in which countries agree to coordinate their trade, fiscal, and/or monetary policies is referred to as economic integration' (Suranovic, 2007). Whilst other forms of integration such as political and social are considered in this paper, there is a strong focus on economic policies which affect trade, investment and taxation. Integration removes trade barriers and creates which draws economies closer together creating a greater interdependency on other nations. By countries reducing trade barriers and integrating through regional agreements capital movements can occur more freely, and hence there is greater potential for tax competition and perhaps harmonization (Farrow & Sunita, 2006).

The rise of strong regional trading blocs, such as NAFTA, MERSOCUR, Andean, EU and ASEAN have increasingly defined global trade and therefore an analysis of regional tax competition and harmonization an important area (Daly& Weiner, 1993). ASEAN being among the fastest growing regions in the world has made significant moves to increased openness and integration which the Asian Development Bank (ADB) has recognised as important contributors

to the East Asian economic miracle (Asian Development Bank, 2005). Integration in ASEAN and intra-regional trade has lagged behind the EU and other regional blocs and can attribute with the remarkable transformation of the Asian-Pacific countries to foreign direct investment (FDI) (Daly& Weiner, 1993). Whilst ASEAN and the EU vary greatly in terms of their involvement in intra and extra regional trade, their foundations, geographical proximity within the region and current economic position the EU serves as a good model to assess future possibilities for ASEAN taxation as it is currently the most integrated regional bloc. The EU is far more advanced in regional integration than ASEAN as the EU has a common currency and common external policy with a strong internal market. This has diminished the importance of national barriers and allowed free capital movement within the EU, thus also increasing sensitivity to tax differentials amongst members (Daly& Weiner, 1993). However, ASEAN is pursuing a policy to promote greater intra-regional trade and the adoption of the AFTA and several other integration policies will, if successful, change the flows of trade and investment in the region. With the goal of creating an internal market ASEAN needs to be aware of the implications this could have on their national taxation policies.

The paper explores how integration, corporate tax competition and harmonization have evolved in the EU and compare this to the current state in ASEAN. If ASEAN does show similar trends to the EU, should they try to avoid moving down this path? Or on the other hand, if ASEAN does not seem to be showing similarities in terms of the level of competition or harmonization in the region is this equally a cause for concern? The case for tax competition and harmonization is a contentious one as different models and theories have different findings, so the paper explores both theory and data to try and determine the best way for ASEAN to progress with integration and corporate taxation. Corporate taxation in ASEAN is a timely issue as the failure to adopt appropriate policy when needed can have significant repercussions for taxation revenue and national competitiveness.

Methodology

Data and collection

The paper uses data on inter and extra regional trade and national statutory rates on corporate taxation. The corporate taxation rates data has been collected from KPMG's publicly available database and these figures where available have been crossed checked with taxation information from PriceWaterhouseCoopers. Trade data and information on integration and regional agreements have been collected from international bodies such as the World Trade Organisation, International Monetary Fund, European Commission's statistical database (EUROSTAT), OECD (Organisation for Economic Co-operation and Development) and ASEAN Statistical database. For taxation specific information on issues such as double taxation agreements the information came from the largest international Audit and taxation services firms, KPMG and PriceWaterhouseCoopers have been used. There have been no inconsistencies found between the various sources when comparisons in data have been made. Additionally the widespread use of the data from these sources in legal documents and literature provides additional assurance that data is highly reliable. All data has been extracted from the most direct source, where possible.

This data examines the statutory tax rate which is the rate that is legally imposed. There is often the discussion of how this is different from effective taxation, which is the amount of tax an individual or firm pays when all other government tax offsets or payments are applied, divided by the tax base (total income or spending) (Australian Commonwealth Government). Verrue (2004) notes that often a reduction of statutory tax rates has been accompanied by a decline in

effective average corporate tax rates. Effective tax rates however are not readily observable and unfortunately have significant methodological and data problems (Kelly & Graziani, 2004). Researchers employ various methods to determine the effective tax rate and using inadequate data and historical data which complicates the comparisons of rates over time and between countries (Kelly & Graziani, 2004). Therefore statutory rate is the key measure discussed in this paper. Attention is also given to elements of taxation rule which accompanies taxation rates as the other element of a taxation system. The decision on a tax rule is a long-run decision since the tax rule is changed less often than the corporate tax rate (Janeba, 1995).

Focus of the paper and limitations

To narrow the focus for the paper data on statutory taxation rates will be used over the time period of 1998-2006. The Asian Financial Crisis which occurred in 1997 affected the ASEAN countries dramatically and therefore data from this year has been excluded due to the lack of sound policy making at this time. Whilst the flow on of the crisis in 1998 is arguably still largely tainted by the financial crisis it was the beginning of the response to the crisis which had important implications for ASEAN's recovery. The year 2006 is used as the end date because information from 2007 was not complete across all countries.

In order to address the national taxation changes in the ASEAN region with some depth, six countries will be examined to allow for appropriate analysis. These countries are Philippines, Indonesia, Singapore, Malaysia, Vietnam and Thailand will be classified from here onwards as ASEAN6. This leaves out the other ASEAN members Cambodia, Laos, Myanmar and Brunei. The ASEAN6 represent a demographic mix of the founding members and a recent member (Vietnam in 1995), the largest trade partners, the fastest growing and largest volume of exports. These countries are inter and intra regionally the largest players in ASEAN.

The EU countries studied will be the EU 15 which consists of the members which joined prior to 2004. This comprises of countries joined before 2004. This includes: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom. The new members are discussed in the paper, however, since the paper makes an analysis of the statutory rates up to the year of 2006 it would not be as helpful a comparison to have included these countries as the effect of their integration into the EU may not be indicative in the data from the period from 1998.
Furthermore, only taxation at a national level is considered with no discussion of tax competition between inter-governmental levels.

Structure of the paper

The paper is divided into five parts. Part 1 will discuss the case of corporate taxation and integration in the EU, Part 2 will present the case for the current situation in ASEAN, Part 3 will compare the EU and ASEAN, Part 4 will draw light on some of the key reasons behind the regional differences and Part 5 uses the tax theory and empirical results to determine the current path that tax competition is on and whether this will have positive or negative consequences to the ASEAN region.

Literature and theoretical review

This paper examines relatively new territory in research and there a few studies which compare the effect of integration and tax harmonization in ASEAN at present. Building on research

conducted into tax competition and tax harmonization, theoretical models are reviewed which attempt to model the effects of capital mobility in situations of differential tax jurisdictions. Tax competition has been best identified by the decline in corporate tax rates. Devereux (2003) considers whether the decline in corporate taxation has been driven by tax competition in the race to attract the mobile element of the corporate tax base, or yardstick competition whereby voters compare their country to another or whether there has been a common intellectual trend which influences policy makers to reform the nature of capital taxation. It is concluded that tax competition is the best explanation, a finding which is supported by Mitchell (2004) who argues that tax competition has played a key role in this global shift to lower tax rates

There is a certain degree of controversy and a vast array of literature surrounding tax competition and harmonization. The literature can be divided by the following major schools of thought in the field. Firstly, there are two key theoretical concepts which explain the model of tax competition: Standard model of tax competition and the new economic geography theory (Hansson & Olofsdotter, 2004). This helps identify whether the EU has emerged in a way the theories suggest and if it will continue to follow them. The debate is then divided into welfare vs. economic arguments which applies to the question of whether tax competition or harmonization is to be encouraged or not. The final relevant research area is one of a taxonomical nature, and that is the classification of tax harmonization which helps to identify more accurately what types of policy changes constitute the differing degrees of harmonization (Velayos et al., 2007).

Standard Tax Competition Model vs New Economic Geography theory

There are different predictions as to how tax competition will affect an integration Union. The Standard Tax competition model shows grave concern for the outcomes of tax competition where as the Economic Geography theory finds that tax competition will not occur in a 'race to the bottom situation' as the standard model fears.

The theoretical models of corporate taxation which have originated from the public finance stream such as that of Zodrow & Mieszkowski (1986) have developed the basic model of tax competition and efficient provision of public local goods. In the standard models, there are two factors of production, labour and capital. Capital can move freely across national borders but labour is immobile. Taxes are assumed to be source based and the provision of social goods is financed through the tax levied on capital and labour. If a higher marginal tax is placed on the mobile factor of production then an outflow of capital occurs, reducing the tax base and decreasing public spending. Lower tax rate on capital therefore implies a sub-optimal supply of the public good. This shows a negative relationship between factor mobility and tax rates. Linking factor mobility to integration, Hansson & Olofsdotter (2004) explain that 'due to increased factor mobility, continuing integration will be associated with ever-decreasing tax rates, the race to the bottom case'.

Although these standard models yield important insights they are based on several large assumptions. The Zodrow & Mieszkowski (1986) model assumes fixed factor supplies, perfect capital mobility, absence of pure profits, no foreign ownership of domestic firms, completely symmetric countries and no endogenous fiscal instruments apart from source-based capital tax.. Krogstrup (2002) relaxes some of the restrictive assumptions in the earlier models to allow for economies of scale on a country level that arise from increasing rate of returns on capital which implies that there is a margin within which a tax rate can be applied on capital that does not lead to outflow.).

The new economy geography theory is a contemporary analysis of corporate tax competition which takes into account the different characteristics of nations and how they relate to tax rates. Baldwin & Krugman (2004) show that integration, as reflected by reductions in trade costs, increases the importance of the agglomeration forces and leads to a concentration of production in certain countries or regions. According to the new economic geography theory reductions in trade barriers will intensify tax competition, which is the same conclusion tradition tax competition literature draws. The difference with the new economic theory is that further integration tends to increase the importance of agglomeration forces and consequently decrease tax competition (Hansson & Olofsdotter, 2004).

Economic and Welfare debate

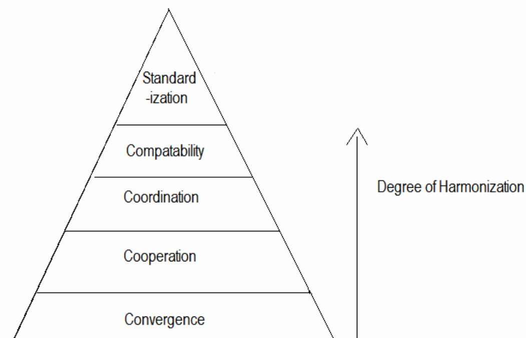
Despite the assumptions the Zodrow & Mieszkowski model, and those of similar models of Oates (1972) and Wilson (1999) the findings are consistent with the recommendation that tax rates should be harmonized as the international trade and capital mobility will, harm the efficient supply of public goods. Oates (1972) noted that local governments competing for capital are likely to keep tax rates low to attract investment and that this can lead to a less than efficient level of local services. An extensive literature supports the view that tax competition may lead to inefficiently low tax rates and sub-optimal levels of public spending (Wilson (1999), Tanzi (2002) which would imply grave concerns for regions such as the EU that are showing a rapid decline in corporate tax rates. Janeba's (1993) perspective is useful as it views tax competition as an uncooperative game with respect to both corporate tax rates and the form of double taxation relief. According to Janeba (1993) since the non-cooperative game playing equilibrium yields an inefficient allocation of global capital stock, moves to cooperate and co-ordinate taxes can be welfare-improving for both countries. Whilst public finance models of taxation typically argue that tax competition has a negative effect as it will damage the social provision other research is quick to argue that it can help economies grow faster and that in fact lower tax rates have not implied lower tax revenues (Mitchell, 2004). Mitchell (2005) views harmonizing tax rates as eliminating fiscal competition which can be liked to a situation of price-fixing agreement among gas stations destroys competition for gasoline. He argues that it competition leads to efficient practise in other areas why should it not apply for taxation as well? Krogstrup (2002) has adamantly defended the fact that the EU average tax revenues from corporate taxation increased during the last 20 years, both in percent of GDP and in percent of total tax revenues. However Krogstrup's later studies suggest that this trend may be reversing (Stults, 2004).

A multidimensional tax harmonization

Sorenson (2002) noted the standard analyses above also assume that the alternative to tax competition is global tax coordination. Keheler (1993) argues that in such an integrated environment policy makers adopt either a policy competition or co-ordination approach. Whilst harmonizing tax rates would mean making them more similar or aligned to other systems there is a discrepancy in the literature as to whether this means co-ordination at some level or making them completely identical (Velayos et al., 2007). González Cano (1996) argues that in fact harmonization is not a singular concept but rather there exists two forms of tax harmonization: uniformity and compatibility. In González Cano's opinion compatibility is most relevant at early stages of economic integration when tax harmonization is just beginning. Other efforts to break down the classification of 'harmonization' into sub groups which better explain the situation include the work of James (2000) who establishes a scale from 'no harmonization' to

'standardization' Velayos, Barreix, & Villela (2007) piece together the various theories and classifications of 'tax harmonization' to establish a scale of harmonization which proves particularly useful for the analysis of this paper. The dimensions are graphically displayed in Diagram 1 below.

Diagram 1: Levels of Tax Harmonization



Methodologically Velayos et al. (2007) use political commitment as a criterion for classifying actions of harmonization. Other classifications which may involve the economic importance implied or different legal instruments are less consistent for drawing comparisons. The terms in the pyramid can be explained as follows:

Standardization: the highest form of harmonization which entails having the same tax which equalizes the tax burden under equal circumstances.

Compatibility: involves 'adjusting the tax structure in order to counteract or compensate for the distortionary effects caused by the tax burden disparities upon the integration process (González Cano,1996). This does not mean that elements in the tax structure are identical in rate or tax benefits to their full extent (otherwise there would be no difference from standardization. Compatibility is linked with more advanced integration objectives, when internal tax distortions are detected. When free trade areas are created, such as the EU and the AFTA, the compatibility of regulations may occur at an early stage. Velayos et al. (2007) use the example of mutual tariff benefits which may not be uniform but are compatible when all parties involved respect the 'global reciprocity' principle.

Coordination: The concept of tax coordination in the literature varies greatly. One explanation by Velayos et al. (2007) is that coordination is an 'in between' category as it may involve various elements of the other classifications. Coordination involves any harmonizing mechanism which may not be confined to one category of harmonization. Codes of conduct are identified as coordination.

Cooperation: Entails a condition of mutual assistance, either for reasons of reciprocity (for instance, in regards to sharing information regarding taxation between the countries) or out of mutual interest (such as when double taxation is detected and two countries undertake to cooperate). Cooperation does not involve sharing a common tax policy as this would be a higher level of harmonization but may be practical, as in the above examples or theoretical. Velayos et al. (2007) identify taxation advice and sharing of best practice examples as theoretical cooperation. Cooperation contributes to consistent application of tax systems across

jurisdictions by establishing bilateral and multilateral cooperation mechanisms which can align tax administrations.

Convergence: Velayos et al. (2007) define convergence as a spontaneous movement in the same type of taxation policy direction as a result of pressures from globalization and competition. Convergence is regarded as the last step from the stance of voluntary political commitments. No one in particular harmonization action has been taken for reasons of political pressure but rather as the country cannot escape from the trend or concedes that it is in the best interest to take that action.

National sovereignty, a important consideration to any discussion regarding national policy, is most respected under the cooperation classification as it involves no compromise on policy. According to Velayos et al. (2007) it is the most civilized form of harmonization which occurs when there is identified mutual interest.

This paper employs the multidimensional approach to tax harmonization and distinguishes between the different levels of tax harmonization when appropriate. Caution is taken in redefining which classification is used when discussing the theory as it would be misleading to change the general term of ‘harmonization’ from one literature to fit it in with one of Velayos et al.’s (2007) classification. It should be noted however that when other literature adopts a strictly harmonize or compete classification that this is likened to the classification of standardization or convergence according to Velayos et al. (2007).

Part 1: The European Union

The European Union- a model for regional integration

In economic, trade and monetary terms, the European Union has become a major world power. The EU has a strong influence within international organizations such as the World Trade Organisation (WTO), the United Nations (UN) and at world summits on the environment and development. The EU has become highly integrated and as a unit has much more economic, social, technological, commercial and political strength than the individual efforts of its Member States, even when taken together (EUROSTAT, 2006). According to the EUROSTAT (2006) "There is added value in acting as one and speaking with a single voice as the European Union". The EU has become so powerful as a unified voice that national sovereignty has become harder to maintain in policy areas.

The basic objective of the EU is to promote economic and social progress which is balanced and sustainable (EUROSTAT, 2006). To achieve this it is important that there are no internal market barriers or distortions which include taxation policy. Financial integration advanced with the establishment of Economic and Monetary Union that introduced a centrally controlled currency (EUROSTAT,2006). To reach economic and social objectives, economic activities should be developed in a sustainable way throughout the community and promote growth as a whole region. According to the EU Commission (EUROSTAT,2006) 'The Member States are to regard their economic policies as a matter of common concern and to conduct their economic policies with a view to the objectives of the Community. Therefore, Member States coordinate their economic policies within the Council.'.

Further integration and cohesion in the EU means that many policies have been standardized leaving corporate taxation as one of the few tools EU member countries can use to manipulate economic conditions in their country. However given that corporate taxation is strongly linked with economic policy, trade and investment are challenging areas to retain autonomy over.
For this reason, tax harmonization has recently re-emerged in the public political debate of several EU Member States against the background of the enlargement of the EU (Verrue, 2004). The diversity of preferences, cultures and economic structures amongst the EU countries makes corporate taxation an issue well met with political tension as all countries should be working towards common EU goals yet pursuing their national objectives (Teather, 2005). It has become clear that the need to foster standardized EU tax arrangements in certain areas is vital to the functioning of the internal market and this is increasing the role for EU policy makers. Moves towards standardization of corporate taxation are a new area for the EU and given that there is not a unanimous agreement from member states on its level of involvement in taxation at this stage, any reforms are unlikely to occur in the near future.

History of Integration in the European Union

Looking into the pace of integration in the EU may help to establish the key areas of integration which have contributed to current trends in tax competition and harmonization.
The Table below summarizes a short timeline of integration in the EU.

Table 1: Timeline of European Union Integration

1951	Treaty of Paris establishes the European Coal and Steel Community
1957	Treaties of Rome establish the European Economic Community and the European Atomic Energy Community
1962	Launch of the Common Agricultural Policy
1968	Completion of the customs union
1970	Launch of European Political Cooperation (foreign policy coordination)
1975	Launch of the European Council
1979	Launch of the European Monetary System
1986	The Single European Act launches the single-market program and extends Community competence in the fields of environmental policy, economic and social cohesion, research and technology policy, and social policy
1989	Extension of Commission responsibility for competition policy
1992	The Treaty on European Union sets the EU on the road to economic and monetary union, transforms European Political Cooperation into the Common Foreign and Security Policy, and launches intergovernmental cooperation on justice and home affairs
1997	The Treaty of Amsterdam extends Community competence over certain aspects of justice and home affairs and sets a target date for completion of "an area of freedom, security, and justice"
1999	Launch of a common monetary policy and a single currency (the euro)
2001	The Nice Treaty reforms the EU's institutions and decision making Procedures
2002	The Convention on the Future of Europe begins
2003	The Convention submits a draft Constitutional Treaty
2004	EU leaders agree on and later sign the Constitutional Treaty Czech Republic, Cyprus, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia join the EU.
2005	The European Parliament gives its approval for the entry of Romania and Bulgaria into the EU. Actual accessions are scheduled to take place in 2007

Source: European Union, European Commission (2006).

Established as an industrial union the EU has increased integration to a large extent for economic motivations related to industry. However, increased political commitments have involved the EU in a wider range of issues and the EU has continued to grow through several rounds of enlargements which have increased scale and the scope of integration.

Opening up trade in the European Union

In relation to corporate taxation competition, there are several key steps in integration which have increased internal capital mobility and trade flow. These are: the establishment of the European Monetary System in 1979, the Single European Act in 1986, Treaty of the European Union in 1992, the launch of the common currency (the Euro) in 1999 and the accession of new member countries in 2004.

The Monetary System in 1979 linked members' currencies together to avoid large fluctuations and inflationary problems. This paved the way for closer financial integration and increased the interdependency of EU members. The Single European Act in 1986 formally established the single market and European political commitment to an internal market. This was adopted after pressure in the early 1980's to free trade between all member countries to eliminate barriers between countries, increase harmonization and the competitiveness of European countries (Europa, 2007). Historically, the European Union with its current pillar system was created under the Maastricht Treaty (Treaty of the European Union) in 1992. The three pillar system comprises of different levels of integrated policy: *First Pillar:* the European Community (covering most of the policy areas encompassed by the EU). *Second Pillar:* the Common

Foreign and Security Policy, including the European Security and Defense Policy. *Third Pillar:* police and judicial cooperation (European Commission, 2006). A significant step towards closer integration was the European Monetary Union (EMU) in place from 1999 which created the Euro and was adopted by 12 of the members at present (Bridges, 2007). The EMU which deepened the function of the EU also meant a new set of constraints on policy making (Bridges, 2007). As the EU moves towards complete integration of its internal market taxation will be a contentious issue (Verrue, 2004). After introducing the EMU and the "Europeanization" of the monetary policy, fiscal policy including taxation remains one of the few remaining elements of nation economic policy sovereignty (Stults, 2004).

A decade of decline, evidence from corporate tax rates in the European Union, 1998-2006

The corporate tax rate fell considerably during 1998-2006. There leaves no doubt that tax convergence/ competition has taken place with declines occurring across the Union and un-simultaneously. Table 2 below shows that in 2006 the average EU-15 corporate taxation rate fell below 30 per cent, a significant figure.

Table 2: EU-15 Corporate taxation rates 1998-2006

Country	1998	1999	2000	2001	2002	2003	2004	2005	2006	Change
Austria	34.0	34.0	34.0	34.0	34.0	34.0	34.0	25.0	25.0	-26.5%
Belgium	40.2	40.2	40.2	40.2	40.2	34.0	34.0	34.0	34.0	-15.4%
Czech Republic	25.0	35.0	31.0	31.0	31.0	31.0	28.0	26.0	24.0	-4.0%
Denmark	34.0	32.0	32.0	30.0	30.0	30.0	30.0	28.0	28.0	-17.6%
Finland	28.0	28.0	29.0	29.0	29.0	29.0	29.0	26.0	26.0	-7.1%
France	41.7	40.0	36.7	35.3	34.3	34.3	34.3	33.8	33.3	-20.0%
Germany	56.6	52.3	51.6	38.4	38.4	39.6	38.3	38.3	38.3	-32.3%
Greece	40.0	40.0	40.0	37.5	35.0	35.0	35.0	32.0	29.0	-27.5%
Ireland	32.0	28.0	24.0	20.0	16.0	12.5	12.5	12.5	12.5	-60.9%
Italy	41.3	41.3	41.3	40.3	40.3	38.3	37.3	37.3	37.3	-9.7%
Luxembourg	37.5	37.5	37.5	37.5	30.4	30.4	30.4	30.4	29.6	-20.9%
Netherlands	35.0	35.0	35.0	35.0	34.5	34.5	34.5	31.5	29.6	-15.4%
Portugal	37.4	37.4	37.4	35.2	33.0	33.0	27.5	27.5	27.5	-26.5%
Spain	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	35.0	0.0%
Sweden	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	0.0%
United Kingdom	31.0	31.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	-3.2%
Average	36.0	35.9	35.2	33.5	32.4	31.8	31.1	29.7	29.2	-19.0%

Source: KPMG, various years

The average rate in 1998 was 36.8 percent. This rate consistently fell over the period to an average of 29.5 per cent in 2006, 19.7 per cent lower than in 1998. Table 2 shows that Spain and Sweden maintained there taxation rate over this period, Finland, Italy and the United Kingdom fell by under 10% , Belgium, Denmark, France and the Netherlands fell 10-20%, Austria, Germany, Greece, Luxembourg and Portugal fell between 20-35% and Ireland the special exception fell by over 60%. Except for Finland, no country increased their rate at any stage during 1998-2006. Interestingly in 2001, just two years after the EMU was brought in, there appeared to be a breaking point for several countries to reduce their corporate taxation rate. Germany dropped their rate from 51.6% in 2000 to 38.4% in 2001, Greece dropped to below 40% and Portugal from 37.4% to 35.2%. The declines in 2002 continued indicating a

convergence of lower taxation rates towards 35% in 2000, around 32% in 2002-2003 and 30% and below by 2005. It can also be noted that the two countries which did not adjust their rates over this period, Spain and Sweden began the period with rates below the average rate. Sweden who has held the rate of 28 per cent still has among one of the lowest rates in 2006. This gives a strong indication that taxation rates are converging to a certain point.

Competitive forces at play in the European Union drive down rates

No country has highlighted the issue of tax competition in the EU like Ireland, who provides sound evidence of the impact of playing the tax cutting game. Ireland's transformation has been heralded as a miracle as less than 20 years ago, Mitchell (2005), reports that Ireland was the "sick man of Europe" with a weak economy and double-digit unemployment. This was in part caused by hefty tax burden on companies. In 1984 the top tax rate on corporations was 50 per cent, which was slightly reduced in the late 1980s, but remained very high in the early 1990s compared to many other EU countries (Mitchell, 2005). Over the past decade, tax rates were slashed dramatically, especially on capital gains and corporate income (Mitchell, 2005). This aggressive "supply-side" tax rate reduction for corporations has shown enormous benefits for the Irish economy. It has experienced the strongest growth of all industrialized nations, expanding at an average of 7.7 per cent annually in the 1990s (Mitchell, 2005). FDI flowed into the country creating the IT hub of Europe. Companies such as Microsoft that have based themselves in Ireland and transferred profit reporting from the United States to Ireland which has saved an estimated $US 500 Million per year on their federal tax bill (Finfacts, 2006).

The reaction of the EU to Ireland's taxation by most politicians from other EU countries was to reprimand Ireland's fiscal policy as there was considerable pressure for other countries to do the same in a way (Mitchell, 2005). Indeed, Ireland has previously used tax rates as a strategy to bolster investment. In 2001, the European Commission took action against Ireland's tax regime which was deemed 'harmful' under the OECD guidelines by abolishing the Irish International Financial Services Centre (IFSC) regime. The IFSC regime gave tax reductions to companies based in the Dublin docklands that operated in the financial sector (Teather, 2005). The tax rate was 10% for these companies as opposed to 30% taxation charged to other Irish companies. The EU Commission found this to be illegal state aid as it amounted to a discriminatory grant for that industry (Teather, 2005). The response of the Irish government was to implement the low rate of 12.5% corporate tax across all industries which could not be discriminatory by the European Commission (Teather, 2005).

Another strong competitive influence is the newly joined members of the EU: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. The corporate tax rates of these the new member countries of Eastern and Central Europe are considerably lower than most of the older EU members (Verrue, 2004). Robert Verrue, Director General for Taxation and the customs Union of the European Commission in 2004 reports that in 2003, the average corporate tax rate in the new Member States was 24%, considerably lower than the average tax rate of the EU-15 and that further reductions are scheduled in most of these new Member States in the coming years. Verrue (2004) states "the trend in corporate tax rates will be accelerated by the adhesion of the new Member States". The 10 newly joined members have different jurisdictions and tax regulation which are designed to boost growth and attract economic activity (Mitchell, 2004). Given the ease at which EU investments and activity can take place and relocate in these new EU members it is no surprise that the competitive pressure on EU's corporate tax rates will increase as investors take advantage of more favourable tax rates (Mitchell, 2004).

Movements to greater harmonization: better for all?

As early as 1962 there were official reports supporting harmonization of corporate tax systems in the European Economic Community (Mitchell, 2005). Concern, back then was to minimize distortions that occur from differential tax regimes. The debate for harmonization has largely stemmed from a fear that corporate tax rates would fall continuously if no intervention occurred. In 1975, the European Commission tried to agree on a minimum corporate tax of 45 percent. This motion failed, as well as another attempt with the 'Ruding Report' in 1992 which called for a minimum of 30 percent (Mitchell, 2005). It seems that the predictions back in the 1970s have proved correct as tax rates continue to fall in the EU below 30 per cent.

Ireland's fierce pursuit of tax competition has certainly pushed the issue of corporate tax harmonization to the attention of other EU members but it has certainly not been the only reason, which is a testament to the earlier attempts to harmonize. Additionally, it is being recognized that corporate tax payers in a cross-border situations are many, and may suffer discrimination through double taxation or other additional costs through having to comply with several different rules. This creates inefficiencies in the taxation system which can cause outflow of capital. Furthermore the sharp increase litigation by taxpayers in national courts and the European Court of Justice over the last few years contesting such forms of taxation discrimination was a catalyst for recognizing the need to improve co-operation and better co-ordination between Member States (European Union, 2006). The co-existence of 27 different taxation rules in an internal market is sure to create more obstacles to cross border activities within the EU than if there was a harmonized central corporate taxation agreement (Oestreicher & Spengel, 2007). With each Member state being a separate jurisdiction complying with these different rules incurs considerable costs and also more scope for tax loopholes to exist.

Harmonization of taxation, although presently unpopular politically for corporate taxation has already occurred in other areas of taxation in the EU. An example of a harmonized EU tax is the value-added tax (VAT) which requires that all member countries charge a minimum of at 15 percent on all sales. The EU also has harmonized tax rates for fuel, alcohol, and tobacco, and there are ongoing efforts to expand harmonization of taxation into the areas of personal and corporate income tax rates (Teather, 2005).

A direct harmonization which aimed to align rates would require the EU members to agree on a minimum rate at which corporations must be taxed. Countries would be then be free to tax corporations at the rate at which they require to meet welfare obligations (Mitchell, 2004). This is politically contentious as countries such as the United Kingdom argue that taxation is incontestably a sovereign affair, "the right of Member States to determine their own tax policies is a fundamental one" (UK Government) and furthermore that it would impede economic growth and not promote it (Teather, 2005). Mitchell (2005), notes that there is not upper restriction on tax rates.

However a recent move by the EU, has given power to impose tax over investments with a "Savings Tax directive" that allegedly requires governments to collect financial information on non-resident investors and to share that information with tax collectors from foreign governments (Teather, 2005). Despite considerable opposition the Directive was passed in 2005 and came into force later that year. This means all interest payments to EU residents will be subject to a minimum tax within the EU (Teather, 2005). EU residents will be taxed on interest gains depending on a resident based principle. Generally this implicit form of taxation has been

regarded as problematic as there it relies on exchanging information on corporate earning from the jurisdiction where the income is earned to the legal location of the holding. However, if such information systems are being set up to report this type of taxation, Teather (2005) suggests that this could establish the ground work for other forms of tax harmonization. Furthermore, Jones & Brown (2007) argues that acceptance of the international financial reporting standards (IFRS) by the EU and the International Organization of Securities Commissions (IOSCO) in 2002, which harmonizes financial accounting, may have spill over effects on taxation. Jones & Brown (2007) notes that countries are under pressure to conform to international tax initiatives to create greater transparency in particular through the exchange of information. Improved cooperation on matters such as double taxation has so far proved successful and this may be the beginning of more substantial efforts to harmonize taxation.

Examining the level of harmonization using Velayos et al. (2007)'s scale

Examining the case of the EU for tax harmonization involves looking beyond the tax rate alone. Harmonization can occur in the tax rate but also the rule which encompasses a wider range of measures such as double taxation treaties and other mechanisms and policies. Statutory taxation rates are a useful tool of comparison as they are a highly visible measure of intent of policy makers (Stewart & Webb (2006). Despite criticism that they do not take into account tax base which differ widely across countries the importance of this paper is to ascertain the intentions and pressure towards tax harmonization. Statutory tax is not a good measure of tax burden (Stewart & Webb, 2006) but they are relevant to understanding corporate taxation in a world of mobile capital. Hallerberg & Basinger (1998) argue that changes in statutory rates of taxation are useful for studying the rate at which governments can respond to changing international pressures. In the EU is clear that governments have responded quickly to the changing taxation environment and there exists a sound degree of flexibility in the taxation systems to allow this. Velayos et al. (2007)'s sub division of the harmonization definition are particularly useful in determining how flexible the EU has been to change their corporate taxation system, and most importantly, how voluntary this has been.

Bottom-up progression, from convergence to standardization?

Recalling Diagram 1; the scale of harmonization moves from convergence, up the pyramid through co operation, co ordination, compatibility to standardization suggesting that convergence drives harmonization to other levels. Has this occurred in the EU?

Most literature would support the view that statutory rate of corporate taxation has been reduced through convergence as the pressure from the EU member states has intensified, particularly with low rates in Ireland and the new member states. This convergence can be identified by the declines over a long period of time and the fact that the rate decreases occurred one by one by the member countries. This is reported to be occurring involuntarily in many member states which was highlighted by 1992 'Ruding Report' which pushed for a minimum of 30% corporate taxation across Europe and a maximum of 40%. The Ruding Report proposed that the scope for tax convergence within its member states could and should be reduced. The report written by European Commission by an independent team of experts headed by Onno Ruding, a former Dutch finance minister argued that differences in corporate tax rates and rules distort investment decisions across the EU (The Economist, 1992). The report argued by harmonizing the minimum and maximum corporate tax rate would help to address these distortions within the Single Market and avoid problems with EMU. This proposal did not pass and since then the corporate tax rates have continued to converge towards lower levels with no strategic

cooperation between countries. Each country has adjusted the rate when needed to or when under threat from rate cuts from other Member countries.

In recent moves to opt for more co-ordination in corporate taxation measures the European Commission in 2006 under an Act of 'Coordinating Member States' direct tax systems in the Internal Market'. The act introduces a set of initiatives 'intended to promote better co-ordination of the national direct tax systems in the Union. The aim is to ensure that national tax systems comply with Community law and interact coherently with each other. The initiatives seek to eliminate discrimination and double taxation for the benefit of individuals and businesses, while simultaneously helping to combat tax evasion and to preserve the tax base.' (European Commission, 2006, Act 52006DC0823). The Act was introduced to address the need to be compatible and coordinated on an EU level given the increased pressures brought about by cross-boarder activity within the EU. The European Union Commission faces a challenge with the presence of 27 different tax systems in an internal market. For purposes of efficiency alone more coordinated tax systems contribute to the success of the Internal Market and help enhance the competitiveness of EU business (European Commission, 2006). The objective of the 2006 Act was to further a coherent and co-coordinated approach to taxation in the EU by eliminating discrimination and double taxation, preventing unintended non-taxation and evasion, and reducing the compliance costs associated with being subject to more than one tax system (European Union Commission, 2006). Double Taxation and preventing tax evasion are concrete examples of specific areas in which a coordinated approach are mutually beneficial to all Members hence demonstrating elements of co-operation in the EU corporate tax harmonization.

Further changes to be made in the EU point to a direction of increased co-ordination and standardization. The current push is consolidating the corporate base of taxation, not the taxation rates (European Union Commission, 2006). The Commission has announced its intention to present a comprehensive legislative proposal for such a Common Consolidated Corporate Tax Base (CCCTB) in 2008 (European Union Commission, 2006). This consolidation would significantly reduce the costs of compliance for companies operating within the internal market, resolve transfer pricing issues and allow greater simplification of international operations (Farrow & Sunita, 2006). In short the consolidated corporate tax base reduces complexity and enhances the competitiveness of operation within the EU. A further area to enhance this is in relation to international corporate losses. In the case where cross-border losses are not offset for companies, their profits and losses risk being allocated across different jurisdictions (European Union Commission, 2006). When this happens, offsetting of the losses is limited to the location in the member state where investment was made. As a result there is the risk that companies pay tax on a base which is larger than their total EU-wide profit. To overcome this problem of offsetting corporate losses the European Union Commission proposes a coordinated approach by member states (European Union Commission, 2006).

Whilst Velayos et al. (2007) acknowledge that the difference between co-operation and co-ordination is narrow; the changes above are more symbolic of co-ordination as they do reflect an in-between area of harmonization. Whilst they are agreed upon co-operatively they are also decided upon by the central body of the EU commission and hence there may exist pressure to conform. Also, they are not individual country co-operation measures between but rather a unified agreement which includes all the members.

In principle for EU to function as a single market a certain degree of standardization and compatibility are needed to ensure that tax measures do not hamper the free movement of goods, services and capital or distort competition (Farrow & Sunita, 2006). Previous moves to

harmonize corporate taxation have shown significant resistance, however the Commission readdressed its approach in the 1990s and adopted practical measures to deal with convergence (Farrow & Sunita, 2006). In 1990 the "package of three" was introduced which formed a parent-subsidiary directive, a merger directive and an Arbitration Convention. The Arbitration Convention, hailed by Farrow & Sunita (2006) as a revolutionary innovation in international tax law, was a concentrated effort to eliminate double taxation by establishing a competent authority in the member states to settle disputes in transfer pricing.

In 1992 the European Union Commission agreed upon several issues regarding corporate taxation and issued corresponding guidelines. Standardization occurred in the establishment of common definitions on rules concerning headquarter allocation costs and the definition of shareholder costs (Farrow & Sunita, 2006) and common rules on the treatment of 'thin capitalisation'. Both these measures were implemented to eliminate double taxation. It is also noted that the increase of cases at the European Court of Justice relating to non compliance by member states in relations to corporate taxation provides more evidence for the involuntary convergence towards a more harmonized taxation system (Farrow & Sunita, 2006, European Union Commission, 2006). The most noted tax standardization in the EU has been the Value Added Tax (VAT) which imposes a minimum level of VAT which each member must charge ensures that cross-boarder shopping does not distort trade (European Commission, 2006).

A bottom-up pattern to harmonization appears to have occurred in the EU. As it faces various challenges brought about by increased integration and pressure of globalization the force which pushes the EU to respond quickly to the environment of increased capital has been convergence. This convergence lead harmonization may encourage a more pro-active approach to tax harmonization in the future as co-operative measures are employed as a way of circumventing such competition. Farrow & Sunita (2006) argue that the major reason that changes in taxation have occurred at such slow paces compared to the integration in the EU in many other economic measures is because changing the EU treaty of tax requires unanimity for any change to be approved. With so many varying interests and tax systems this makes tax reforms highly complex. Given the importance of harmonizing corporate taxation elements for the benefit of the entire community several proposals are underway which if successful would grant the European Union Commission more central taxation control and extensive involvement (Farrow & Sunita, 2006).

Summary of key findings from the EU

The EU has shown a period of steady declines in tax rates which has been brought about by competitive forces of the lower taxation rates in the new members and the example of Ireland which has done extremely well from pursing a much lower corporate tax rate than other member countries. Greater moves to co-operative and non-rate harmonization efforts have occurred in the EU to ensure efficiency in the tax systems.

Part 2- ASEAN

Evolving integration in ASEAN

The ASEAN trade bloc was formed at the Bangkok declaration in 1967 with Indonesia, Malaysia, Singapore, Philippines and Thailand being the founding members. ASEAN has grown to 10 members and there are further proposals to include more countries. With a fast growing population of 500 million combined and a GDP of around $US 700 billion ASEAN is a region to watch, (www.asean.org). The growth of ASEAN is even more impressive given that in 1997 the Asian financial crisis severely affected the entire regions economic growth and stability. It was huge increases in FDI that helped the Asian region recover following the crippling financial crisis (Thanadillapakul, 2004).

The integration of ASEAN has progressed slowly prior to the financial crisis and since 1998 showed a more solid progress towards cohesion. With different legacies, some members have colonial backgrounds. Yong (1997) argues that there were greater structural and psychological barriers that discouraged strong ties in the earlier period of 1960-1980s. Continued divergent interests such as political and security issues over this period impeded better integration. Territorial disputes, ethnic, economic and social instability in the region made integration limited to basic trade agreements (Yong, 1997). Yong (1997) reports that ASEAN countries during the early period were characterized by indifference and scepticism in attitudes towards integration, but economic growth throughout the region has narrowed the power disparity between the more industrialized and less developed countries. However over the past two decades external expansion and internal consolidation have instilled in the region a secure enough sense of identity to encourage further expansion and co-operation

History of integration in ASEAN

Establishing the measures ASEAN has taken to progress its integration can help to establish the key areas of integration which may lead to tax competition and harmonization. A short history of ASEAN integration is explained in Table 3 below:

Table 3: ASEAN history of integration

1967	Creation of ASEAN
1976	Treaty of Amity and Cooperation in Southeast Asia
1984	Brunei Darussalam joins
1992	ASEAN Free Trade Agreement created
1994	ASEAN Regional Forum established
1995	Vietnam joins, Treaty on the Southeast Asia Nuclear Weapon-Free Zone
1997	Lao PDR and Myanmar joins
1998	"Hanoi Action Plan," a declaration that emphasized economic recovery based on free-market policies formed.
1999	Cambodia joins, Increased cooperation with Japan, China and South Korea in an "East Asia Forum" known as ASEAN+3 and to move toward a common market.
2002	China and ASEAN agreed to a China-ASEAN free-trade area to be implemented in stages up to 2015.
2004	Signed with China an accord to create the world's biggest free trade area by removing tariffs for their 2 billion people by decade's end.

Source: ASEAN

Rapid changes in ASEAN policy

ASEAN was formed with the objective of accelerating economic growth, social progress and to promote regional peace and stability. It has ambitious goals for integration in the next 20 years (www.asean.org) but how well has it progressed so far?

After a long period of lagging integration recently significant moves to enhance economic integration and create an open regional economic group have occurred with the launch of several new ASEAN co-operation schemes. Noticeably ASEAN decided in 2003, that an ASEAN Community shall be established comprising three pillars, namely, ASEAN Security Community, ASEAN Economic Community and ASEAN Socio-Cultural Community, following the model of the EU's pillar system. Thanadillapakul (2004) identifies the major moves to truly integrate ASEAN as the ASEAN Free Trade Area (AFTA), the ASEAN Framework Agreement for Liberalisation Trade in Service (AFAS) the ASEAN Investment Area (AIA) and the ASEAN Industrial Co-operation Scheme (AICO).

The major development was to form the AFTA which will introduce a common effective preferential tariff scheme and trading agreements. Similar to the EU horizontal expansion raises the question of vertical integration (Yong, 1997). The Asian Development Bank (2005) has recognized that the 'global trend toward regional cooperation, and a desire to enhance productivity and international competitiveness, have prompted Asian countries to forge closer ties through schemes such as free trade agreements'. What has been remarked as 'Open regionalism' in the ASEAN region reflects the greater effort at cooperation and integration with the rest of a world as a more unified trading bloc (ADB, 2005, Rana, 2007).

ASEAN, big growth, little changes on corporate tax rates

Over the past decade ASEAN has been a highly dynamic region showing the strong growth rates and increasing substantially investment and trade opportunities. It would be no surprise if corporate taxation rates also displayed such large changes as the economies have. However, to somewhat of a surprise taxation rates in the ASEAN 6 show little change over the period of 1998-2006. Table 4 below shows the corporate taxation rates over this period and compares it with the rest of the Asian-Pacific region.

Table 4: Corporate Taxation Rates in ASEAN 6, 1998-2006

Country	1998	1999	2000	2001	2002	2003	2004	2005	2006	Change
Indonesia	30.0	30.0	30.0	30.0	39.0	30.0	30.0	30.0	30.0	0.0%
Malaysia	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	0.0%
Philippines	34.0	33.0	32.0	32.0	32.0	32.0	32.0	32.0	35.0	2.9%
Singapore	26.0	26.0	26.0	25.5	24.5	22.0	22.0	20.0	20.0	-23.1%
Thailand	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	0.0%
Vietnam	35.0	35.0	32.5	32.0	32.0	32.0	28.0	28.0	28.0	-20.0%
Average ASEAN 6	30.5	30.3	29.8	29.6	30.9	29.0	28.3	28.0	28.5	-6.6%
Average Asia Pacific	32.4	31.8	31.9	31.3	31.5	30.6	30.4	30	30	-7.4%

Source: KPMG, various years

With corporate taxation rate in ASEAN 6 has fallen by 6.6% per cent on average this also only due to the fall in two countries, Vietnam and Singapore, by 20% or more. The Philippines was the only country to increase rates however the increase of the rate to 35% in 2006 is a temporary one (PriceWaterhouseCoopers, 2006). Comparing this to all the countries in the Asia Pacific Region the ASEAN 6 is has declined less that the regional average decline of 7.4 per cent.

However the rate in ASEAN is lower than the region by 1.5%, perhaps indicating less pressure from the ASEAN6 to reduce rates. However, this may be seen to change, especially if the rates in other parts of the world fall to a level below the average ASEAN rate. The case of Singapore is particularly interesting as its rate in 1998 was the lowest in the region and it has maintained this status every year until 2006. This is indicative of a strategy pursued by Singapore to maintain the lowest rates in the region as opposed to other countries converging to the lower rate and Singapore retaining its rate of 26% in 1998 which would still be the lowest rate in ASEAN in 2006. Interesting as well is that there is not a steady pattern in ASEAN with rates going in a clear direction. In 2002 Indonesia set their rate to 39% for the one year only and the Philippine rate has fluctuated between 32 and 35% with more changes scheduled for the following years (PriceWaterhouseCoopers, 2006).

Singapore- The Ireland of ASEAN

Many countries in the Asia Pacific region have actively pursued preferential tax treatment to promote the inflow of capital which has so dramatically increased GDP levels. This has been particularly evident in the countries which few natural resource endowments or promising industries as a way to 'catch up' with the other Asian Tigers (Kuroda, 2002). Neighbouring countries, and former British Colonies, Singapore and Malaysia have among the lowest rates of corporate taxation in ASEAN and Asia Pacific. Rogers (2002) argues that Asian Tier economies of Singapore, Hong Kong and Malaysia exist partially because of tax competition as governments in these countries 'lured' in foreign direct investment through advantageous tax for corporate profits. Malaysia as gazetted in law on 31st of December 2006 will reduced the corporate tax rate to 27 per cent. The 1 percentage point decrease from the previous rate which had remained unchanged since 1998, came out of need to maintain and improve Malaysia's competitive position relative to other Asian countries for the choice of FDI (PriceWaterhouseCoopers, 2007). PriceWaterhouseCoopers (2007) notes however that this may need to be re-evaluated as Singapore decided to reduce their corporate tax rate by 2 percentage points to 18 per cent coming into force in 2008. The force for change behind the corporate tax reduction in Malaysia came from repeated calls from the business community who compared this rate with their close neighbours in Singapore (PriceWaterhouseCoopers, 2007). The Singapore reduction of 2 percentage points is partially introduced to compensate for the increase in Good and Service Tax (GST) from 5 to 7 per cent. This follows the models of tax competition that the tax burden is shifted to less mobile sources. In the view of the OECD (2007) taxes on consumption such as the GST and VAT will be the way of the future with moves to increase these taxes on domestic consumption seeming the easiest way to counter-act losses in tax revenue from import and export duties and lower corporate taxation rates. The PriceWaterhouseCoopers (2007) Asian Tax Report for 2007 reported that the 2 percentage reduction in corporate taxation came as some what of a surprise for the business community. The changes in the Singaporean tax system are indicative of bold efforts to create an investment friendly regulatory environment. The changes in 2006 in Singapore were the first time that a decrease in corporate taxation has occurred without the non-resident individual tax rate being aligned with this decrease showing that the changes are heavily targeted at foreign corporations and not individuals. Additionally Singapore has increased its thresholds for tax exemptions for small and medium sized enterprises (SMEs). With Singapore and Malaysia being geographically so close and both being small open economies it seems highly probable that the situation of tax competition will only intensify.

Vietnam, the effects of opening up the economy on corporate taxation

Vietnam has undergone very large structural changes over this period and the fall in corporate taxation rates has occurred as Vietnam decentralizes ownership of State countries and allows foreign owned companies to work in new business sectors which have previously been restricted to State control (Business Asia, 2003). Vietnam still has large problems with corruption and infrastructure which may have been a key reason behind the drop in corporate tax rates as it was one of the easiest responses to complaints from foreign investors to actualize. Infrastructure and corruption take more time and are more complex to solve than a change of corporate tax rate (Business Asia, 2003). Hence the change in rate may not reflect a strategy such as Singapore to attract foreign investment through lowered tax rates but rather it may be to maintain the current investors and abate the complaints. An interesting change in Vietnamese taxation is the increasing use of VAT, but in a some what unpredictable manner.

The IMF and other international institutions have advised developing countries over the past few decades to replace trade taxes with domestic taxes on consumption, particularly VAT, relative to corporate tax rates (Reuven Avi Yonah, 2006). Vietnam which is the fastest growing country in the Asian Region appears to have followed this advice. Corporate tax rates in Vietnam have become more competitive however Business Asia (2003) report that there are many deterrents to investment in Vietnam that persist including a large scale investigation for transfer pricing investigations for all foreign enterprises which started in 2004. Vietnam joining the WTO in 2006 has meant the agreement to drop many tariffs and taxes on imports and adopting the WTO trade rules which meant a reduction in many import duty revenues (www.wto.org). This creates uncertainty as to how Vietnam will compensate for the loss in such taxes as many reforms have resulted in several problematic taxes (Business Asia, 2003). One such example is Vietnam's tax policy on its domestic automotive industry which attracted attention for its worst case example of how to cripple domestic demand by adding an excessive with an excessive VAT on domestically produced cars (Business Asia, 2003). Unpredictability in the Vietnamese taxation reforms creates uncertainty as to whether the corporate tax rate will continue to fall.

The call for greater harmonization in ASEAN

A unique characteristic of trade in the Asia-Pacific region is the intra-regional trade on semi-finished products in the same industry (Kuroda, 2002). In addition a large proportion of the finished electrical goods made in the region are consumed as final products there. Being so interlinked for trade of semi-finished products the business cycle in ASEAN is becoming more synchronized (Kuroda, 2002). This intensified interdependency brings about not only closer relations in ASEAN but a heightened need to co-ordinate policy in finance, trade and tax (Kuroda, 2002). After the Asian crisis several developments in international financial cooperation came about. The Chang Mai initiative formed in the year 2000 was one such measure created to agree on a network of bilateral currency swaps to prevent any future currency crisis. This level of monetary co-operation is a significant development and sign of ongoing commitment to ASEAN regional integration (ASEAN, 2007). Integration agreements in trade, the approaching AFTA and several other large intra regional trade agreements such as the Japan-Singapore Economic Partnership Agreement are examples of regional liberalization in trade and financial systems. Internationalization calls for appropriate tax systems to ensure that taxation is efficient and non-discriminatory (Farrow & Sunita,2006 & Tanzi,2002). Liberalizing the financial markets requires communication, sharing of information and innovations leading to harmonization in certain technologies and systems (Lao-Araya, 2003). Technological globalization has made it increasingly easy for large companies to avoid taxes through transfer pricing in less developed countries Lao- Araya (2003). Given that good governance and anti-

corruption are still developing in many Asian Pacific countries the need to maintain well governed and co-ordinated tax administration in ASEAN is essential to avoid companies using state of the art technology to capitalize on tax loopholes (Lao-Araya, 2003). Kuroda (2002) notes that the "foot loose" globalization ties countries of different development stages close into relationships of mutual dependence there are also greater opportunities for tax avoidance and unfair play. Taxation systems that allow tax evasion, whether intentional or not, are what the OECD brands as 'harmful tax competition' (Stuart & Webb, 2006) as tax which should be paid is being lost, rather than simply shifting to another jurisdiction.

Improving 'coordinabiltiy' in ASEAN

ASEAN's ability to respond to changes in the business environment have improved since the financial crisis yet still need to respond more swiftly to the ever changing environment. It has been widely called for that tax harmonization at some basic levels needs to occur in ASEAN to establish common ground for treating corporate tax. Indeed, this is increasingly important as regional integration deepens and widens, creating larger economic and political blocs. Despite the economic need to change taxation policy Velayos et al. (2007) acknowledge that legal, institutional and cultural barriers adversely affect attitudes towards changing tax systems. This can lead to a risk of lagging behind in the processes of modernization and integration (Velayos et al. 2007).

Hence a new and desirable feature of a modern tax system, and one that according to Velayos et al. (2007) is 'unavoidable if regional economic integration is to be deep, is its capacity to adapt to other tax jurisdictions (its economic partners)—in short, "coordinability"'.

Farrow & Sunita (2006) and Kuroda (2002) find several areas in urgent need of harmonization in ASEAN taxation: the need to improve double taxation treaty coverage, addressing tax avoidance and establishing a plan to assess the future of corporate taxation in regional and global perspective. Double taxation occurs when the same tax burden is played in more than one jurisdiction and therefore can discriminate those companies who operate in cross-boarder situations (Kuroda, 2002).

Double Taxation treatment an important area for harmonization

Double taxation is a particularly inefficient situation for countries to tolerate as it won't take long for companies who pay double on their corporate tax bill to move to a more favourable tax location (Kuroda, 2002). Two ways to avoid international double taxation is unilateral relief under domestic law or bilateral relief through tax treaty. Janeba (1995) identifies three ways to relieve international double taxation: (i) including foreign taxes in deductible expenses in calculating taxable income (ii) foreign tax credit (iii) exception of foreign income.
The current ASEAN bilateral double taxation treaties vary in approach and generosity between countries (Farrow & Sunita, 2006). Singapore, Indonesia and Vietnam have the most extensive, modern bilateral treaty network in ASEAN according to Farrow & Sunita (2006), whilst Malaysia, Philippines and Thailand have extensive treaties but older treaty networks. Having outdated standards may cause additional costs and lead to inconsistency in the double taxation ruling. Looking at the whole ASEAN region the treaty of double taxation treaties is still non existent between many member countries. The table below shows the extent of coverage of double taxation treaties and the year they were signed upon.

Table 5: ASEAN Treaty Network Coverage and year signed

	Brun	Cam	Indo	LPDR	Mal	Myan	Phil	Sing	Thai	Viet
Brun			2000					2005		
Camb										
Indo	2000				1991	2003	1993	1990	2001	1997
LPDR									1997	1996
Mal			1991			1998	1982	2004	1982	1995
Myan			2003		1998			1999	2002	
Phil			1993		1982			1977	1982	2001
Sing	2005		1990		2004	1999	1977		1975	1994
Thai			2001	1997	1982	2002	1982	1975		1992
Viet			1997	1996	1995		2001	1994	1992	
Source: International Bureau for Fiscal Documentation										

Source: Farrow & Sunita (2006).

Cambodia has no existing treaty network and Singapore, Malaysia and Thailand have the longest standing agreements with their fellow ASEAN members.

The absence of a comprehensive double taxation treaty across all of ASEAN is an area which needs to be harmonized to allow for greater integration and to conduct transactions more smoothly (Farrow & Sunita, 2006, Kuroda, 2002). The need for harmonization of bilateral treaties may be recognised by the pressure coming from increasing business costs, administrative burden and creating a general disincentive to regional in/out bound investment and profit repatriation (Janeba, 1995, Farrow & Sunita, 2006). Additionally with the outdated treaties many new forms of income which have been created from rapid technological change have been unrecognised by the treaties. Transactions from certain services, online systems, R&D have certain complexities and uncertainties when assessed by many differing bilateral agreements. Farrow & Sunita (2006), report that the average age of the double taxation treaty in ASEAN is between 10 to 15 years old. This may give rise to missed investment opportunities if the lack of a double taxation relief law is in place to realise a new form of income requiring double taxation relief.

Another element of discrimination in the taxation scheme is found in the withholding rates which determine the level of corporate profit at which taxation begins to occur. The bilateral agreements rates ASEAN has are often not as favourable between ASEAN member countries as they are with the rest of the world Farrow & Sunita (2006). This is the case for withholding tax rates for Indonesia, who have the lowest rates agreed with United Arab Emirates, Malaysia with the best agreement between Bahrain and Vietnam, Phillipines with China, Israel and Indonesia, Thailand with France and Laos and Vietnam (Farrow & Sunita, 2006). Providing more advantageous withholding taxation rates to countries outside the ASEAN does not create the incentive to promote intra-regional trade and economic integration which conflicts with ASEAN's development plans.

Top down movement to harmonization?

Referring once more to Velayos et al.'s (2007) harmonization scale there are several elements of co-operation which are important to the case of ASEAN and its changes in corporate taxation.

It has been widely recognised that to achieve common benefits through further international trade and investment and to prevent the spread of crises in the region (Kuroda, 2002). ASEAN will need to improve its 'coordability' of corporate taxation between members and additionally with the rest of the world. But are they doing so in the way that Velayos et al.'s (2007) harmonization scale would predict, from convergence to standardization? It appears that it is not.

Convergence in the statutory taxation rates downwards for Singapore and Malaysia is the best evidenced account of this type of harmonization. However it should be noted that whilst Singapore has constantly lowered its taxation rate, Malaysia has not moved theirs until the change which is scheduled for 2007. Commentary from PriceWaterhouseCoopers (2006) remarked upon how there was speculation that Malaysia may further reduce this rate given that Singapore decide to reduced theirs as well. Whilst there is at present a weak convergence between the two countries this may intensify with the recent policy changes.

The case appears more strongly however for co-operation between Singapore and Malaysia. Singapore and Malaysia replaced the original 1968 treaty between the two countries. The new treaty came into force in 2006 and reflects the developments in both the countries and expands the scope of tax exemption and adopts a structure which moves closer to the OECD Model Tax Convention (neither Singapore nor Malaysia are OECD members) (Tek & Poh, 2007).The new Tax Treaty signed in 2004 signals the commitment by both countries to reduce and eliminate occurrences of double taxation and tax evasion follow suit of the efforts made in the EU (Farrow & Sunita, 2006). Specific changes in the Tax Treaty towards complicated shareholding situations of companies operating cross boarder highlight the move to a more complete co-operation and as well as greater compatibility.

Compatibility between the two countries, whilst being the strongest in the ASEAN region given the similar colonial base, is enlarged as the new treaty adopting a format closer to the OECD Model Taxation Convention (Tek & Poh's, 2007). Several changes in the new treaty include a withdrawal of exemption in foreign dividends in Malaysia if received by a Malaysian resident company (excluding banking, insurance, shipping and air transport businesses) (Tek & Poh's, 2007). Under the new treaty if the Malaysian resident owns 10 per cent or more of voting shares of the Singaporean company paying the dividend then double taxation relief is granted. The extensive framework for double taxation relief between Singapore and Malaysia as highlighted in Tek & Poh's (2007) report is a positive move towards a more cooperative framework.

Standardization for ASEAN seems a far way away. The lack of a basic agreement or classification on many taxation elements demonstrate how much progress needs to be made before standardization can occur. It is not certain however that the push to increase standardization will occur in the bottom-up way that it has in the EU. Given that there are measures to increase co-operation and co-ordination whilst not having a strong degree of convergence it shows evidence of following its own informal evolution which is neither bottom-up nor top-down direction. However, given that many ASEAN countries may not have the capacity to make individual harmonization agreements efficient solutions may be posed at an ASEAN level by leading members and adopted by all. Given that Singapore and Malaysia both have a higher quality of institutions and decision making bodies than other members (Tek & Poh's, 2007) it may be that these two countries lead the way towards greater harmonization which would obviously create some bias towards their taxation systems. Given that the 2004 Tax Treaty moves towards a structure of the OECD model of taxation it will be interesting to see whether harmonization will continue to progress closer to this framework.

Summary of key implications for corporate taxation in ASEAN

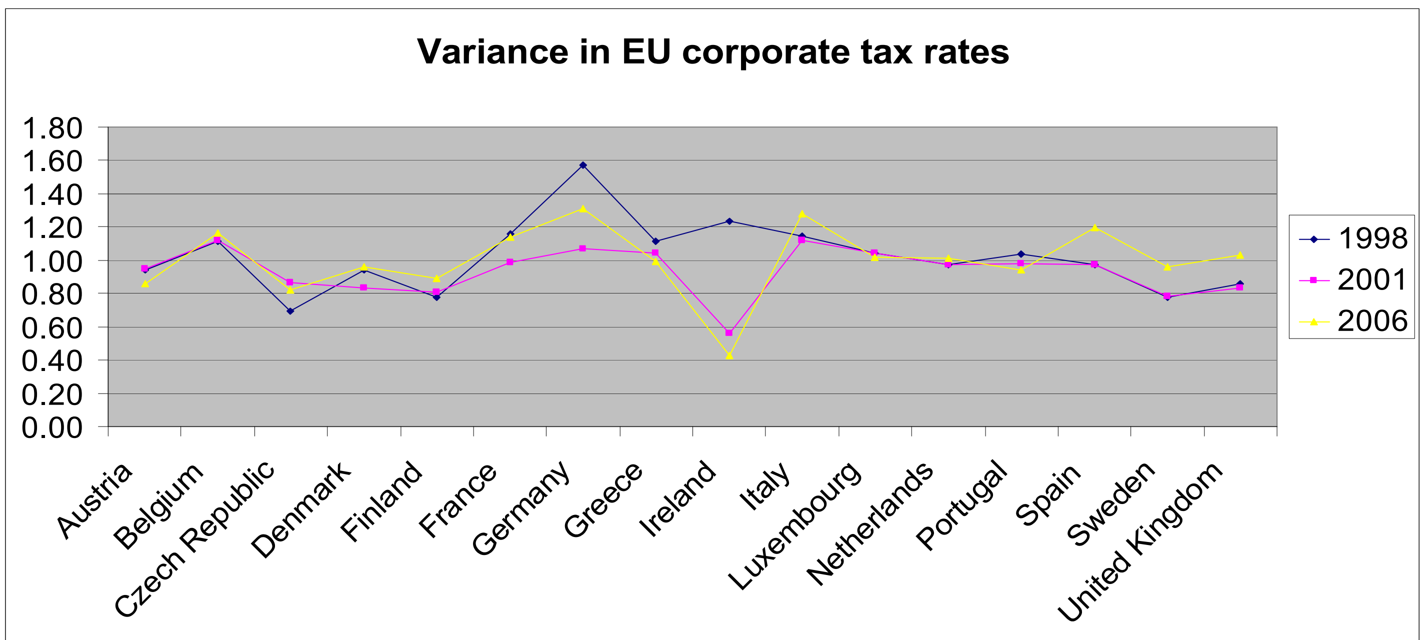
ASEAN integration is an evolving as a more unified trade bloc. Integration in the region has increased stability and helped attract FDI which has resulted in strong economic growth. However closer economic relation pose the need to better integrate taxation policy in key areas to maintain and improve the attractiveness of the whole region. ASEAN corporate taxation rates do not show any significant trend, despite the overall 6.6% decrease over 1998-2006 between the 6 member countries studied. Fluctuating taxation rates or no changes at all have been the main pattern. Singapore is the only member to pursue a consistent strategy to reduce corporate taxation to attract FDI. Vietnam may be following this path as they have made consistent decreases in the overall rate but still show signs of inconsistent taxation strategy, making it too early to ascertain whether the current trend to decrease corporate taxation rates will continue.

Part 3: Comparing ASEAN to the EU

How has corporate tax rates moved relative to each other?

The statistics show that EU member countries have decreased their corporate taxation rates substantially more than the ASEAN member countries over the 1998-2006 timeframe. Over this period EU made substantial moves to further integration, in particular the common currency which reduced many financial barriers to trade and investment. The result has been the converging tax rates to a rate below 30 per cent in 2006. ASEAN on the other hand has not experienced such strong declines, and the declines experienced were limited to two countries only. Comparing the variance of taxation rates relative to other member countries in the EU and ASEAN respectively shows further indication that the patterns of taxation rate changes do not show much similarity. The graphs below display the variance patterns between the regional tax rates over three selected years, 1998, 2001 and 2006.

Graph 2: Variance in EU Corporate Tax rates, 1998, 2001, 2006

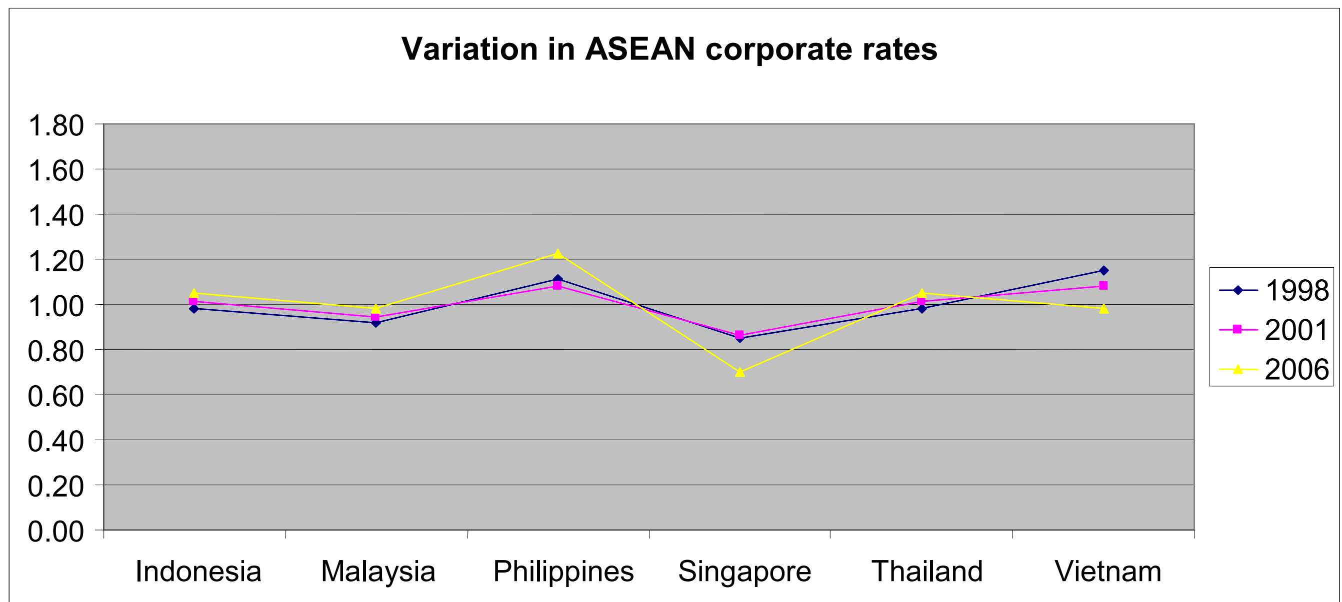


Source: Tax rates from KPMG

Large fluctuations from the regional average rates in fact show weak evidence of becoming more similar. Lower rates have occurred across the region but the differences between the members still remains similar. Austria has become proportionally lower to the average by a small amount, Belgium has remained constantly above by around 15%, Czech Republic became closer to the average after 1998 but still remains around 20% lower, Denmark has remained very close to the average as has Finland, Luxembourg, the Netherlands and Portugal. France, was well above average in 1998 and is again in 2006. Greece seems to be becoming increasingly average whilst Italy, Spain and Sweden become proportionately higher. Germany has changed its position every year significantly. Starting from a position of 57% higher than the average rate in 1998, it was only 7% higher in 2001 and in 2006 shifted back to a higher position of 31% higher in 2006. The other big mover is Ireland which was above average in 1998 and moved to of around 43% lower in 2006.

Whilst the average rate may be declining in the EU the members are not becoming more similar to each other. In ASEAN the rates are relatively more similar to each other than in the EU. Graph 3: below demonstrates this.

Graph 3: Variation in ASEAN Corporate Tax rates, 1998, 2001, 2006



Source: Tax rates, KPMG

The pattern of variation in 1998 and 2001 is almost identical with the only difference being Vietnam who dropped from a position of being relatively higher at 15% above the average regional rate in 1998 to 2% below in 2006. Singapore and Philippines have moved in the opposite directions from one another with Singapore falling to 30% lower in 2006 and Philippines 23% higher. The year 2006 is showing more differentiation in the rates, however, but smaller differences than in the EU.

Different patterns regionally, similar globally?

The question arises as to whether the decrease in corporate tax rates is related empirically to the increased integration in regional blocs. One way to compare this is to measure the EU against OECD countries to give an idea of how taxation rates are changing in other parts of the world in

countries which haves similar economic conditions. The table below shows the changes in the OECD countries (other than in ASEAN or the EU15) over the same period.

Table 6: Statutory Corporate Tax Rates 1998-2006 OECD

Country	1998	1999	2000	2001	2002	2003	2004	2005	2006	Change
	%	%	%	%	%	%	%	%	%	
Australia	36	36	36	34	30	30	30	30	30	-16.7%
Canada	44.6	44.6	44.6	42.1	38.6	36.6	36.1	36.1	36.1	-19.1%
Hungary	18	18	18	18	18	18	16	16	16	-11.1%
Iceland	33	30	30	30	18	18	18	18	18	-45.5%
Japan	51.6	48	42	42	42	42	42	40.69	40.69	-21.1%
Korea, Republic of	30.8	30.8	30.8	30.8	29.7	29.7	29.7	27.5	27.5	-10.7%
New Zealand	33	33	33	33	33	33	33	33	33	0.0%
Norway	28	28	28	28	28	28	28	28	28	0.0%
Poland	36	34	30	28	28	27	19	19	19	-47.2%
Switzerland	27.5	25.1	25.1	24.7	24.5	24.1	24.1	21.3	29	5.5%
Turkey	44	33	33	33	33	30	25	30	30	-31.8%
United States	40	40	40	40	40	34	34	40	40	0.0%
Average Corporate Tax Rate	35.2	33.4	32.5	32.0	30.2	29.2	27.9	28.3	28.9	-17.8%

Source: KPMG, various years. Note: Only OECD countries which have complete data over the period of 1998-2006 have been included. EU countries which joined prior to 2004 (classification of EU-15) have also been deducted from the OECD classification.

Apart from Switzerland, all other countries maintained the same rate or decreased it with the average falling to 28.9 per cent. Interestingly Poland decreased its rate the most by 47.2 per cent over the period. In 2004 Poland joined the EU and that same year reduced its tax rate from 27 per cent to 19 per cent. Hungry also decreased their rate in 2004, to 16% which is the lowest of OECD countries in 2006. The average corporate tax rate for the above OECD countries was 17.8 per cent less in 2006 than 1998. Comparing the United States rate of 40% with Canada it is interesting to note that whilst Canada dropped its rate by 19.1% over the period the Unites States have not changed their rate. In fact the major declines from the OECD average have occurred in the EU new members or close neighbours, Turkey and Iceland. Similar to the EU the decline has been strong, but not as strong as the EU.

Comparing the OECD declines with ASEAN and EU below it shows that tax competition in the EU has driven down the tax rates more than the OECD countries average. ASEAN has in comparison fallen an even more insignificant amount given the trends that have occurred around them and to major trading partners.

Table 7: Comparison of average decline in corporate taxation rates 1996 vs. 2008.

	ASEAN	EU	OECD
Average decline	6.6%	19.7%	17.8%

Harmonization efforts- different drivers of change

The debate about standardizing corporate tax rates in the EU has arisen from those concerned that the rates will continue on their trend downwards having severe repercussions on tax revenue and tax burdens. This has been sparked by the converging tax rates across all the members in the EU which has reduced the national sovereignty of the EU members in their decision making

ability of corporate taxation. It would be a challenge or rather an unwise decision if a member of the EU decided to increase their set corporate tax rate. Most likely corporations would move causing a loss of jobs, a loss of tax base and a strengthening of position for another member country. Harmonization efforts have attempted to minimize the unnecessary loss in taxation in the Union by creating better coordination in the tax systems to avoid tax evasion and strengthen their position on double taxation prevention. ASEAN has made little progress to improve its co-ordination between members with the outdated treaties and incomplete coverage of double taxation an outstanding issue. Recent moves to make the Singapore-Malaysian systems more compatible have occurred out of a sincere need to improve the efficiency of taxation rather than there being the pressure of convergence. The move to adopt a more international framework in the reforms is a significant step towards harmonization of taxation not just between Singapore and Malaysia but also the rest of the world. Much more harmonization is needed in the other ASEAN member countries to avoid harmful taxation practices and update the taxation policies to reflect the changes that have occurred over the past decade.

Has regional integration caused similar changes in ASEAN as it has the EU?

Looking into the history of integration in the EU and ASEAN it is clear that EU is at a much advanced stage of regional integration, however both regions have made significant advances over the period studied. However, despite ASEAN moving forward there seems to be little evidence of tax competition occurring as a result of closer regional relations. This is a curious finding as ASEAN has not only not shown a similar response to integration as the EU but also the rest of the world as it is was shown the rates of taxation changed significantly less than OECD countries and the EU15.

Part 4: Explaining the differences

If ASEAN is not heading down the same path as the EU has, why is this so? Several factors may contribute to the differences, some which are unidentifiable but several which are. These include the different strategies pursued by the regions, the different structure of the unions and the problems which ASEAN shows in its functioning.

Open regionalism- promoting extra trade more than intra-regional trade?

ASEAN having pursued the 'open regionalism' approach discussed earlier meant that integration did not necessarily lead to greater intra-regional trade as it did for the EU. Blomström, Globerman & Kokko (2000) discuss the foreign direct investment response that occurs with different types of inter-regional agreements. In principle, agreements which reduce the trade barriers and tariff agreements between countries encourage the flow of FDI. However, interestingly there is empirical evidence that implies increased integration in ASEAN did not necessarily bring about an increase in intra-regional FDI. Sharma & Chau (2000) found that despite the ASEAN integration scheme there was not an increase in intra-ASEAN trade but rather an increase occurred in trade with the APEC (Asia Pacific Economic Cooperation) countries. Even though there has been an increase in intra-regional trade within ASEAN since the start of the 90's it is still disproportionately less than with the rest of the world (Cortinhas, 2007). Looking into intra-regional ASEAN trade statistics and FDI, Table 8 below shows support for Sharma & Chau's (2000) finding that integration has not meant greater trade intra-regionally.

Table 8: The Role of Intra-ASEAN and Extra- ASEAN Exports (%)

Country	1995	2002	2003	2004
Intra- ASEAN exports	25.0	22.3	22.6	22.9
Extra-ASEAN exports	75.0	77.7	77.4	77.1

Source: ASEAN statistics (2006)

As the table above illustrates the intra and extra regional trade in ASEAN has remained stable. There has not been a large increase in Intra trade from 1995-2004 as could be expected by comparing it to the EU. In the table below it is shown that FDI has similarly shown a fallen with in ASEAN between member countries.

Table 9: FDI inflows into ASEAN Member Countries from ASEAN, 1995-2004 (US $ Million)

Host Countries	**1995**	**2002**	**2003**	**2004**
Indonesia	609	1337	384	32
Malaysia	1677	0	251	980
Philippines	242	38	175	116
Singapore	1165	774	637	649
Thailand	161	1223	670	336
Vietnam	387	200	100	243
Total ASEAN 6	4241	3572	2217	2356

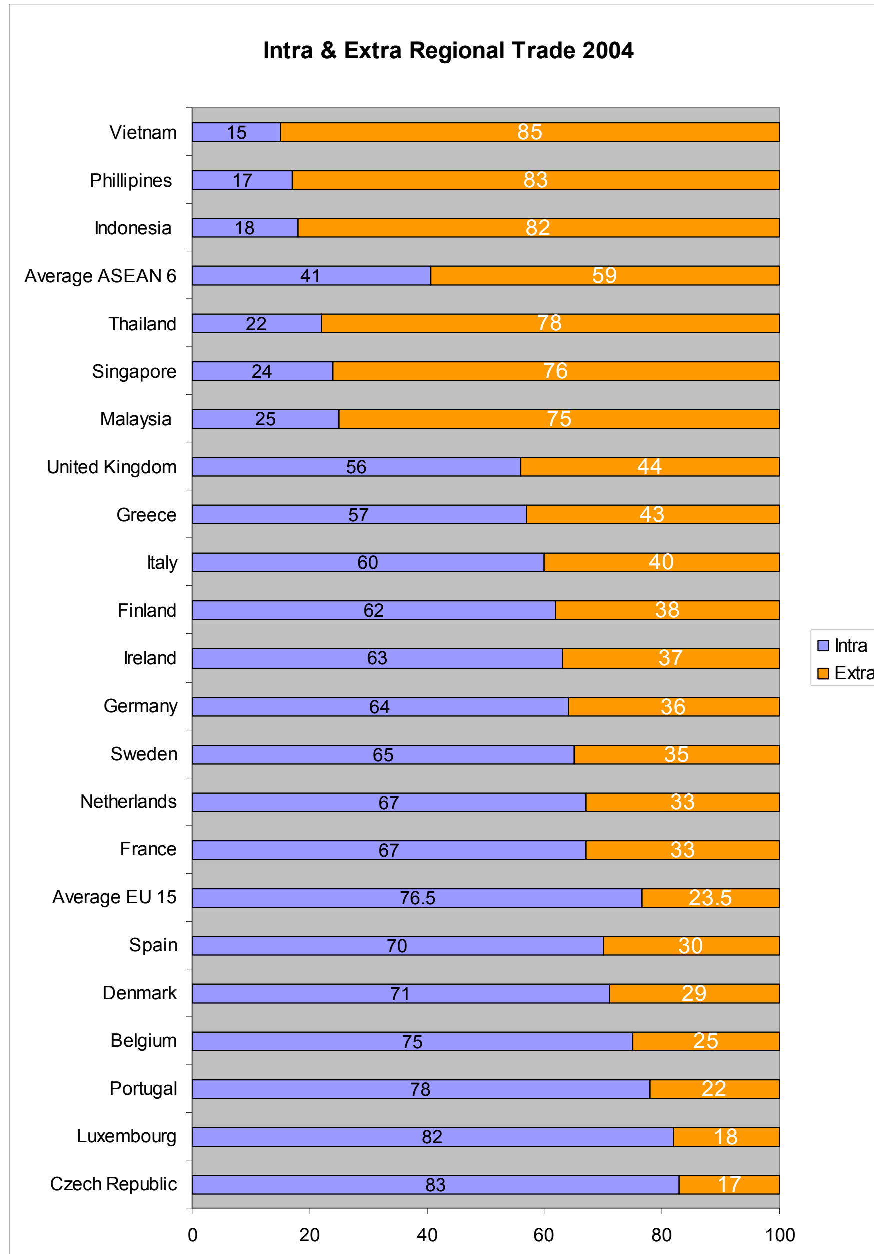
Source: ASEAN statistics (2006)

Pre-Asian Crisis figures in 1995 portray an intra-ASEAN investment situation that was of greater value then than in 2004 (ASEAN Statistics, 2006). Due to the successes of export-led growth and the fear of loosing attractiveness as FDI host countries, the AFTA was agreed upon. However it remains to be seen how this will change intra-ASEAN trade flows given that in the

early 90s trade from Singapore to Malaysia alone represented 52 % of total intra-ASEAN trade (Yap & Edillon, 1993).

Extra-regional trade is therefore of a greater importance to ASEAN than it is to the EU. A comparison of the division of intra and extra regional trade in 2004 is shown in table 10 below:

Graph 5: Intra & Extra Regional trade in ASEAN and EU, 2004

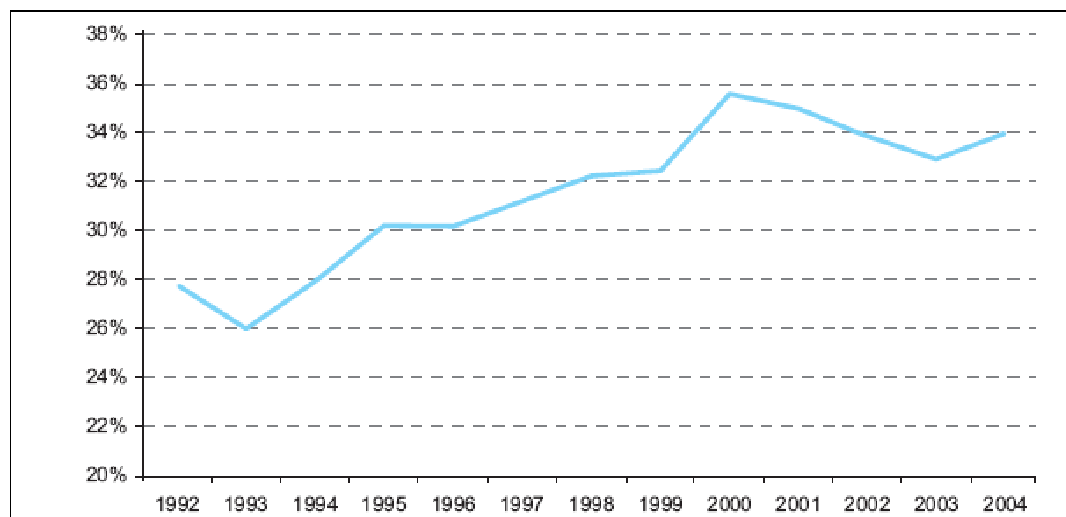


Source: EU Commission, ASEAN

The EU countries show a far greater reliance on intra regional trade with the average in the EU15 in 2004 being 76.5% of trade within the EU compared with the ASEAN6 average of 41%.

Comparing these findings to the EU and the impact of integration on intra-regional trade it can be shown that EU intra-trade increased with increased integration. Noting the introduction of the pillar system in 1993 and the common currency in 1999 there seem to be increases in intra-EU15 trade following these eventful years as is shown in Graph 6 below:

Graph 6: Intra- European Union Trade, Share of intra- EU-15 trade in EU-15 GDP



Source: Eurostat

The strong intra-EU trade highlights a key reason tax competition in the EU is more pronounced than in ASEAN. ASEAN corporate taxation may be less influenced by the regional rates as a larger percentage of trade comes from extra-regional. ASEAN corporate tax rates could therefore be influenced more by major trading partners than fellow members. The US and Japan which have been the largest trading partners and source of FDI for ASEAN over the 1998-2006 period have rates averaging at around 40 per cent (WTO, 2006). Given that both the US and Japan have only in the last few years started to cut the rate, perhaps it will become more competitive as the ASEAN tax rate becomes relatively less enticing than in previous years.

A country which has an increasingly dominant role in the ASEAN, Asia-Pacific and global markets is China. China has been particularly important when analysing Asian trade and investment patterns. Since China is not part of the ASEAN trade bloc it counts as extra trade however China has become the driving force behind Asia's export boom as they import more from Asia and export more to the rest of the world (Gruenwald & Hori, 2008). China's taxation policy changes may have the most influence on ASEAN's rate and policy in the near future especially as China continues to join many regional integration schemes. This is an area to watch.

Poor tax harmonization is a barrier to integration in itself

Economic integration according to Musgrave (1967) is the 'process through which economic relations and interdependence among areas are broadened and deepened'. For integration to be attained barriers must be removed that discourage such relations.

It is also worth exploring that integration of ASEAN has not lead to an increase in tax competition or harmonization as evidenced in the EU, because taxation itself can a barrier to integration and impede free flow of capital. A comprehensive study by Farrow & Sunita (2006) finds many elements of ASEAN's corporate taxation system, or rather lack of that impede grow by acting as a disincentive to invest intra rather than extra regionally. It is argued that a lack of tax harmonization has caused a barrier to integration as a basic level of agreement and

coodordability is needed for the smooth functioning of international taxation systems (Farrow & Sunita, 2006). Tax policy can therefore either impede or stimulate greater integration and economic growth and whilst investment decisions are multi faceted taxation is still a very important one.

There has been little development in ASEAN on double taxation agreements since 2003 meaning that issues of double taxation and tax avoidance are unresolved for the large part (Farrow & Sunita, 2006). This is an impediment to growth and integration within ASEAN if the lack of relief from double taxation problems continues. Whilst it is difficult to quantify the extent of intra-ASEAN and extra-ASEAN cross-border tax avoidance given the advances in technology and globalisation factors this is likely to increase if actions are not taken (Farrow & Sunita, 2006). The IMF in a recent working paper explain that ‘ differences in tax regimes across the region…hinder the development of capital markets as they prevent free movement of capital across the region. Pro-Active regional approach to identifying tax-related problems, and policies towards a more harmonized approach to capital markets would be advantageous’. (Cowen, Salgado, Teo & Zanello, 2006). The need to harmonize to some level will increase as ASEAN economies become more integration in the global economy. Economic integration will increase the potential for tax payers to structure transactions to maximise any advantage from the different ASEAN tax arrangements (Farrow & Sunita, 2006). A lack of harmonization on any aspects of corporate taxation within the ASEAN bloc can harmful to ASEAN trade and adds much complexity. Separate bilateral agreements have also been found to have many inconsistencies. Inconsistency between member countries and the additional tax costs that come from different tax administrations can be a disincentive for investment for the ASEAN region as a whole as intra-regional trade is not as attractive (Farrow & Sunita, 2006, Kurkoda, 2002).

Structural weakness to fix these issues

Whilst it may now appear evident that tax policy in ASEAN should be more harmonized to benefit all members of the union there is still the question as to how this could be done in practise. The EU has a strong institutional framework)which has demonstrated an ability to update policy when needed and appropriate (Bridges, 2007).

However the two regional unions are fundamentally very different since their conception (Bridges ,2007). The EU has always been politically entwined in some way. The EU was set up in the 1950s worked out within the framework around the US sponsorship and Soviet hostility, where as ASEAN has favoured market driven economic cooperation following the path towards ‘Open regionalism’ (Bridges, 2007). ASEAN has favoured policies which favour economic development and interdependence by in general avoiding political and security issues in order to create the sense of community without the threat of political domination from the larger nations. Whilst the EU built its integration on a highly institutionalised, legalistic approach which created as Bridge (2007) describes as a ‘supra-nationality’ of EU homogeneous backgrounds although this continues to evolve as the EU widens there are set traits and standards newly joined members had to meet. ASEAN countries are still culturally very diverse from one another and economically still have large differences in GDPs and do not have the same institutional back ground as the EU (Yong, 1997).

ASEAN has so far emerged more informally, relying minimally on institutionalisation and compromise of national sovereignty. The EU has, as past developments have shown, reduced national sovereignty of policies for a greater economic or social gain at a regional level. Bridge (2007) believes the difference with ASEAN is that ‘cooperation’ and ‘open regionalism’ is the

rhetoric whilst ‘integration’ is key to the EU’s direction. Given that taxation is by nature highly political, institutional and legal it seems that the EU would be in a strong position to implement harmonization of taxes from a central decision making position. Musgrave (1989) defines harmonization as ‘the process of adjusting national fiscal systems to conform with a set of common economic aims’ which emphasises cooperation. This appears to be occurring in both ASEAN and EU corporate taxation policies at differing rates.

Additionally, a lack of common mechanism to resolve intra-jurisdictional corporate tax issues is a problem. This creates significant administrative difficulties and increases transaction uncertainty costs. Harmonization on tax avoidance has been a long withstanding area of constant improvement under the EU’s framework on corporate taxation systems (Farrow & Sunita, 2006). Specific measures are needed to establish a common ASEAN framework on corporate taxation avoidance measures especially as a fast pace of globalisation increases the opportunity for tax payers to take advantage of differing tax systems (Kurkoda, 2002, Farrow & Sunita, 2006). Such measures include basic Transfer Pricing Regulations which require co-operation agreements as it involves sharing and exchanging of information amongst the different jurisdictions a company operates in to ensure that an ‘arms length’ basis when accounting for profit reporting. Otherwise subsidiaries can transfer profits to subsidiaries which operate in a lower tax jurisdiction (Farrow & Sunita, 2006). The system of information sharing and reporting to a central body is needed and this would take a considerable amount of work to establish, especially given the problems which still exist with corruption (Business Asia, 2003).

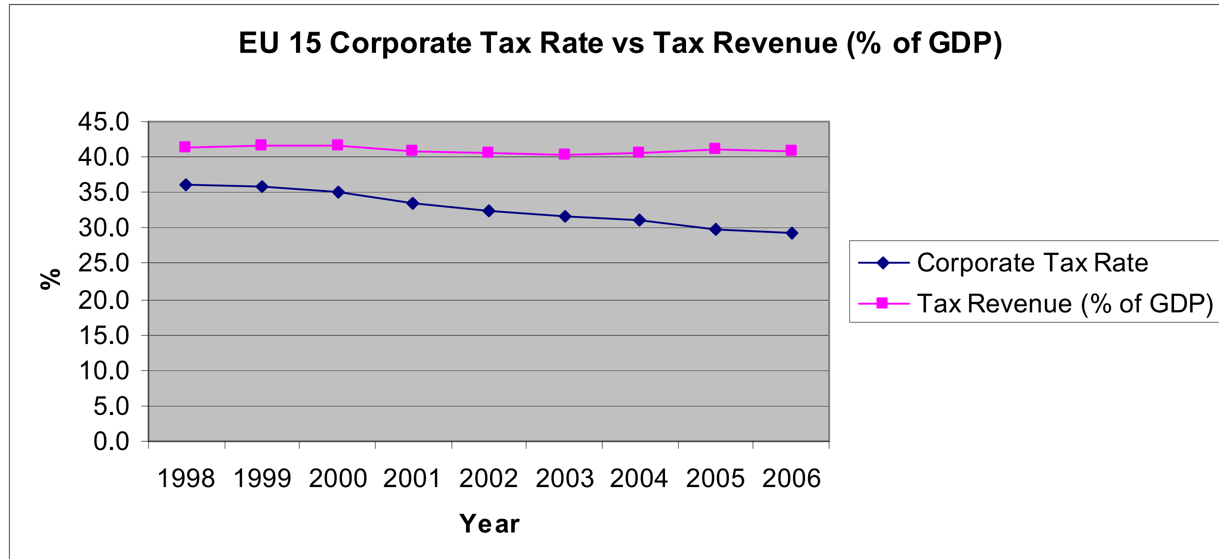
Part 5: Theoretical predictions for the scope of tax harmonization and competition

To understand the most likely trajectory for future corporate taxation changes to both the EU and the ASEAN it is useful to explore what the theoretical models predict for the situations of increased capital mobility in an integrated trade area. The two major theoretical explanations for tax competition and harmonization are the standard model of tax competition and the new economic geography theory. Whilst not totally in opposition they do hold different views on the progression of tax competition and its origins.

Standard Tax Competition Model

So far much of what the standard models of taxation predict have been realized in the evidence of the EU. Models such as that of Zodrow & Mieszkowski (1986) argue that increased factor mobility on capital whilst fixed mobility of the other factors of production, namely labour, results in a shift of tax burden from the mobile source to the fixed and will lead to economic distortions and that 'racing to the bottom' which will erode the fiscal foundations of the modern welfare state (Koester, 2005). This is a matter of serious concern as tax revenues are the principle source of government revenues which are used to finance public expenditures. Hence a shift to favor consumption taxes has been found to agree with this theory. However interestingly whilst these models would expect the taxation rate on individuals to increase they have not done so drastically (Mitchell, 2005). A limitation of such standard models is that labour is generally fixed where as in the EU this is not the case. Labour mobility exists, placing restrictions on the ability for countries to shift taxation from corporations to individuals, for what is a company without its employees? However other models of within the standard competition fields argue that the limit to the highest individual taxation rate should only equal the top corporate tax rate to avoid loopholes in the system by allowing high-income taxpayers to reduce their individual income tax burden by transferring this to be part of the corporation's income (Tanzi, 2002). This is why Tanzi (2002) has argued that falling tax rates will result in lower social welfare as it is not possible to shift the tax burden from one source to another so easily. The standard model predicts that open barriers to trade and free flow capital with no harmonization measures in place will lead to inefficiently low levels of social good provided (Janeba,1995). Janeba (1995) argues that the gains that come from cooperating with other tax jurisdictions to establish a harmonized tax system which does not interfere with one another are second only to the choice to maintain national autonomy over tax policy and no loss of welfare. In Janeba's (1995) theory this win-win situation occurs for the country which holds the lower corporate taxation rate. However, Janeba (1995) does not regard the pressure of convergence as contradictory with autonomy even though, as described by Velayos et al. (2007) it is because a country may be forced to lower their rate to retain capital and prevent outflow. Despite the arguments made in the standard competition models that competition will lead to a lower social welfare an examination into the tax revenue against tax rate changes in the EU shows that this is not necessarily the case. The Graph below shows the relation between corporate tax rate and tax revenue (as a percentage of GDP).

Graph 7: Corporate Tax Rate vs Tax Revenue (% of GDP), 1998-2006



Source: European Commission

Whilst tax rates have show a downwards trend tax revenue has remained stable over the period. This creates serious doubts over the concern for tax competition that the standard tax competition models hold. However there whilst corporate tax rates seem to be averaging under 30 percent the standard taxation model argues that this will continue to fall as a 'race to the bottom' in inevitable. The new economy geography field can provide a compelling case for why this is unlikely to happen.

New Economic Geography Theory

As aforementioned tax rates are not the only determinant of corporate investment location. Factors such as market access, infrastructure, national stocks of "know-how", experience and technology generate externalities that are influential (Hansson & Olofsdotter, 2004). The new economic geography perspective suggests that agglomeration forces occur from grouping of economic activity which can provide significant effects on factor mobility in the economic integration process (Olofsdotter, 2005). These agglomeration forces, such as that of IT in Ireland or automotive industry in Germany, reduce the mobility of factors in production, according to the new economic geography theory, as there is location benefits associated with these agglomerations. Countries that benefit from these forces can afford to maintain higher taxes without experiencing an outflow of the mobile capital as the traditional literature would suggest. This theory show relevance for the case of the EU there has been weak evidence of a "race to the bottom" situation. Despite falling corporate tax rates Verrue (2004) notes the stability in the corporate tax revenue as an indication to this. The ratio of corporate tax revenues to gross domestic product remains around 3% which is a result of the broadening of the tax base and increased profitability of companies (Verrue, 2004). If the new economic geography theory holds then it can be argued that pressure to harmonize taxation rates further in the EU may not be as imminent as recent debate suggests. For ASEAN the development of textile, unfinished products, finished electronics may also constitute agglomerations. Whilst geographically ASEAN is much more spread out than the EU, the considerable linkages intra-industry that are developing are doing so at a pace which could create even stronger agglomerations.

Agglomerations would form more strongly with reduced costs on trade (Fujita, 2007). Given that the lack of coordination between ASEAN member countries has been identified as a form of trade cost and barrier to trade it would be advantageous to ensure that a basic level of harmonization occurs in ASEAN. Zodrow (2003) acknowledges some of the advantages the new economic geography theory has but argues that tax harmonization, in the form of standardization would be unadvisable if this theory holds true, as it would destroy the different economic rents which allow for differentiation of the different agglomerations.

Furthermore the political reality of harmonizing taxation in the EU remains an obstacle as many countries are averse to compromising their sovereignty in regards to taxation policy (Zodrow, 2003, Teather, 2005). Teather (2005) and Zodrow (2003) acknowledge that harmonization in the EU could yield net benefits for certain members but most certainly would cause net losses for other member countries (who would oppose tax harmonizing measures) making the case for harmonization politically and economically unrealistic.

Changes in corporate taxation in the EU a good or bad thing?

It appears that the problems posed by the standard model of tax competition have not occurred in the EU despite a decade of strong declines in corporate tax rates and increased capital mobility. Tax revenue remains stable and the lower rate of corporate taxation is an incentive to further trade and investment in the EU. There are additional benefits of tax competition being allowed to play out in an integrated region which could actually prove to be very appropriate for ASEAN.

Mitchell (2004) argues that fiscal rivalry generates efficient allocation of resources and that it is a powerful Hansson & Olofsdotter (2004) economic liberalization which helps promote good tax policy the location of economic activity offsets shortcomings in government budgeting process and limit the tendency to spend tax excessively. Even the OECD (1998), despite advocating that tax competition should be avoided, acknowledges that being able to choose by allowing greater individual profits and people can guard against corruption by having the freedom of moving capital amongst jurisdictions. This is certainly an area of strong relevance to ASEAN as there are still high levels of corruption in some of its less developed members. According to the World Bank, around 20 per cent of the Philippines fiscal budget is lost to corruption (Balboa, Medalla & Yap, 2007).

Implications for ASEAN policy making

It appears that there are significantly more benefits to tax competition than disadvantages, if the EU case can be taken as a good example. ASEAN should therefore not avoid moving in the direction that the EU has gone by increasing integration, internal trade flow and allowing tax competition to occur without standardization. With the introduction of the AFTA a new scope of trade opportunity will be opened up by expanding the role of the internal market in ASEAN. If ASEAN wishes to fulfill their aim of creating a strong internal market in the EU it is necessary to reduce some of the barriers to integrating their financial and taxation systems. Agreements on key taxation areas urgently need to be ratified to ensure an efficient and effective taxation system which will allow ASEAN to be prepared for changes in the internal trade environment and eliminate the identified areas of 'harmful taxation.

Conclusion

This paper explored the pattern of corporate taxation in the EU to provide the ground work for analysing whether the increasing moves to integrate ASEAN should be treated with caution when considering taxation policy.
The EU is at an advanced stage of integration and has shown a decade of declining corporate tax rates. Whilst this decline has provoked much debate over whether or not tax rates should be harmonized it was found that empirical evidence does not suggest that falling rates lead to lower social welfare. Tax revenues have remained stable and the new economic geography theory suggests that the ‘race to the bottom’ will not occur as there are a wider range of factors that affect trade and investment decisions.

ASEAN has exhibited weak evidence so far to suggest that it is following the EU’s pattern of tax competition and harmonization. ASEAN does not appear to be engaging in tax competition as the statutory tax rates have shown a relatively small decline over the period studied despite integration having progressed steadily in the region. Integration has not necessarily brought about the same taxation changes in ASEAN as it did to the EU for several reasons. Firstly, ASEAN pursued an ‘open regionalism’ approach to trade and investment development which focused more strongly on reducing trade barriers outside the region than within. Secondly the EU created a strong internal market which has a strong cohesive legal background providing a solid base for harmonization, ASEAN on the other hand has not. Many elements of the taxation systems of the member countries in ASEAN need improving as the present state of the double taxation treaties, tax evasion measures and withholding rate agreements are not an incentive to conduct intra-regional trade or investment. When ASEAN adopts the AFTA, there are many barriers to trade that need to be resolved before capital mobility is as liberated as in the EU. Taxation is a strong element of ASEAN policy which needs reforming. Thirdly, the weakness in the central decision making capacity to move towards tax harmonization on basic levels is acting as an impediment to further integration which is not a good path for ASEAN to follow.

Whilst the EU has reduced its taxation rates and a degree of sovereignty in taxation policy, they retain their competitiveness by increasing attractiveness of investment and show no evidence thus far of a decline in tax revenue. If ASEAN wants to succeed in goal for an internal market it is advisable to follow the EU and cooperate with taxation measures which eliminate harmful taxation practises, such as double taxation and tax evasion which only increase trade costs and are a disincentive to investment.

This finding however is not without exceptions. Malaysia and Singapore, the most economically integrated members of ASEAN, have started to reduce their corporate taxation rates in response to each others moves. Singapore in a similar move to Ireland seems to be leading the way making bold cuts in tax rates to attract FDI. Whether this will affect the greater ASEAN region is yet to be seen however as intra-ASEAN investment and trade is still a small proportion of the total activity in the region.

The paper finds that whilst integration in the EU has encouraged a decline in corporate taxation rate and increased pressure to harmonize taxation it has not harmed the region as tax revenue remains stable and investment continues to growth within the region. Given the finding that the new economic geography theory was better able to explain the future of corporate tax competition than the standard model it was found that the ‘race to the bottom’ fear many standard tax model theorists have will not occur. The new economic geography further argues

that tax rates should not be standardized. ASEAN should not take measures to avoid the occurrence of tax competition but establish a solid groundwork on regional taxation agreements so that ASEAN is prepared to handle the changes in its business environment, in particular the aspired increase in intra-regional trade flows.

Learning from the EU experience, which has defied so far the arguments of the standard theory that tax competition will decrease welfare, ASEAN should adopt the necessary level of tax harmonization to ensure the most efficient tax system, even if this may compromise national sovereignty. Measure to ensure a well coordinated corporate taxation system will prove increasingly important as globalisation and technology create new opportunities in corporate taxation loopholes.

End of Thesis.

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