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Summary of the Economic and Social Survey of Asia and the Pacific 2014

Note by the secretariat of the Economic and Social Commission for Asia and the Pacific**

Summary

The average growth rate of the developing economies of Asia and the Pacific is forecast to rise moderately in 2014. However, in line with the diversity of the region, the growth performance will vary across subregions and countries.

Faster growth in the region is being held back by a number of factors. First, slow growth in advanced economies continues to negatively impact the region's exports and financial markets. Second, the tapering of quantitative easing by the United States of America is putting further pressure on the recovery of several economies in the region by causing significant capital outflows. Third, economies, especially some of the larger developing economies, are facing a number of domestic challenges, including infrastructure shortages, large budget deficits, inflationary pressure and rising and persistent inequality.

With constrained growth prospects, productive government spending is critical to supporting inclusive growth and sustainable development. Unlocking the fiscal space for such spending poses a challenge that the *Economic and Social Survey of Asia and the Pacific 2014* seeks to examine. It does so by analysing how countries can raise more tax revenues, given the fact that taxes in most countries in the region are often neither sufficient nor equitable. The *Survey* estimates show that a large number of countries have significant tax potential. Tapping this would enable tax revenues to rise by 70 per cent or more in several of them.

* E/2014/1/Rev.1, annex II.

** The late submission of the present document is due to the non-availability of 2014 data by the deadline for submission of documents to Conference Services.

Tax revenues may be enhanced through a number of policy measures, including, in particular, broadening tax bases and rationalizing tax rates to provide greater incentives for tax compliance. Strengthening regional tax cooperation would further contribute by stemming tax competition and the illicit transfer of funds.

The *Survey* argues that tax administrations must be made more effective and transparent to tackle tax evasion and tax fraud. It provides a number of policy options for sequencing tax policy reforms and tax administration and calls for the establishment of special tax courts to deal with tax fraud expeditiously. It also makes the case for establishing an Asian tax forum, under the aegis of the Economic and Social Commission for Asia and the Pacific, to monitor the tax legislation of member countries and publish a regular review of tax reforms with a view to harmonizing tax regulations and sharing best practices.

The Commission may wish to deliberate on the issues and policy proposals set out in the present document and consider how the proposals could be strengthened for the shared benefit of Member States.

Contents

I. Introduction

1. In 2014, the average growth rate of the developing economies of Asia and the Pacific is forecast to rise to 5.8 per cent.[1] This represents a modest increase of 0.2 percentage points over 2013. Reflecting the diversity of the region, growth performance is forecast to vary substantially among subregions and economies. While growth in South and South-West Asia and developing Pacific economies is expected to improve, the other subregions are likely to see stable or slowing performance.

2. Although the developing Asia-Pacific economies continue to anchor global economic recovery, both external and internal factors are holding back faster growth of those economies. Besides slow recovery in advanced economies, capital outflows owing to reversal of monetary policy in the United States of America pose difficulties for a number of economies. Growth in some large developing economies in the region is also challenged by domestic structural impediments.

3. Growth and macroeconomic stability in the region continue to be affected by the low growth and policies of the developed world. Concerns about the United States Federal Reserve's reduction of quantitative easing, or bond buying programme (referred to as "tapering"), caused significant asset market volatility first in September 2013 and again in January 2014. Countries responded with a mix of policies, namely, allowing currencies to depreciate, using foreign exchange reserves and raising interest rates.

4. In 2013, some of the region's major economies were also impacted by domestic challenges, including infrastructure shortages, large budget deficits, inflationary pressure, inadequate expansion of good quality jobs in the formal sector and rising inequality. The region's constrained domestic growth prospects underline the importance of productive government spending to support inclusive growth and sustainable development. A critical challenge will be the funding of the necessary development programmes.

5. The *Survey* analyses in detail how to raise domestic resources and, especially, expand fiscal space. In particular, countries need to strengthen tax collection, since current tax revenue levels are neither sufficient nor equitable. Analysis of the level and composition of existing tax revenues in selected countries of the region demonstrates that several of these countries have significant tax potential that remains untapped. Tapping that potential would enable tax revenues to rise by 70 per cent or more in a number of economies. While some tax exemptions and concessions are useful, many are unproductive and are depressing tax revenues. Moreover, unless foreign investors can offer something extra compared with domestic investors, preferential tax treatment of foreign investors only distorts competition and puts local companies at a disadvantage.

6. Tax revenues may be enhanced through a number of policy measures. These include, for instance, broadening tax bases, rationalizing tax rates to provide greater incentives for tax compliance, expeditious dealing with tax evasion and tax fraud and making tax administrations more effective and transparent. In this context, the *Survey* outlines a strategy for sequencing tax policy and tax administration reforms, including establishing special tax courts. It also argues that strengthening regional

[1] All forecasts and data are as at 17 April 2014.

cooperation would enable countries to raise tax revenue levels by stemming tax competition and illicit transfer of funds. In that regard, the *Survey* proposes an Asian tax forum under the aegis of the Economic and Social Commission for Asia and the Pacific (ESCAP).

7. The following summary of the *Survey* is divided into four sections. Section II considers the challenges facing the region in greater detail. It begins with a discussion of growth prospects in developed countries and the potential for spillover of the policies of developed countries to the region. It then discusses growth and inflation prospects in the region, including in some major regional economies. This is followed by the outlook for regional trade developments and prospects for foreign direct investment. Section III discusses some major socioeconomic challenges in the region, such as the problem of job creation and its quality and the persistent problem of inequality. Section IV provides policy recommendations to address some of these issues. They include productive government spending to directly support growth in the short term while helping to address structural challenges affecting growth in the long term; measures to address youth unemployment, a particularly important part of the jobs challenge; and policies to manage the risks from volatility in financial flows.

8. Section V explains in greater depth the findings of the *Survey* on how to expand fiscal space. It begins by explaining why strengthening tax revenues may be the most promising path to creating fiscal space in the region and highlights how the composition of tax revenues matters as much as the level of revenues. This is followed by a presentation of estimates of the tax potential in selected countries of the region, highlighting those that are currently collecting lower tax revenues than would be appropriate given their economy's structure. Lastly, policy options on how countries could enhance their tax revenues are presented.

II. Growth recovery under pressure

A. Slow growth and policies of developed economies impacting the region

9. In 2013, growth in the region was impacted by slow growth in the major developed economies, namely, the United States, the euro zone and Japan. Given the importance of these economies in terms of trade and investment linkages, their continued slow recovery remains a concern for the region. It will be challenging to significantly increase growth in the major developed economies in the near term. A surge in consumer demand is unlikely to occur in the United States and the euro zone with joblessness remaining high. While 2013 saw reasonably calm euro zone financial markets, there remains the risk of macroeconomic instability resulting from any renewed loss of confidence by investors in the progress of debt resolution. Furthermore, there are differing views regarding the possibility of deflation in the euro zone.[2] Within Asia and the Pacific, the growth outlook for Japan will depend on the impact of the ongoing reform programme, including a range of policies to be announced to change the country's economic structure and the increase in the sales tax enacted in April 2014.

[2] International Monetary Fund (IMF) "Euro Area: 'Deflation' Versus 'Lowflation'" (2014).

10. Policies in the developed world also had a significant impact on the region through spillovers from the tapering of quantitative easing by the United States. January 2014 saw an episode of capital outflows from the region. The greatest equity market falls were in Turkey (7.7 per cent) and in India (4.4 per cent). This followed a more widespread exit of funds in the third quarter of 2013 in the expectation in the financial markets that tapering would start in September 2013. The Turkish equity market experienced the greatest decline (-25 per cent) between June and August 2013, followed by Indonesia and Thailand (nearly -20 per cent). In August 2013 alone, stock market capitalization in seven economies in the region declined by $323 billion compared with the previous month.

B. Domestic impediments to growth

11. Growth in the Asia-Pacific region in 2013 was also impacted by relatively low growth in some major regional economies owing to domestic challenges. Some of the major challenges are infrastructure shortages, large budget deficits, inflationary pressure, inadequate job creation in the formal sector and rising inequality.

12. Infrastructure shortages have led to significant gaps in productive capacity. These gaps have contributed to inflationary pressures. Inadequate growth in formal sector jobs and the rise in informal or vulnerable jobs constrain sustainable expansion of domestic demand when external demand is faltering. Research confirms that rising inequality, which is growing across the region, is harmful to economic stability and growth. The *Survey* finds a positive association between inequality (Gini coefficient) and household debts.

13. Relatively slow growth in China, India and Indonesia compared with the pre-crisis level impacted the growth in smaller countries owing to their dependence on these larger economies through the regional value chain.

C. Growth and inflation prospects in the region

14. Growth in the region in 2013 increased slightly from 5.4 per cent in 2012 to 5.6 per cent. However, subregional growth experiences in 2013 vary. In East and North-East Asia, a highly trade-dependent subregion, growth edged up to 4.2 per cent in 2013, benefiting from improved global growth prospects. The deceleration in growth witnessed in China since 2010 was halted in 2013, while growth in most other economies improved. The subregion as a whole is projected to exhibit steady growth performance in 2014, although the economies of China and Japan could slow modestly. China is unlikely to return to the pre-crisis growth rates in the short to medium term, since more effort will be put into rebalancing growth and increasing the share of domestic demand, particularly through consumption. Recent structural reforms, such as China’s transformation towards a market-based system and the Republic of Korea’s effort to promote corporate investment and job creation, should help to enhance the subregion’s medium-term growth prospects.

15. South-East Asia’s growth momentum slowed from 5.5 per cent in 2012 to 5 per cent in 2013. A sluggish global economic recovery held back exports, particularly in the first half of the year. Growth in domestic demand also decelerated in large emerging economies such as Indonesia owing to monetary tightening in response to higher inflation and capital flights and in Thailand on the back of rising

household debts and political uncertainty. In contrast, the economy of the Philippines grew rapidly, despite Typhoon Haiyan in late 2013. The least developed countries in the subregion, Cambodia, Lao People's Democratic Republic, Myanmar and Timor-Leste, maintained high growth rates, underpinned in part by steady inflows of foreign investment. Growth rates in this subregion are expected to remain largely unchanged in 2014. Exports should bounce back owing to stronger global demand and help in sustaining growth. However, financial market volatility, which increased in mid-2013 owing to prospects of tapering of quantitative easing, will continue to pose a downside risk.

16. North and Central Asia recorded a slower growth of 2.1 per cent in 2013 compared with 3.8 per cent in 2012. Subdued global demand for energy, gold and metals held back growth in resource-based economies, particularly the Russian Federation. Public spending, especially on social programmes, was raised in several economies in an effort to sustain domestic demand, which adversely impacted their fiscal balances. In net energy importing economies, output growth declined owing to subdued household spending with a deceleration in workers' remittances and reflected an economic slowdown in the Russian Federation, the largest host of migrant workers in the subregion. Output growth in the subregion is expected to decline further in 2014 primarily because of the impact of ongoing geopolitical instability on the economy of the Russian Federation, which is projected to grow at merely 1 per cent. Owing to strong linkages with the economy of the Russian Federation, several other economies of the subregion are also expected to experience slower growth.

17. Economic growth in South and South-West Asia picked up to 3.9 per cent in 2013 from 3.4 per cent in 2012. Growth improved in India, Maldives, Sri Lanka and Turkey. Household spending led the rebound in these economies, supported by steady farm incomes and workers' remittances. Energy shortages have constrained economic activities in several economies. Political tensions and security issues also held back growth in Afghanistan, Bangladesh, Nepal and Pakistan. The tapering of quantitative easing in the United States triggered capital market volatility in India and Turkey, which underscored weak macroeconomic fundamentals such as large current account deficits that were financed by short-term external borrowing. Room for fiscal manoeuvrability is limited given the large fiscal deficits. Growth in the subregion is projected to increase further in 2014 subject to a stronger global economy and improved household consumption and investment. Tackling supply-side constraints, especially energy shortages, is vital to the subregion's future growth.

18. Growth in Pacific island developing economies dipped from 5.3 per cent in 2012 to 4 per cent in 2013, mainly because of an economic slowdown in the resource-rich economies of Papua New Guinea and Solomon Islands. Natural disasters also constrained output growth in Fiji and Samoa. Some improvement in the performance of this subregion is expected in 2014, commensurate with the prospects of the global economy. Heavy reliance on imported food and fuel together with limited export capacity have generally caused sizeable current account deficits. Generally, key development challenges are poor resource bases, remoteness from global markets, weak public services delivery and high vulnerability to natural disasters and climate change.

19. Inflation differed substantially across the region in 2013. Inflation in exporting economies, such as those in South-East Asia and East and North-East Asia, declined or remained stable in 2013 owing to constrained global demand. Low inflation allowed accommodative monetary policy in most of these countries, with policy interest rates being stable or lower in 2013 than in 2012. On the other hand, inflation rates were generally high in South and South-West Asia and monetary policy was tightened in response in some of the countries in the subregion. The inflation outlook in 2014 in the whole region is generally moderate. However, a number of major economies such as India, Indonesia and Pakistan will continue to face significant price pressures.

D. Gradual trade recovery

20. Exports from the region are expected to pick up in 2014 as the medium-term prospects for global trade improve with ongoing recovery in major developed countries. One of the key factors preventing an even more favourable outlook for trade is the limited progress in the Doha Round of multilateral trade negotiations. The multilateral trading system has remained fragmented as seen at the Ninth Ministerial Conference of the World Trade Organization, held in Bali, Indonesia in 2013. Furthermore, ESCAP analysis indicates that export growth in the region is being hampered significantly by non-tariff trade protectionist measures globally and in the region, as well as high prevalence of trade costs.

21. Intraregional trade has expanded in recent years, helped by a deeper form of trade integration through harmonization of rules and standards. This has occurred between the Association of Southeast Asian Nations (ASEAN) and other regional economies in particular. A factor of critical importance for the region’s trade relationships will be China’s reform policies to improve the quality of growth by reorienting towards domestic consumption away from exports and investment. This could have significant benefits for exporting economies in the region, especially for exporters of consumer goods.

22. The low share of the least developed countries in Asia-Pacific trade continues to be a concern. These countries account for only 0.7 per cent of total regional exports, valued in 2012 at $50 billion. It is therefore particularly important to integrate the least developed countries further into regional supply chains by providing preferential market access and improving their productive capacity. At the same time, better connectivity through improved hard and soft infrastructure will be required for deeper trade integration across countries and subregions.

E. Positive outlook for foreign direct investment

23. Inflows of foreign direct investment (FDI) to developing Asia-Pacific subregions increased slightly in 2013.[3] With the increasing importance of destinations such as the ASEAN countries and China, the developing Asia-Pacific region remained the largest recipient region of global FDI flows, accounting for nearly one quarter of global FDI. Among the developing Asia-Pacific subregions,

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[3] United Nations Conference on Trade and Development, *Global Investment Trends Monitor*, No. 15, 28 January 2014.

East and North-East Asia continues to attract the largest amount of FDI inflows, although the share of South-East Asia is also increasing. The developing Pacific attracts less than 1 per cent of the region's FDI inflows. Intraregional FDI flows within Asia and the Pacific are also on the rise. ASEAN countries and China are especially attractive destinations for Asian investors. However, least developed countries received FDI inflows of only about $5.5 billion in 2012.

24. Falling greenfield FDI and the possible effects of FDI in agriculture are a concern. Greenfield FDI usually has more direct benefits compared with cross-border mergers and acquisitions by creating new investment through the establishment of production facilities. FDI in agriculture has, in some instances, led to the displacement of smallholders and damage to the environment. The World Bank has highlighted the danger of land acquisitions that neglect local people's rights and the susceptibility of smallholders to manipulation by investors.[4] Appropriate policies should be in place to safeguard against speculative land investments or acquisitions and to prevent environmental degradation.

25. In addition to FDI, there is growing scope for foreign exchange earnings from remittances and tourism. By 2013, remittances to developing countries in Asia and the Pacific had increased from $49 billion in 2000 to $265 billion. The Asia-Pacific region remains the highest remittance-receiving region in the world, both in absolute and relative terms. International tourism receipts increased from $169 billion in 2004 to $320 billion in 2013. For many countries in the region, especially in the Pacific, the level of dependence on the tourism sector and related services is very significant and stands at around 20 per cent of gross domestic product (GDP).

26. Both remittances and tourism thus have the potential to play a significant role in development in the region. However, policymakers must be cognizant of possible drawbacks, such as brain drain and adverse socioecological consequences. For example, manpower exports may exacerbate brain drain and, unless remittances are invested in productive resources, have the potential to worsen inequality. Similarly, uncontrolled expansion of tourism can have adverse ecological and social consequences.

III. Socioeconomic developments

A. Jobs growth and quality: continued mixed progress

27. Considering the main socioeconomic issues facing the region, a principal concern is low formal sector job creation in many economies. Both before and after the crisis, growth in GDP in the region was not accompanied by a commensurate expansion in formal sector employment. This is due partly to technological change and labour substitution, but also to the nature and pattern of economic growth that was not based on broad-based economy-wide development.

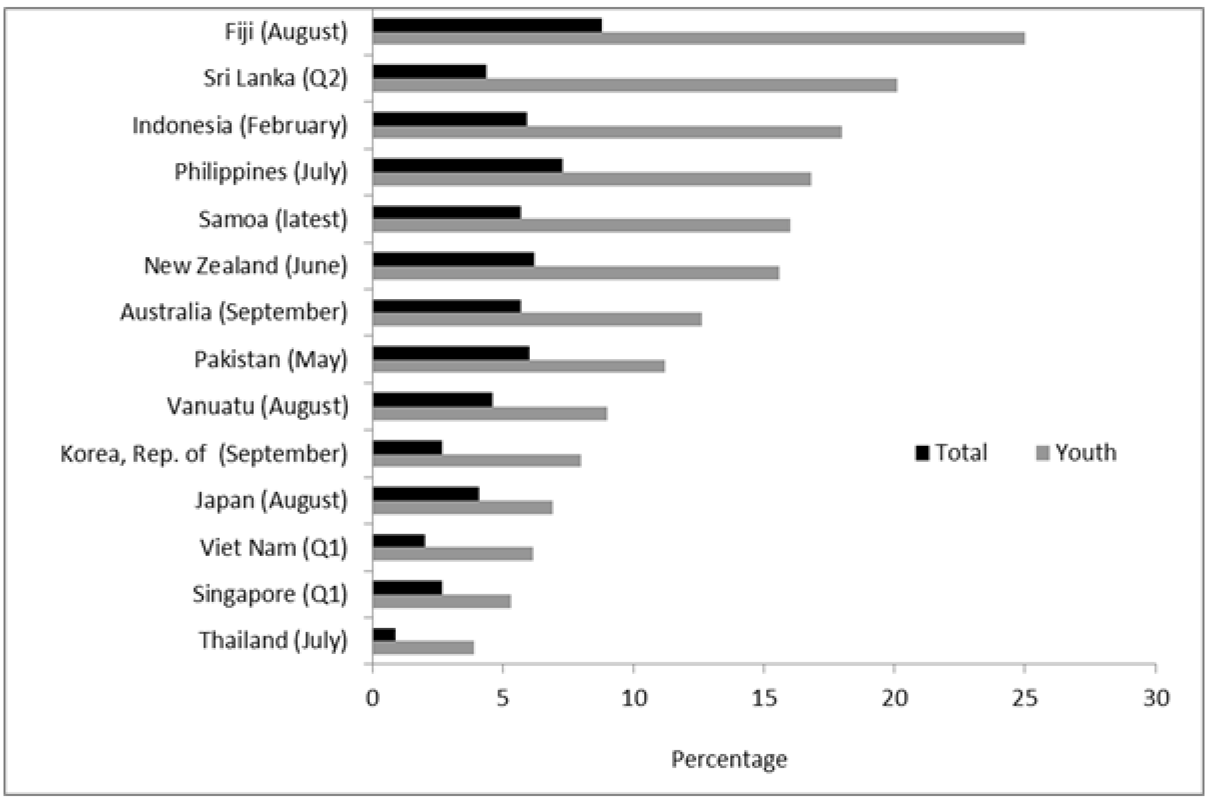
28. There are also concerns about job quality. A majority of workers in the region are informally employed own-account or contributing family workers with limited opportunities for finding work that is more productive, secure and salaried. There is also an elevated percentage of people in the region working in very low-paid jobs.

[4] World Bank, "Land and Food Security" (2012).

The number of working poor, those who earn less than $2 a day, is highest in South and South-West Asia. The prevalence of working poverty and vulnerable employment is a clear manifestation of the lack of economic and social opportunities.

29. Young people, in particular, struggle to find decent and productive employment (see figure I below). The youth unemployment rate in the region is almost three times the adult unemployment rate. There are numerous causes for the high youth unemployment rate in the region. In addition to the lack of adequate decent and productive jobs, this is also an outcome of the mismatch between education and employers' requirements, low secondary school completion rates, gender discrimination and high youth aspirations. Many countries now have a potential demographic dividend. Yet, to make the dividend a reality, they will need to secure productive employment for the growing pool of young people, especially young women.

Figure I
Total and youth unemployment rates in selected Asia-Pacific economies, 2013 or latest available data



Sources: Economic and Social Commission for Asia and the Pacific (ESCAP), based on data from the International Labour Organization and estimates from national labour force surveys. Pacific economies information obtained from the secretariat of the Pacific Community.

Note: Total includes ages 15 and above; youth includes ages 15 to 24, except Pakistan (ages 15 to 19) and Singapore (residents aged 15 to 29); non-seasonally adjusted.

Abbreviations: Q1, first quarter; Q2, second quarter.

B. Inequality hampering sustainability of growth

30. Inequality is another key socioeconomic challenge for the region. At the regional level, income inequality (Gini index) increased from 33.5 in the 1990s to 37.5 in 2010. At the national level, there has been an increase in the Gini index in many major economies in recent decades. A specific area of concern is gender inequality. Intrinsically linked to gender inequality is the prevalence of gender-based violence in the region. These challenges continue to inhibit the full participation of women in public life, affecting not only the well-being of women themselves but also that of their families and their communities, and can weaken social and economic stability.

31. High levels of income inequality seriously undermine the economic and social achievements. For example, GDP per capita for many economies in the region declines significantly when adjusted for income inequality. The ESCAP social development index,[5] which combines education and life expectancy, shows that inequality in several emerging and low-income economies is also having a serious impact on social development.

32. ESCAP analysis of country-level household debt and inequality data, drawn from 81 developing countries globally including 26 economies in the region, and covering the post-crisis period, shows a positive association between inequality and household indebtedness. This finding conforms with recent research at the International Monetary Fund (IMF).[6] With income growth lagging, the poorer sections of society increase debt-financed consumption, made possible by the availability of credit as higher-income groups deposit their increasing wealth in the banking system. Such a transmission process could lead to ever-rising household debt in countries with growing inequality, making them vulnerable to shocks. As households spend more than they earn, countries increasingly face growing current account deficits, exacerbated by luxury imports by higher-income groups.

IV. Policy options to deal with the challenges

A. Productive government spending to support sustainable growth

33. The obstacles to higher growth in the Asia-Pacific region are partly related to slow economic recovery in the developed world, but also to long-term structural impediments to growth. This highlights the need for productive and countercyclical government macroeconomic support. Such policies can support growth in the short term while helping to remove structural impediments in the long term. The ongoing reallocation of international capital away from the region as monetary policy in the United States is normalized will also increase the need for supportive policies for domestic investment. Some possible supportive measures are highlighted below.

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[5] See *Economic and Social Survey of Asia and the Pacific 2012* (United Nations publication, Sales No. E.12.II.F.9).

[6] See Michael Kumhof and Romain Rancière, “Unequal = Indebted”, *Finance & Development*, vol. 48, No. 3 (Washington, D.C., IMF, September 2011).

Social protection spending

34. Increasing spending on social protection would help to support growth as well as reduce inequality. Recognizing the importance and necessity of adequate social protection systems, in April 2009 the United Nations System Chief Executives Board for Coordination adopted, the Social Protection Floor Initiative, which was endorsed by the Member States at the United Nations Conference on Sustainable Development. Social protection is now a development priority in the post-2015 development agenda.[7]

35. Several countries in the region have recently initiated policies and programmes to enhance social welfare. There is a significant positive correlation between the extent of coverage of these policy measures and reductions in inequality as shown in the *Survey* 2013. Based on World Bank data,[8] ESCAP finds that within a universal system, targeted social protection and labour market programmes are likely to reduce inequality. ESCAP has designed a social protection "toolbox" to facilitate policymakers in their endeavours to build stronger and more robust social protection systems.[9] It enables policymakers to identify gaps at the national level, while providing useful examples on how to move forward.

36. An important challenge to increasing the coverage and depth of social protection measures will be their sustainable financing. Critically, the design of social protection measures will need to address growing budgetary demands owing to the ageing structure of populations. The private sector must also contribute and partner with Governments. Some global and regional funds could be established by using innovative sources of financing. The 2013 ESCAP theme study proposed regional initiatives in that regard.

Infrastructure spending

37. Governments need to address the significant shortage in infrastructure provision across the region. Apart from current needs, the demand for infrastructure is projected to increase significantly with growing populations and greater urbanization. An ESCAP study in 2006 estimated the infrastructure financing gaps in the Asia-Pacific region to be in the order of $600 billion per annum.[10] A more recent study by the Asian Development Bank (ADB) in 2009 put the figure at $800 billion per annum over the period from 2010 to 2020.[11] The private sector acting alone is not coming close to meeting this requirement, with annual spending on infrastructure in the past 20 years averaging $13 billion and being concentrated in less risky investments.

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[7] United Nations (United Nations System Task Team on the Post-2015 United Nations Development Agenda), "Social protection: A development priority in the post-2015 United Nations development agenda: Thematic Think Piece" (2012).

[8] World Bank, "The Atlas of Social Protection — Indicators of Resilience and Equity", ASPIRE Database, 2014.

[9] The toolbox provides access to a database of over 80 good practices in social protection from developing countries. For details see www.socialprotection-toolbox.org/.

[10] See ESCAP, *Enhancing Regional Cooperation in Infrastructure Development Including That Related To Disaster Management* (United Nations publication, Sales No. E.06.II.F.13).

[11] Asian Development Bank and Asian Development Bank Institute, *Infrastructure for a Seamless Asia* (Tokyo, 2009).

38. Existing forms of infrastructure investment in the region could be complemented with a new large-scale lending facility for infrastructure that taps public resources. Such a regional institution could issue securities to enable the region's central banks to park their surplus reserves with it. The infrastructure financing facility could help to coordinate other sources of lending such as multilateral and bilateral development agencies and private financial institutions. Its backing for infrastructure projects could also signal opportunities to private investors. As a regional mechanism, the facility could also be in a position to keep track of intraregional spillovers and finance economically significant cross-border projects. Another possible function of the facility could be to provide advisory services and technical assistance in the financial design of infrastructure projects.

39. Apart from shortfalls in financing, it is clear that significant improvement is required in legal and regulatory frameworks for infrastructure investment across much of the region. Recent years have seen a lack of clarity in such frameworks; this has been a significant factor in the worsening of investment climates and resulting reduction in new projects in many countries of the region. Without improvements in regulatory frameworks and policy certainty, even in the presence of adequate financing, investors will remain wary of entering into major investments. Political instability also discourages private sector investment in large infrastructure.

Environment-related spending

40. Governments will need to undertake spending to address environmental factors which will otherwise hamper growth prospects. Environmental damage is already constraining growth in the region. For example, environmental degradation was estimated in 2012 to cost India almost 6 per cent of GDP annually.[12] Economic potential has also been impacted by widespread loss of natural ecosystems and biodiversity.

41. Policies are also required to improve access to modern energy sources. Using such sources can make growth more sustainable and will contribute to increased growth by making households more productive. In order to improve access to modern energy, several countries have formulated investment strategies for energy infrastructure aimed at improving energy efficiency and increasing the use of renewable sources.

42. Another area for action to ensure the sustainability of growth is better addressing climate change through improving climate finance. Sources of climate finance should be mobilized from both the public and private sectors. Public finance can focus on leveraging private funding to tackle climate challenges. Specifically, climate finance mechanisms should be mainstreamed into the evolving financing framework in the context of the post-2015 development agenda.

B. Investment in youth

43. The region is facing the enormous challenge of securing productive and decent employment for the largest generation of young people in history. This is crucial for

[12] World Bank, "Diagnostic Assessment of Select Environmental Challenges in India", Report No. 70004 (2013).

reaping a demographic dividend. While some of the problems are caused by a lack of adequate decent and productive jobs, many young people are entering the labour force with skills that are limited or do not match the changing demands of labour markets.

44. Governments need to address the way in which young people develop from an early age and help to prepare them for work with adequate knowledge, skills and experience. In that context, the transition between secondary and tertiary education needs to take into account the capacities and potential of young people. Active labour market programmes will also be important to effectively link education, training and skills development systems with the requirements of employers. The challenge of increasing access to education is especially great for low-income economies, where the probability of obtaining tertiary level education is low.

45. Improving education systems will have to pay special attention to gender inequalities. Although gender inequalities in education in the region have fallen over recent years, there are still disparities that translate into untapped productive potential for both medium- and long-term growth. The South and South-West Asian subregion is lagging, with 8 girls for every 10 boys enrolled in secondary education, but an even greater concern is that only three women for every four men are enrolled in tertiary education. There are many barriers to female education, including the burden of household work, limited appreciation of the benefits of educating girls and women, and negative social and cultural attitudes. Addressing such prejudices will require greater investment in the recruitment of women teachers and targeted support for poor families in order to render educational establishments more women-friendly.

C. Mitigating risks from capital volatility

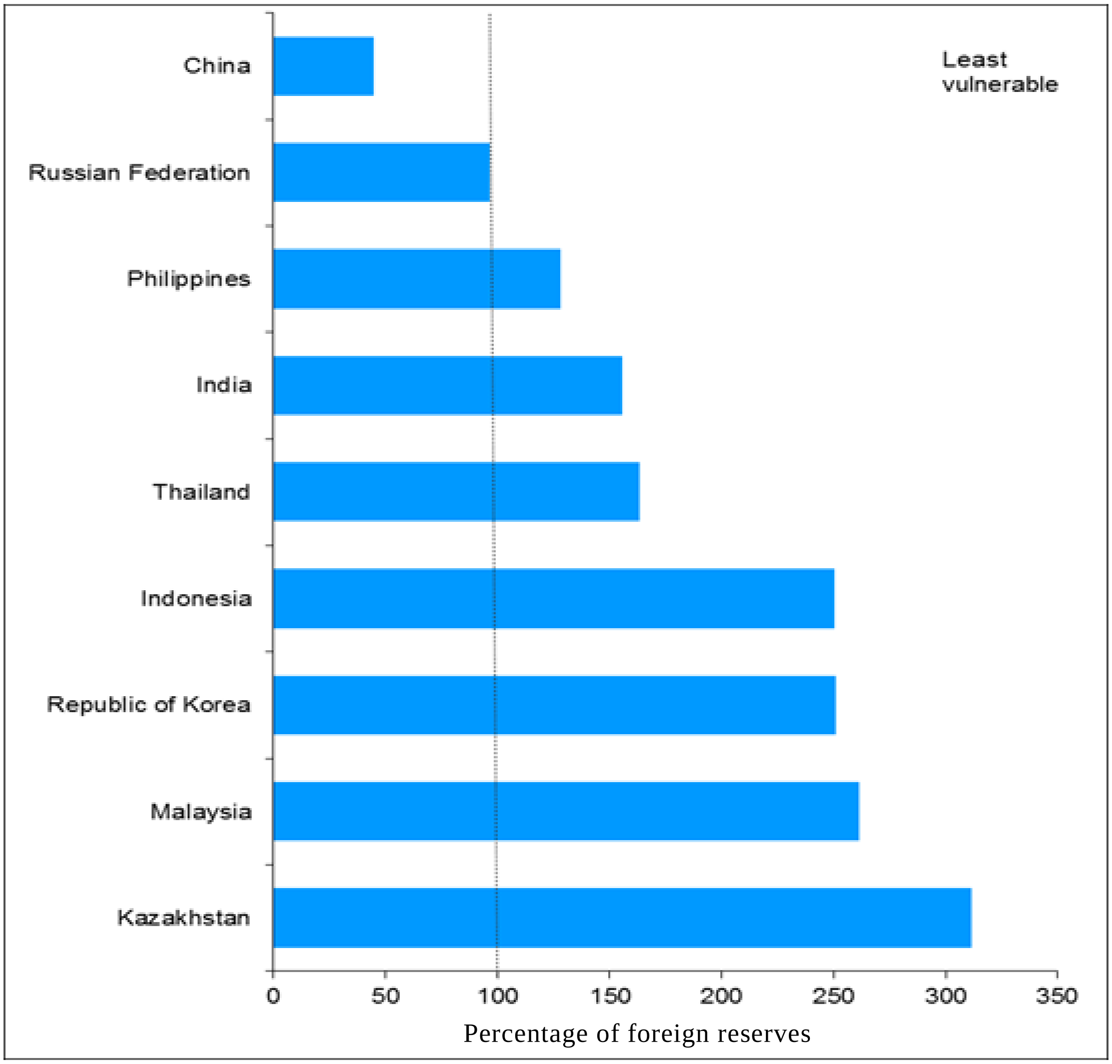
46. Economies in the region have managed the impact on their exchange rates of capital flow volatility by a combination of approaches, namely, allowing for depreciation, using foreign exchange reserves and raising interest rates. Turkey allowed its currency to fall vis-à-vis the dollar by 7 per cent in January 2014. In the period from June to August 2013, the largest depreciations were seen in India (13 per cent), followed by Indonesia, Malaysia, the Philippines, Thailand and Turkey (all between 6 per cent to 9 per cent). To prevent excessive depreciation, countries managed the extent of currency falls by spending some of their foreign exchange reserves. India, Indonesia and Thailand saw the largest declines in their foreign exchange reserves, having used between $11.5 billion and $19.3 billion during the period from January to August 2013. Another policy used by some countries to manage depreciations was to raise interest rates and thus increase the attractiveness of their currencies. Interest rates were also raised to manage the inflationary impact of depreciation on domestic prices. In January 2014, Turkey sharply raised its overnight lending rate from 7.75 per cent to 12 per cent, while India increased its repo rate by 25 basis points to 8 per cent. During the earlier period of capital outflows (second half of 2013), Indonesia increased its reference rate between May and November 2013 from 5.8 per cent to 7.5 per cent.

47. Countries should be vigilant about holding sufficient foreign exchange reserves to help to defend against excessive currency depreciation resulting from capital flow volatility. The build-up of reserves has been one of the main tools of

Governments to protect their currencies and prevent the macroeconomic instability resulting from sharp exchange rate depreciation. The ESCAP vulnerability yardstick considers the level of short-term foreign exchange commitments, comprising portfolio flows, short-term debt and a number of months of imports, as a percentage of foreign reserves. It indicates that some economies in the region may have insufficient foreign exchange reserves to cover the exit of foreign funds from their financial markets and hence face risks of excessive exchange rate depreciation (see figure II below).

Figure II

Vulnerability yardstick as a percentage of foreign reserves in selected Asia-Pacific economies, latest available data



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com/ (accessed 20 February 2014).

Note: The vulnerability yardstick is the sum of short-term external debt, latest quarterly imports based on four-quarter moving average and estimated international portfolio investment position.

48. Concerns about the lack of sufficient reserves at the national level to respond to the risks from capital flow volatility have highlighted the need for greater regional support. Currency-related difficulties in various countries in 2013 highlighted the lack of use of current regional schemes such as the Chiang Mai Initiative Multilateralization. In recent instances, when countries have needed currency support, even those within ASEAN plus China, Japan and the Republic of Korea (ASEAN+3) have looked to ad hoc regional sources of funds through numerous bilateral swap agreements. An alternative to current arrangements could be a comprehensive Asia-Pacific financial support mechanism using some of the sizeable foreign reserves available to the region's Governments. Such a mechanism is important even for countries that are currently covered by regional agreements, since currency crises in non-protected countries can cause contagion in an interconnected region.

49. While the use of foreign exchange reserves can stabilize currencies after pressure is experienced, they may be complemented by national measures for capital flow management. The use of foreign reserves does not deal with the negative impact on asset markets of any sudden outflow. Therefore, as highlighted by IMF studies,[13] an important additional supportive measure could be to apply capital flow management at the national level to deal with inflow/outflows surges in asset markets. Such measures have been gaining in popularity, as recommended by ESCAP over a number of years. Some recent capital account management measures have been market-based, such as through taxes or levies on particular instruments. Others have been quantitative, such as through caps or prohibitions on purchases of particular instruments. Furthermore, while most measures have been directed at capital inflows or purchases, some have also been targeted at discouraging capital outflows or sales. A general guideline should be for such regulations to be a component of long-run policies to prevent economic booms and busts.

V. Domestic resource mobilization: options for expanding fiscal space

50. In order to adequately fund the development needs of the region, domestic resource mobilization will need to play an important role. There is a particular need to expand fiscal space, given large fiscal deficits in many countries.

51. Governments have a range of options for creating fiscal space. These include increased levels of borrowing, making existing expenditure more efficient, reprioritizing expenditure to orient it more towards development, or increasing tax and non-tax revenues. Expanding indebtedness can be risky, even where levels of debt are relatively low. For one, future debt servicing represents a drain on resources. Net interest payments already consume a quarter of total revenue in India, a third in Pakistan and a fifth in the Philippines. Other risks from borrowing include a potential rise in interest rates and maturity mismatches. Higher levels of foreign-denominated debt can also constrain countercyclical macroeconomic policy.

52. Governments can, of course, create fiscal space by making better use of existing resources. One way would be to reduce expenditure on non-priority areas. A

[13] See IMF, "Liberalizing Capital Flows and Managing Outflows" (2012); IMF, "The Liberalization and Management of Capital Flows: An Institutional View" (2012).

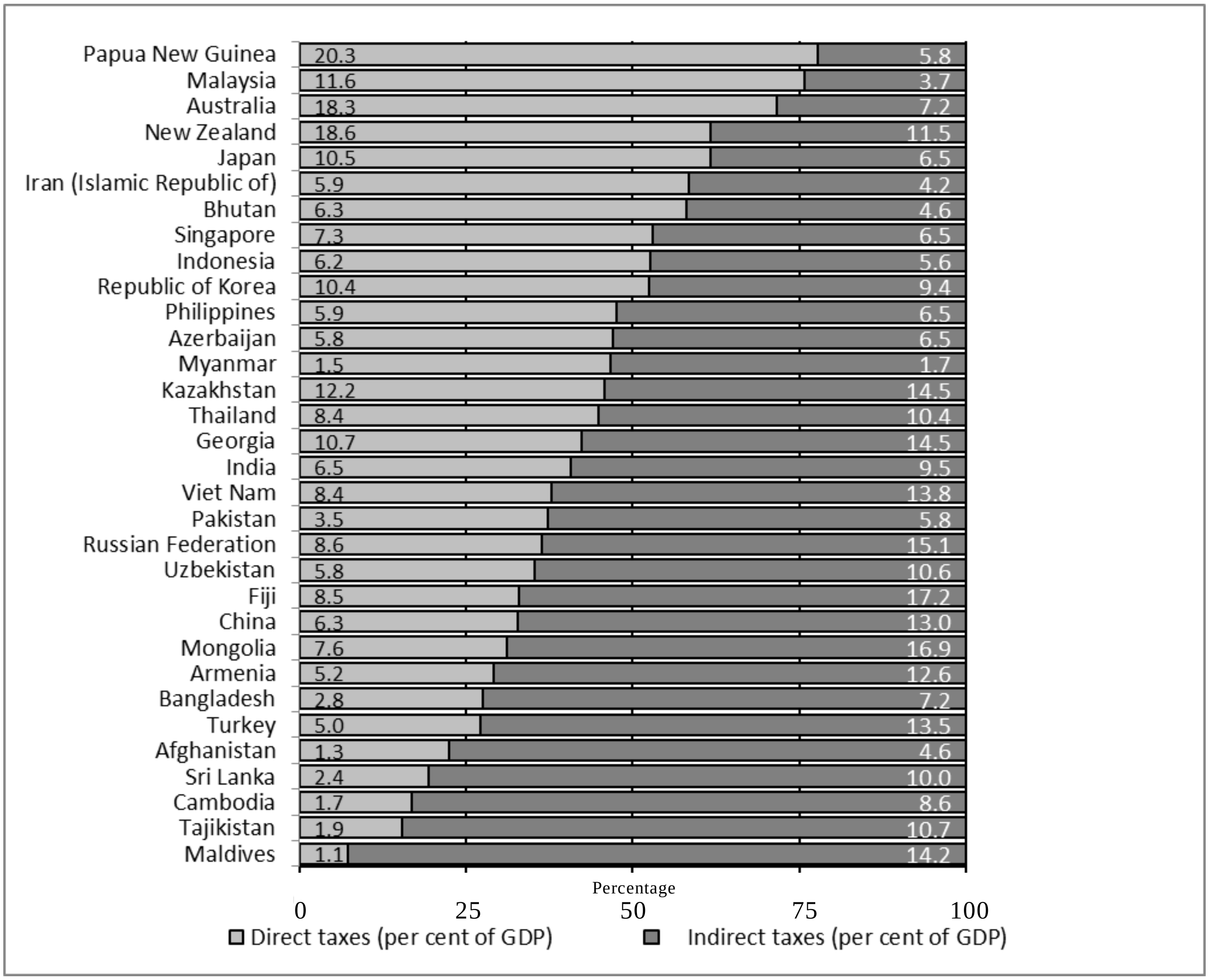
target for cuts would be defence expenditure, which in several countries exceeds expenditure on health and education combined and makes little if any contribution to development. Another option would be to reduce various kinds of poorly targeted consumption subsidies, which in many countries account for a significant proportion of total public expenditure.

53. Primarily, Governments need to raise more revenue, especially from taxes. Tax collection in Asia-Pacific developing countries is neither sufficient nor equitable. Experience across the region demonstrates numerous opportunities for improving all forms of taxation, direct and indirect, whether for corporations or individuals. In fact, many countries have been able to strengthen tax revenues over the past decade.

54. Tax collection by central governments in developing Asia-Pacific countries averaged only 14.8 per cent of GDP in 2011, compared with 17.1 per cent of GDP in Latin America and the Caribbean and 16.3 per cent in sub-Saharan Africa. Only seven countries (of which four were resource-rich) collected tax revenues of more than 20 per cent of GDP in 2011, while in several others, tax-to-GDP ratios were in the single digits. This is far from the 25 per cent to 35 per cent of GDP that is considered one of the prerequisites for being able to provide the necessary financing and expenditure to become a developed country.

55. The composition of tax revenues matters as much as the level of revenues. Indirect taxes are the largest source of tax revenue in more than half of all countries in the region (see figure III below). However, their contribution to total tax revenue has been declining in most countries. A substantial component of indirect taxes in the region, particularly in the Pacific, is on international trade. To encourage trade, many economies have in recent years reduced trade taxes and focused attention on taxes on goods and services, such as value added taxes (VAT) or general sales taxes (GST). However, although revenues from VAT or GST have on average risen from less than a fifth of indirect taxes to around one half since 1990, they have not been able to offset the fall in revenues from taxes on trade in many countries (for example, Malaysia, Pakistan and Vanuatu).

Figure III
Share of direct and indirect taxes in tax revenue and tax revenues as per cent of GDP, 2011



Source: ESCAP calculations based upon IMF government finance statistics, accessed November 2013, and official data sources.
Note: Data are for 2011 except for Myanmar and Tajikistan (2004); Afghanistan (2007); Bhutan and Islamic Republic of Iran (2009); Cambodia, China and Maldives (2010).

56. Over the past two decades, about two thirds of the countries with available data have seen increases in direct tax revenues, comprising taxes on income, profits and capital gains, payrolls and property income. For instance, in Bhutan, India, Malaysia and Pakistan, the share of direct taxation in overall tax revenues has increased by approximately a quarter. This shift is generally desirable since indirect taxes affect prices and thus influence resource reallocation. Moreover, growth in indirect taxes, especially GST, always falls behind growth in income or GDP, since usually expenditure grows at a slower rate than income. As a result, GST needs periodic upward adjustments both for the rate and coverage. This not only makes the tax system more regressive, but also encourages tax evasion or cash economy. On

the other hand, direct taxes are more equitable since they can be progressive, with higher rates at higher levels of income.

57. Yet, in most countries less than half of tax revenues are raised directly. Moreover, increases in revenue from direct taxes often have been relatively small. One reason is that in many countries, personal income tax revenues are low, especially where a large proportion of the labour force is active in the informal sector or in agriculture. However, even wealthier individuals in many countries may pay little income tax as a result of tax avoidance and non-compliance. In several countries, less than 1 per cent of the population pays income tax.

A. Monitoring tax revenues

58. Governments need to be able to monitor their tax systems closely. One measure is "tax buoyancy", which captures the responsiveness of tax revenues to changes in output without distinguishing between discretionary and automatic growth in revenue. Between 2007 and 2012, tax buoyancy was mixed. It was greater than 1 in 12 out of 20 countries with data, indicating that in those countries, tax revenues increased at a higher rate than output. Among them, all four least developed countries (Bangladesh, Bhutan, Lao People's Democratic Republic and Nepal) had buoyancy coefficients greater than 1.5. As tax-to-GDP ratios are less than 15 per cent in those countries, higher buoyancies augur well for the future since tax-to-GDP ratios will increase as levels of output grow.

59. Most countries in the region are currently collecting tax revenues below their potential. Clearly, a country's ability to raise taxes will depend on many factors — structural, developmental, institutional and socioeconomic.[14] When judging a country's capacity for raising more tax, it is important to allow for such factors. Analysis that takes structural factors such as income per capita, the share of agriculture in output and the openness of the economy into account shows that the tax potential can be quite significant. In several countries, the gap between actual revenues collected and the level that would be appropriate given the economy's structure is equivalent to 5 per cent of GDP or more (see table below). By embracing their tax potential and closing existing tax gaps, the economies of Afghanistan, Bangladesh, Bhutan, the Islamic Republic of Iran and Hong Kong, China would be able to raise their tax revenues by over 70 per cent.

Estimated tax potential in selected Asian economies

		Tax-to-GDP ratio			
Countries	*Year*	*Actual*	*Potential*	*Tax gap*	*Tax gap as proportion of current tax revenue*
Afghanistan	2011	8.8	15.0	6.2	70.5
Azerbaijan	2012	12.9	15.1	2.1	16.6
Bangladesh	2013	10.5	18.0	7.5	72.1
Bhutan	2009	9.2	16.0	6.7	72.9

[14] See Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (New York, McGraw-Hill, 1989).

Countries	*Year*	*Tax-to-GDP ratio* *Actual*	*Potential*	*Tax gap*	*Tax gap as proportion of current tax revenue*
Cambodia	2011	10.0	13.0	3.0	30.4
China	2012	19.4	21.2	1.8	9.4
Hong Kong, China	2011	14.2	26.7	12.5	88.1
Indonesia	2012	11.9	16.6	4.7	39.3
Iran, Islamic Republic of	2013	5.8	13.1	7.2	124.5
Japan	2012	17.0	19.3	2.2	13.1
Malaysia	2012	16.1	17.4	1.3	7.9
Maldives	2010	10.7	16.5	5.8	54.2
Nepal	2013	15.2	16.1	0.9	5.6
Pakistan	2012	10.3	12.1	1.8	17.3
Philippines	2012	12.9	14.3	1.5	11.4
Singapore	2011	13.8	20.7	6.9	50.3
Thailand	2011	18.8	19.0	0.2	0.9

Source: ESCAP calculations.

Note: The tax gap is calculated by taking the difference between the estimated tax potential and the actual tax-to-GDP ratio for a given country in the year with most recent data. Only countries with a positive tax gap are listed in the table.

60. One of the reasons for low tax revenues in the region may be relatively low tax rates. For instance, at 28.2 per cent in 2013, the average corporate tax rate in the region was somewhat lower in 2013 compared with Latin America (32.2 per cent) and Africa (29.8 per cent). Corporate tax rates are often low because countries have reduced taxes competitively in order to attract FDI. Thus, over the past seven years, two thirds of a sample of 24 countries from the region reduced their corporate tax rates. Countries with large reductions include China, from 33 per cent to 25 per cent; Sri Lanka from 32.5 per cent to 28 per cent; and Thailand, from 30 per cent to 20 per cent. However, the impacts of these reductions on FDI are not clear. If foreign investors can offer something extra compared with domestic investors, it may be useful to offer them special incentives.[15] If this is not the case, preferential tax treatment distorts competition and puts local companies at a disadvantage.

61. Many countries are not using their tax potential to the fullest extent. This is due to the liberal use of exemptions and concessions, which are also reducing the scope for tax progressivity in the region. Tax exemptions and allowances can, for instance, take the form of tax holidays, reduced corporate income tax rates, investment tax allowances and partial profit exemptions to reduce the cost of capital. At the individual level, they include tax deductions and credits for a wide range of items. Many countries also set lower tariffs on imports than their most favoured nation rate would allow. This reduces custom and import duties. Also, tax

[15] See Magnus Blomström, Ari Kokko and Jean-Louis Mucchielli, “The Economics of Foreign Direct Investment Incentives”, National Bureau of Economic Research Working Paper No. 9489 (Heidelberg, Germany, Springer, 2003).

exemptions and difficulties in implementing VAT/sales taxes contribute to lower tax revenues.

62. Tax concessions can be useful, especially if they lead to higher investment or higher growth. The revenues foregone (“tax expenditures”) owing to these deductions and allowances can be significant. In Georgia, the Philippines and Tajikistan, tax expenditure in corporate income tax reaches 0.5 per cent of GDP or more. Tax expenditures in customs duties reach more than 1 per cent of GDP in Pakistan and the Philippines and more than 8 per cent of GDP in China.

B. Policy options to enhance tax revenues

63. Countries with untapped tax potential could enhance tax revenues in a number of ways, such as broadening tax bases and rationalizing tax rates, tackling tax evasion and tax fraud, making tax administrations more effective and transparent, carefully sequencing reforms of tax policy and tax administration and strengthening regional cooperation.

64. Governments could take a number of measures to rationalize and extend their tax systems to have larger tax bases with relatively low tax rates that do not create distortions in the allocation of resources. Countries should review their indirect taxes and retain only exemptions or concessions that are achieving their stated objectives. GST and VAT systems should be made simpler. This would also entail extending these taxes to sectors that are currently exempt. There is also a case for expanding the base for customs duties to the import of services, as has already been done in some countries.

65. Revenues from direct taxes should be strengthened by implementing mechanisms for taxing capital gains in securities or property more widely. Also, appropriate mechanisms must be developed to apportion domestic and foreign operations of multinational corporations properly so that there is no loss of tax revenues, especially in the presence of treaties for avoidance of double taxation. This also includes harmonizing income tax rates so that ideally the rate is the same for companies and high-income individuals to preserve tax progressivity and prevent income shifting to reduce tax liabilities.

66. Tackling tax evasion and tax fraud is a priority, especially considering that for the period from 2001 to 2010, illicit capital outflows from developing countries globally reached up to $5.9 trillion, for which the region accounted for more than 61 per cent. To deal with tax evasion and non-compliance, countries could introduce minimum taxes on companies and associations of persons. They could address evasion of personal income tax through withholding or advance taxes and could enhance VAT revenues by increasing incentives for compliance through simpler procedures and faster processing of refund claims. In addition, they should consider the creation of special tax courts to tackle tax evasion and tax fraud.

67. Making a tax system equitable and efficient will require a tax administration that is free from corruption, political interference and pressure from vested interests. In many countries, a careful sequencing of reforms to tax policy and to tax administration is needed. In the first phase of reform of tax administrations, human capacity must be expanded and administrations should be organized along functional lines where, for instance, a single department is responsible for

processing returns and payments, another for audits and investigations and yet another for enforcing collections. Also, information technology systems should be integrated. In a second phase, tax bases should be broadened by detecting new taxpayers and providing greater incentives for compliance. Lastly, tax assessments should be based on collateral evidence collected across government departments and compliance could be strengthened further by reducing the multiplicity of taxes.

68. Reforming tax policy requires Governments to broaden tax bases by expanding upon withholding taxes and advance tax regimes and by reducing exemptions and concessions. Also, VAT should be expanded to cover both goods and services, maintaining measures to offset the disproportionate impact on low-income persons. Tax rates should then be rationalized to reduce distortions and remove any existing tax anomalies. Lastly, legislation should be strengthened to regulate transfer pricing and to determine global incomes liable for taxation.

69. Greater regional cooperation can play an important role in mobilizing tax revenues. While competition for FDI is leading to a "race to the bottom" in terms of taxation of profits of multinational companies, tax harmonization among countries, especially those belonging to regional associations such as the South Asian Association for Regional Cooperation or ASEAN, may foster revenues. Effective regional cooperation can be used to help to avoid double taxation, to combat transfer pricing by multinational corporations and to deal with tax havens.

70. Given the evidence of the status of tax collection in the region, there is a strong case for establishing an Asian tax forum, under the aegis of ESCAP. Such a forum could monitor the tax legislation of member countries and publish a regular review of tax reforms. It could also act as a repository of tax laws, hold seminars and workshops on emerging tax-related issues and share best practices in tax policies, tax administration and tax reforms.