

IMF Policy Discussion Paper

© 1999 International Monetary Fund

This is a *Policy Discussion Paper* (formerly known as Paper on Policy Analysis and Assessment) and the author(s) would welcome any comments on the present text. Citations should refer to a *Policy Discussion Paper of the International Monetary Fund*. The views expressed are those of the author(s) and do not necessarily represent those of the Fund.

PDP/99/2

INTERNATIONAL MONETARY FUND

Regional Office for Asia and the Pacific

Tax Policy and the Asian Crisis

Prepared by David C. L. Nellor ¹

February 1999

Abstract

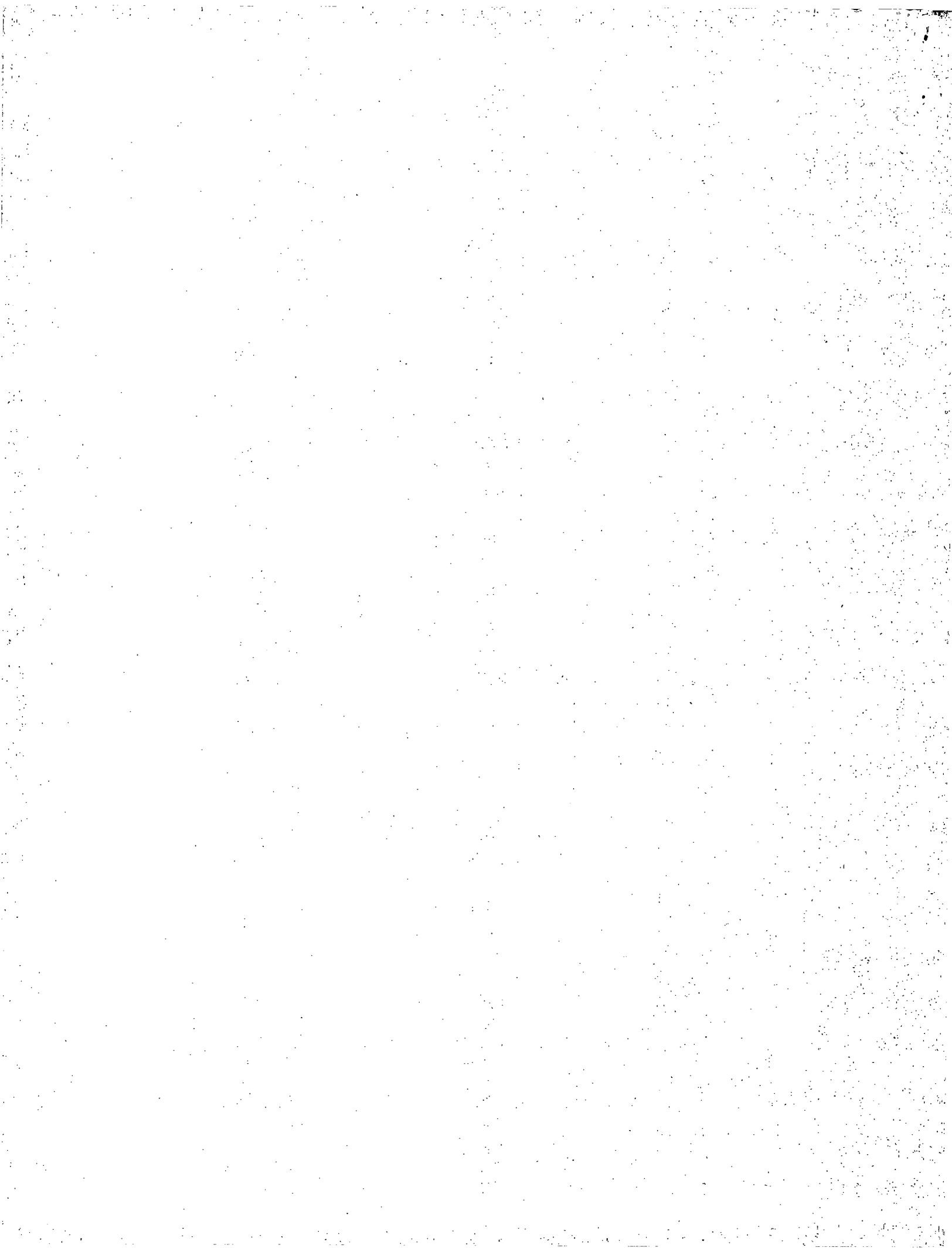
The Asian crisis offers a backdrop for looking at tax policy in relation to two interrelated developments. One, globalization, led to an array of tax breaks for mobile capital and a second, technological change, made it difficult to tax capital. Tax reform can promote sustainable recovery by removing financial sector distortions and facilitating corporate restructuring even though tax policies were neither a necessary nor sufficient trigger for the Asian crisis. Broader lessons are that tax administration requires strengthening when capital accounts are liberalized and international cooperation is needed to apply conventional taxation principles. The Thai and Philippines' tax systems are used to illustrate some points.

JEL Classification Numbers: E62, H25, H87

Keywords: tax policy, capital, Asian crisis

Author's E-Mail Address: dnellor@imf.org

¹ A draft of this paper was presented to The Second APEC-OECD Symposium On International Business Taxation, Cebu Philippines, November 4-6, 1998. The author would like to thank Julio Escolano, Reint Gropp, Milwida Guevara, Michael Keen, Christopher Morris, John Norregaard, Emil Sunley, and other IMF colleagues for helpful comments.



I. INTRODUCTION

The Asian financial crisis is both the same as and different from earlier crises. It is the same as earlier crises in the sense that it observes Kindleberger's (1978) scenario of an infusion of liquidity into the financial sector, insiders inflating nominal asset values, outsiders joining in, and emergence of an asset price bubble. A scramble for liquidity bursts the bubble triggered by a slowdown of the liquidity infusion. Yet this crisis is also different from earlier crises for at least two reasons; globalization and technological change. *Globalization* has bloomed because countries have opened their borders inspired by recognition of the enormous benefits of offshore capital. "Irreversible *technological change* means (that) the amount of money ready, willing and able to move around the world . . . has risen exponentially" (Volcker 1998). It is in the context of these two dimensions of the global economy that this paper considers tax policy and the Asian crisis. The former - globalization - whetted policy makers' appetites leading them to offer a tantalizing array of tax breaks for internationally mobile capital and the latter - technological change - makes it difficult to tax capital. Tax policy, while neither a necessary nor sufficient cause of the crisis, was part of a general policy stance that boosted the size of the bubble that is at the center of Kindleberger's financial crisis.

The paper focuses on tax policy and the crisis in Asia in the context of globalization and technological change. Two sets of conclusions, specific tax reform measures and general lessons from the crisis, form the tax policy agenda on these issues. On measures, tax policy has an important role to play in promoting a sustainable recovery in Asia because:

- Design of tax regimes was supportive of macroeconomic factors triggering the Asian crisis even though tax policies were not its primary cause. These tax distortions, relating particularly to promoting foreign currency funding, should be removed.
- Tax reform is required in some countries to help corporate restructuring that is a defining feature of a sustainable recovery.

On broader lessons from the crisis for tax reform, it suggests that:

- The complexity and volume of financial transactions, associated with the opening of emerging markets, have made tax administration a more challenging task. Just as strengthening financial systems must be a precursor to capital account liberalization, tax administrations clearly also require strengthening in such an environment.
- International/regional cooperation is required to apply conventional principles of tax reform in a globalized economy. Besides standard arguments that cooperation is required to tax returns on mobile capital, pervasive tax incentives, motivated by efforts to attract investment, have eroded tax bases and imposed enormous costs on already weak tax administrations. Asian emerging markets need to develop an institutional solution to overcome this problem.

The paper has three parts. It looks at tax policy and capital flows, structural aspects of the crisis, and the role of tax policy in the corporate restructuring prompted by the crisis. The Thai and Philippines' tax systems are used to illustrate some points although the conclusions apply, to varying degrees, in other countries. The paper does not argue that tax policy had

either a necessary or sufficient role in triggering the crisis. In a concluding section, the paper notes some general principles for tax reform.

II. TAX POLICY AND CAPITAL FLOWS

The scale and changes in private capital flows to emerging markets occurring in the 1990s are of a size that is difficult to comprehend. Private flows to developing countries averaged just \$15 billion in the 1980s and soared to \$240 billion by 1996. These developments represent a fundamental change in the global economic environment.

Table 1. Private Net Capital Flows to Emerging Markets
(In billions of US dollars)

	1984-89 Annual average	1993	1994	1995	1996	1997
Total	15.2	164.7	160.5	192.0	240.8	173.7
Asia	13.0	57.6	66.2	95.8	110.4	13.9

Source: International Monetary Fund, *World Economic Outlook*.

The fact that private capital flows can move quickly and arbitrarily is only too well known following the developments since mid-1997. Immediately before the Asian crisis, the annualized rate of net private flows reached \$400 billion. Just over twelve months later, following the Russian default in August 1998, annualized net private flows were zero. In many respects the dramatic increase and then reversal of flows is the hallmark of the crisis.

The boom in private capital flows to emerging markets reflects, of course, their attractiveness as investment destinations. These capital flows are a desirable use of global capital and are

responsible, in part, for the enormous gains in per capita income in the region. However, some part of capital flows to Asia were prompted by inconsistencies in macroeconomic policy.¹ These inconsistencies involved a combination of effectively fixed exchange rates with attractive interest differentials that offered a “one-way” bet or non-equilibrating arbitrage encouraging short term flows. Investors (resident and nonresidents) could borrow foreign currency at low rates, convert the foreign exchange into local currency, and invest at higher yields. The investor received the spread between the local yield and the foreign borrowing cost. This net return was guaranteed in the sense that the investor was confident that the proceeds of the investment could be used to repay the foreign debt at the initial exchange rate. The exchange rate “guarantee,” like fiscal guarantees offered by government, reduced the risk for private investors willing to commit capital to these countries.²

Responding, inter alia, to the incentives introduced by macroeconomic policies, private capital flows surged in the mid 1990s peaking at about 10 percent of GDP in the Philippines and at 13 percent of GDP in Thailand before collapsing in 1997. However, while flows in aggregate grew dramatically, particular categories of flows grew disproportionately. “Net other flows,” including lending by banks and residents perhaps related most to exchange rate prospects, grew dramatically. In Thailand, these flows increased almost five fold from 1993 to 1995

¹ This is not to suggest that a single factor caused the crisis. Other considerations relate to financial sector supervision and regulation and capital account liberalization. IMF (1997) discusses some of the considerations and Nellor (1998) the policy responses.

² It was the perception that this guarantee could not be sustained that led investors to “rush for the exits” and precipitate the crisis.

when they accounted for more than three quarters of private capital flows. In the Philippines these “other” flows accounted for almost 90 percent of private capital flows in 1996 (Table 2).

Table 2. Net Capital Flows: Selected Asian Countries
(In billions of dollars)

	1993	1994	1995	1996	1997
Thailand					
Private flows	10.4	12.2	22.4	16.8	-9.5
Net FDI	1.4	0.9	1.2	1.7	2.7
Net Portfolio	5.5	2.5	4.1	3.5	5.0
Net other¹	3.5	8.8	17.1	11.6	-17.2
Philippines					
Private flows	2.7	3.8	4.4	8.2	1.3
Net FDI	0.9	1.3	1.4	1.3	1.1
Net Portfolio	-0.1	0.3	0.2	-0.2	-0.4
Net other¹	1.9	2.2	2.8	7.1	0.6
Indonesia					
Private flows	6.3	7.1	12.0	16.8	14.8
Net FDI	1.9	2.4	4.7	6.2	3.1
Net Portfolio	1.8	1.1	1.5	1.8	-2.1
Net other¹	2.6	3.6	5.8	8.8	3.8
Memorandum item: Private flows as percent of GDP					
Thailand	8.5	8.5	13.3	9.3	-6.2
Philippines	5.0	5.9	6.0	9.8	1.6
Indonesia	4.0	4.0	5.9	7.4	2.3

Source: International Monetary Fund, *World Economic Outlook*.

¹ Includes short term bank borrowing and other forms of loans by residents.

But what role did tax policy play in these developments? The tax policies adopted by the crisis countries were not a primary cause of the crisis, nevertheless various tax provisions aimed at attracting foreign capital may have contributed to its emergence. For example, the tax system treated favorably capital flows responding to the “one-way” bet outlined above, particularly those intermediated through the banking systems. Moreover, effective tax rates on capital

were kept low by the constraints on tax administration resulting from technological change. Thus, two features the global economy played a role in tax policy as they did in other aspects of economic developments. The recognition of the benefits of *globalization* spawned tax policy as a key policy instrument for attracting capital and *technological change* constrained tax administrations from applying conventional taxes on income from capital. These same phenomena are, of course, not unique to Asia. The OECD and the EU have devoted considerable effort to finding ways to prevent erosion of the capital tax base.³ But, perhaps the erosion of the capital tax base in Asia is more extreme than in OECD countries; perhaps this should not be surprising because Asian emerging markets are far more exposed to the global economy than OECD countries.⁴

In many emerging markets the capacity to tax capital returns is limited. Tax administrators need to understand and monitor complex financial transactions that grew rapidly due both to financial sector liberalization and technological innovation. Traditional difficulties for tax administrators, such as transfer pricing, that had often been limited to natural resource sectors in developing economies, took on wider importance as local companies gained sophistication and developed offshore operations. These developments posed enormous challenges for

³ See OECD (1998) which develops “guidelines” for the tax treatment of financial and other service activities and EU (1998) which developed a Code of Conduct looking at business activities in general.

⁴ One measure of the scope for external factors to influence domestic economic developments is the sum of exports and imports as a percent of GDP. For ASEAN countries this ratio varies from about 40 percent (Indonesia) to 270 percent (Singapore). In the U.S. and Japan, by comparison, the ratio is just under 20 percent.

already weak tax administrations. One consequence is that tax revenue relied, by design or default, on withholding taxes. Unfortunately, returns on capital are generally not suited to withholding although there are exceptions such as bank interest.

Globalization encouraged countries to adopt measures to attract capital including by reducing effective tax rates. Tax benefits are rationalized by arguing they can be used to attract capital that is highly mobile and can flow to one or another of several broadly homogeneous destinations.⁵ A related view was that tax reductions on capital were necessary to restore a “level playing field” either because other (competitor) countries adopted tax breaks or due to handicaps faced by the country. In the latter case, countries argued that tax breaks were needed to compensate investors because of deficiencies such as inferior infrastructure or lack of natural resources. Emergence of new markets, such as China and Vietnam, added to competition for capital faced by the “original” Asian emerging markets. While this competition was largely in traditional areas such as textiles, the “commoditization” of electronics broadened and deepened competition for capital. Moreover, the pace of technological change meant that physical capital depreciated rapidly and location decisions were made more frequently--electronics became a footloose industry. These developments along with the external orientation and vigorous competition for capital, through legislated tax incentives and discretionary privileges, took tax competition to a new level.

⁵ Some countries in Asia, such as Indonesia, have substantial natural resource endowments and perhaps have less need to compete. Indonesia had abolished most tax incentives in the 1984 reform but reintroduced tax holidays in 1996.

These responses to globalization made the task of tax administration, already burdened by the growing scale and complexity of capital flows, even more difficult. As policy makers introduced tax breaks to attract capital they simultaneously created a myriad of tax arbitrage possibilities. In other words, the various tax breaks produced different tax rates for various activities and locations (within countries) that created opportunities for investors to reduce their tax burdens by shifting deductible expenses and taxable income. Governments sought new and innovative incentives to attract capital. Thus, for example, the 1994 Philippines' Export Development Act provides for tax credits to exporters based, *inter alia*, on the growth of their export receipts over the previous year. These tax credits could also be traded to other taxpayers. These measures are extremely difficult to administer - particularly because they covered service as well as merchandise exports - and pose a potentially enormous tax loophole.⁶ For example, a similar measure in Bolivia led to the emergence of "tourist cows."⁷ Farmers could generate tax credits by leading their herds back and forth across the border presumably with increasing speed to maintain or increase the growth of their "export receipts!"

Finally, and very important, Asia did not have the institutional mechanisms to pursue solutions to these tax competition problems. ASEAN and other groups focused on trade and investment policy that encouraged free trade and flows between its members. They did not pursue tax

⁶ This concern prompted delays in issuing administrative rules and regulations that, in turn, triggered litigation by industry groups.

⁷ See Rodrik (1993).

harmonization, guidelines, or other forms of coordination that many industrial economies have explored or are already emerging.

In the remainder of this section, some specific aspects of the tax systems are outlined to show how tax systems treat capital returns.⁸ In essence, the tax system produced by the factors outlined above was characterized by special treatment of capital overall. In particular, foreign funding and borrowing was treated favorably. In addition, many countries permitted high levels of leverage that reduced the taxable base, and, due to administrative constraints, exempted some forms of capital returns that were difficult to capture. Although the tax system played a role in encouraging foreign capital flows, its quantitative impact is difficult to assess. Nevertheless, the scale of distortions favoring foreign versus domestic funding through the banking system as well as high leverage gives a strong prima facie case for removal of these distortions. The timing of these adjustments, however, must be on case by case basis reflecting the state of the capital account of the balance of payments, health of the corporate sector, and revenue considerations.

A. Taxation of the Financial Sector

Both Thailand and the Philippines provided large tax breaks to financial institutions generating foreign currency deposits or borrowings and using those funds to make foreign currency loans

⁸ The discussion of the administrative constraints on taxation and the scope for discretion particularly related to tax incentives, underscores that the legislated tax system can be quite different to the actual system as practiced. The paper does not examine this issue.

for domestic activity.⁹ These tax breaks included preferential corporate tax rates, exemption from business taxes (proxies for the VAT), and specific stamp taxes. A related aspect is that some specific taxes in the financial sector, such as the documentary stamp tax in the Philippines, discouraged development of derivatives markets that may have enabled more efficient foreign currency hedging. Thus, on the one hand, the tax system may have encouraged foreign funding but, on the other hand, discouraged activities that would have reduced the macroeconomic risks of that funding.

In Thailand, the tax breaks to foreign currency funding were provided to institutions operating in the Bangkok International Banking Facilities (BIBF), an offshore banking facility, introduced in 1993. "Out-in" lending, along with more conventional offshore banking - using borrowings from non residents to lend to other nonresidents - was subject to a preferential rate of corporate income tax of 10 percent compared with the general corporate rate of 30 percent (Table 3). Also very important, the activity was exempt from business tax and stamp tax.

The Philippines offered favorable corporate tax treatment to foreign-funded intermediation as well as exempted these activities from the gross receipts and documentary stamp taxes.

⁹ By comparison with Thailand and the Philippines, Indonesia did not offer special treatment to foreign-funded intermediation. Nevertheless, its balance of payments still shows a sharp build up in short term capital flows albeit not as large in relation to the size of the economy as in Thailand and the Philippines (Table 2). A possible implication is that tax factors were not a necessary condition for the sharp increase in short term flows although the favorable tax provisions clearly did nothing to discourage such flows.

Philippine banks are permitted to offer foreign currency deposits (FCDU) and make loans from these deposits. Exporters and public corporations hold most of the deposits. The banks thus have two distinct sets of activities; domestic operations (that can include foreign currency) and the FCDU accounts. Profits from FCDU accounts are taxed at a 10 percent preferential rate on gross income (compared with the standard rate of 35 percent on net profit). The domestic banking activity is also subject to a gross receipts tax and documentary stamp tax. Tax administration difficulties have arisen due to incentives for tax-related arbitrage across FCDU and the normal accounts.

**Table 3. Tax Rates on Foreign Versus Domestic Funded Intermediation
(In percent)**

	Taxation of profits		Gross Receipts Tax ¹		Tax on Interest income	
	BIBF/ FCDU	Domestic	BIBF/ FCDU	Domestic	BIBF/ FCDU	Domestic
Thailand	10	30	Exempt	3.3	10 ²	10 ²
Philippines	10 ³	35	Exempt	5.0 ⁴	Exempt ⁵	20

Source: Various tax guides prepared by accounting and tax firms.

¹ Paid on gross interest receipts.

² BIBF interest is taxable as regular income whereas non-BIBF interest income is subject to non-final withholding.

³ On gross income.

⁴ Rate on loans of up to two years. Rates are lower for loans of longer maturity and are zero for loans of longer than seven years.

⁵ Interest income on FCDU deposits was exempt from the 20 percent withholding tax imposed on domestic deposits. However, the case for "leveling the playing field" on interest income is compromised by the inability of the tax administration to tax all interest receipts of residents irrespective of source. Imposing withholding on domestic source foreign currency interests of residents runs the risk that funds will move offshore. A 7.5 percent withholding tax on FCDU interest income was, nevertheless, introduced in 1998.

Foreign-funded intermediation in the Philippines also enjoyed a tax break due to favorable treatment under the implicit tax imposed via reserve requirements. FCDU accounts were

exempted from reserve requirements whereas regular accounts were subject to unremunerated reserve requirements that stood at 14 percent in mid-1997.

The favored activities - BIBF in Thailand and FCDU in the Philippines - grew rapidly. The value of BIBF out-in lending expanded from baht 195 billion at end 1993 to baht 807 billion at end 1996. Most of the lending activity of the BIBF involved a foreign exchange deposit by a non resident and a foreign currency loan to a resident. In the Philippines, FCDU deposits grew from peso 136 billion at end 1993 to over peso 300 billion in 1996.

Table 4. Indicators of Foreign Currency Banking Activity
(In billions of local currency)

	1993	1994	1995	1996	1997 ¹
Thailand					
BIBF lending (Out-in)	195.7	456.6	680.8	807.4	1,411.4
DMB foreign liabilities	352.4	780.0	1,164.1	1,249.3	1,904.4
Philippines					
FCDU resident deposits	136.2	158.8	206.7	317.6	433.4
DMB foreign liabilities	80.7	113.3	168.3	377.6	615.9

Source: International Monetary Fund, *International Financial Statistics*, and data provided by the authorities.

¹ Exchange rate developments influence significantly the local currency values in 1997.

B. Thin Capitalization

Neither Thailand nor the Philippines imposes a limit - or a thin capitalization rule - on corporate gearing for income tax purposes. This encourages companies to incur greater levels of (domestic and foreign) debt. Companies can deduct interest expenses as a cost of doing business, reducing the cost of debt by 35 percent in the Philippines and by 30 percent in

Thailand. The absence of thin capitalization measures allows multinational taxpayers to reduce their tax liabilities significantly by earnings stripping. Available data show that gearing levels, in aggregate, were particularly high in Thailand and more reasonable in Philippines (Table 5). The role of taxation in this outcome is, of course, difficult to identify.

Table 5. Debt Equity Ratios: Thailand and Philippines

	Thailand		Philippines	
	Observations	Debt-equity ratio	Observations	Debt-equity ratio
1994	503	2.82	110	1.63
1995	526	3.16	138	1.52
1996	498	3.39	140	1.56
1997 ¹	48	4.09	49	1.89 ²

Source: Claessens et. al. (1998).

¹ Exchange rate depreciation and equity price declines contribute to the increase in the ratio in 1997.

² Lim et. al. (1998), using a larger sample, derive a ratio of 1.94.

C. Treatment of Interest

Tax treatment of interest receipts and expenses permitted institutions to reduce their tax burden. Asymmetric treatment of interest *receipts* - subject to withholding at less than the corporate rate - and interest *expenses* - deductible at the corporate rate - is a problem in both Thailand and the Philippines. Institutions can borrow funds and deduct the interest expense against income and deposit the funds and incur a lower tax rate. In the Philippines, banks used this tax arbitrage by taking deposits (accruing deductible interest expenses at 35 percent) and purchasing government paper (final withholding on interest receipts at 20 percent).

III. STRUCTURAL ASPECTS OF THE CRISIS

Structural aspects of the crisis include weakening bank asset quality, excess real estate capacity, asset price inflation, and ineffective corporate governance. High rates of credit growth were one factor contributing to these developments. In the Philippines, growth of credit to the private sector was 51 percent (year-on-year) at the end of 1996 and in Thailand, while not as rapid, credit growth had been sustained at high rates over an extended period. It has been suggested argued that this credit growth led to asset price inflation and contributed to the subsequent collapse of asset prices. The tax system may have played a role in this process. First, and familiar from the preceding section, the favorable tax treatment of foreign currency lending encouraged credit growth. Demand for credit may have been promoted by weak corporate governance reflected, with the benefit of hindsight, in excessive leverage. The absence of thin capitalization rules (see above) may have encouraged this development. Second, in the Philippines, the inability to treat specific provisions for bad loans as a deductible business expense may have discouraged banks from appropriately managing their assets.¹⁰ Finally, extensive incentives for fixed capital investment combined with the failure of the tax system to capture capital gains meant that the tax system encouraged asset acquisition and thus perhaps contributed indirectly to asset price inflation.

A. Fiscal Incentives

Thailand and Philippines offered an extensive range of tax incentives for investment. Thailand offered reduced import duty rates on machinery and raw materials as well as income tax

¹⁰ Some countries permitted deductibility of specific provisions. However, tax rules were guided by prudential rules that were weaker than internationally accepted standards.

holidays up to eight years and reduced income tax rates thereafter (Table 6). Additional incentives were also provided to enterprises in special investment zones and for export enterprises. Philippines also offered tax incentives including income tax holidays, duty exemptions and locational incentives (Table 7). To the extent that these incentives promoted foreign direct investment, they may be of less concern from a macroeconomic perspective because the flows are less volatile. Nevertheless, the fiscal incentives may contribute to the structural concerns listed above. In addition, it is clear that the incentives increased the difficulty of tax administration thereby complicating economic management.

B. Dividends and Capital Gains

Returns on equity capital are treated favorably even in the absence of special fiscal incentives. Dividends are treated relatively favorably in Thailand and there does not seem to be adequate protection from dividend stripping. Dividend income of business entities is taxed but only on 50 percent of the dividend received if shares are held for at least three months. Inter corporate dividends are exempt if (i) the company is registered on the stock exchange or (ii) dividends are from a company in which holding is 25 percent or greater. Residents can benefit from imputation or a 10 percent final withholding on gross dividends that reduces this distortion. In principle, both Thailand and the Philippines include capital gains as part of taxable income. However, tax administration constraints limit the effectiveness of these provisions.

Table 6. Thailand: Incentives in the Corporate Income Tax ¹

	Zone I	Zone II	Zone III
Corporation tax incentives based on location	No tax holidays except if located in industrial estates or promoted industrial zones and export ratio >80% (three years tax holiday)	Three years tax holiday. Seven years if located in industrial estates or promoted industrial zones and export ratio >80%	Eight years tax holiday and half reduction after the exemption period
Additional incentives for enterprises in special investment promotion zones	Reduction by one half of corporate tax rate for five years after termination of normal income tax holiday or from date of income earning. Allowance to double cost of transportation, electricity and water supply for deduction from corporate taxable income. Allowance, for taxable corporate income, of up to one quarter of the investment costs of installing infrastructure facilities with eligibility for up to ten years from date of earning income.		
Additional incentives for export enterprises	Allowance for deduction, from taxable corporate income, of 1/20th increase in income derived from exports over previous years, excluding cost of transportation and insurance.		

Source: Various tax guides prepared by accounting and tax firms.

¹ Other tax incentives relate to import and export duties. In zones 1 and 2, the standard import duty rate for machinery of 5 percent or reduction by half if duty rate exceeds 10 percent and in zone 3 machinery is exempt from duty. In zone 3, duties can be reduced by three quarters for five years even if the materials are used for domestically sold output.

Table 7. Philippines: Incentives in the Corporate Income Tax for Board of Investment (BOI) Registered Companies ¹

Income Tax Holidays	Eligible for income tax holidays lasting up to 8 years.
Duty Exemptions	Exemption on import of supplies, capital equipment, and spare parts.
Tax Credits	To offset the adverse incentives created for using imported capital equipment rather than domestically manufactured equipment by the BOI duty exemptions. BOI enterprises are entitled to credits equal to the differential between the 3 percent minimum tariff (or the rate of zero, whichever applies) and the standard tariff rate which would have applied to domestic capital had it been imported.
Special Economic Zones and PEZA	Enterprises locating in the Clark and Subic bases, the special economic zones, are entitled to similar tax holidays and duty exemptions to those for the BOI firms, on a permanent basis.
Export Development Act of 1994	Various income tax credits related to share of exports in output and the rate of growth of export receipts.

Source: Various tax guides prepared by accounting and tax firms.

¹ Numerous other incentives are available for specific industries, sectors, regions, and firms.

IV. TAX POLICY AND CORPORATE RESTRUCTURING

Corporate restructuring is a defining feature of restoration of sustainable growth in Asia. The need to restructure is driven by the interaction of the scale of leverage, maturity mismatches, exchange rate developments, demand and price conditions. The importance of “getting assets back to work” has prompted countries to revisit various aspects of corporate law, bankruptcy provisions, and tax policies. The developments associated with the crisis and the subsequent restructuring can create taxable events. Thus the tax system can be supportive or impede the process along with the administrative and legislative requirements for restructuring. This section notes a few of the key issues that must be addressed.¹¹

Foreign exchange gains and losses: The large moves in exchange rates, since mid-1997, resulted in substantial foreign exchange losses. These losses are generally in the nonbank corporate sector.¹² There is no standard income tax treatment of these gains and losses. The financial accounting treatment would require that monetary assets and liabilities be translated at the closing exchange rate on the balance sheet date. This is also probably the best rule for taxation even though many countries recognize gains and losses only on realization.

Nevertheless, the foreign exchange losses in some Asian corporates are so large, following the exchange rate changes, that use of the accruals system might trigger a large number of

¹¹ Thailand has adopted several tax reforms related to corporate restructuring since the onset of the crisis. See Thai Ministry of Finance press release 108/2541, September 11, 1998.

¹² Prudential limits apply to banks net open (long or short) foreign exchange positions mean that banks are less likely to have this problem. However, some suggest that these largely closed positions were undermined by taking positions through subsidiaries or via derivatives.

bankruptcies. Consequently, it might be appropriate to provide a special rule to provide a favorable loss carry over when an accruals system is used. Indonesia provided the option to write off the loss over a five year period which can be added to general loss carry forward provisions. Thailand also offered, on a once off basis, accounting options that would also extend the period of write off for foreign exchange losses. The Philippines did not have general loss carry forward provisions and this could pose severe problems for corporates facing large foreign exchange losses.¹³

Valuation of assets in the balance sheet: Physical assets, shown in the balance sheet at historical cost should, in many instances, be revalued following the large depreciations of local currencies. Such revaluations would, however, normally lead to a tax charge. Relating this to the previous point, setting foreign exchange losses against such revaluation gains would be appropriate - they may well be directly related if a foreign loan was incurred to purchase the capital equipment. Nevertheless, business is concerned about the tax obligations of such revaluations benefits.

Restructuring: Reflecting stress in the corporate sector, shareholders might choose to change the corporate structure of their business assets and liabilities through a merger or restructuring. Tax laws should, in principle, be neutral in such cases. It is likely, however, that the restructuring might be seen as a realization of various gains or losses that create taxable

¹³ Loss carry forward was introduced in the 1998 comprehensive tax reform program.

events without appropriate laws to address such cases.¹⁴ This should be avoided so long as it is clear that the restructuring is not being undertaken as a tax avoidance device.

Consider also the case of restructuring via a debt-equity swap. If a company - in two separate transactions - raised equity and used the proceeds to pay off debt, there would be no income triggered. Both transactions are capital transactions. But, this does not apply when there is a debt equity swap. In these cases there may be debt forgiveness income because the value of the equity is generally less than the value of the debt extinguished. More broadly, the tax status of the restructured entity might influence the incentives for restructuring. For example, a debt equity swap means that the entity, rather than having deductible interest payments, pays dividends from after tax profits. This latter concern relates, of course, to the general bias of the income tax to debt and is not specific to the crisis.

Insolvency related debt restructuring: Debt forgiveness of various forms (partial, complete, debt equity swaps) creates taxable income equal to the debt forgiven. Although this treatment is generally appropriate, the tax law needs to be clear on the status of the corporation. In particular, the tax law needs to allow for cases when a company is insolvent and entering into bankruptcy proceedings where the tax law could permit forgiveness income to be spread over a longer period.

¹⁴ The Philippines' tax law has specific provisions relating to change of control, merger, or consolidation of corporations. See, for example, section 40© on exchange of property that recognizes no gain or loss when the exchange is in pursuit of a merger or consolidation.

Treatment of specific provisions of banks: Strengthening and making more meaningful the information portrayed in bank balance sheets is an integral part of restoring growth in Asia. Recognition of the true costs of doing business is one element of this process. One such expense is the specific provisions for bad loans. Thailand has always provided for deductibility of specific provisions by banks and this also applies to banks' accelerated provisions to meet the year 2000 standard. The Philippines has no such deductibility provisions. However, even in the case of Thailand, the adoption of more rigorous provisioning requirements for banks means that tax deductibility is quantitatively more significant.¹⁵

V. CONCLUSIONS

The paper focuses on tax policy and the crisis in Asia in the context of globalization and technological change. The former - globalization - whetted policy makers' appetites leading them to offer a tantalizing array of tax breaks for capital and the latter - technological change - has made it difficult to tax many forms of capital. These developments eroded national tax bases and damaged the public credibility of tax systems.

Tax reform has an important role to play in promoting a sustainable recovery in Asia. The design of tax regimes was supportive of macroeconomic factors triggering the Asian crisis but was not a necessary nor sufficient cause of the crisis. Tax policies treated returns on capital favorably. In particular, volatile short-term capital flows that may have been associated

¹⁵ In considering the introduction of such provisions, the Philippines is recognizing the trade off between loss of revenues and this structural improvement to the tax system.

with the macroeconomic imbalances that triggered the crisis were encouraged by tax policies. These tax distortions-relating particularly to the financial sector-should be removed.¹⁶ In addition, restoration of growth in Asia calls for substantial corporate restructuring. The tax system must be attuned to taking a neutral position with respect to business decisions. Some aspects of tax systems may have to be revised to allow this corporate restructuring to proceed effectively.

Taking a broader perspective, the crisis teaches some lessons about setting tax policy. It underscores that tax administration is a particularly challenging task due to the complexity and volume of business transactions in open emerging markets. Just as strengthening financial systems must be a precursor to capital account liberalization, tax administrations also require strengthening in such an environment. At its most simple level, this strengthening is about increasing the effective resources devoted to tax administration. Beyond this it has implications for tax policy such as investigating further the role for withholding taxes. A second lesson for individual countries and the international community is that institutions need strengthening. Applying conventional tax reform principles in a globalized economy requires far greater international/regional cooperation and so the institutional deficiencies in this area need to be addressed. The precise form of those institutional arrangements is, to say the least, not clear. Tanzi (1998) proposes a World Tax Organization. Others prefer regional

¹⁶ The timing of these reforms is complex and needs to be assessed on a case by case basis. For example, some measures might discourage capital inflows at a time when the capital accounts of the balance of payments is weak. Similarly, it may not be feasible to introduce thin capitalization rules immediately when many companies have high debt equity ratios.

approaches that call for voluntary compliance.¹⁷ Yet, in the absence of broader economic integration that provides greater scope for compensating measures, arriving at regional solutions to these problems will be difficult.

¹⁷ The OECD (1998) guidelines do not seem entirely applicable in Asian emerging markets because at least two aspects of the four-part definition of harmful tax competition do not apply to the tax issues noted in this paper: the tax preferences are not ring fenced and the regimes are transparent.

References

- Claessens, S. S. Djankov, and L. Lang, 1998, "East Asian Corporates: Growth, Financing and Risks over the Last Decade," *World Bank, mimeo*.
- Commission of the European Communities, 1998, COM(97) 564 Final.
- International Monetary Fund, 1997, *World Economic Outlook, December 1997: Interim Assessment: A Survey by the staff of the International Monetary Fund* (Washington).
- Kindleberger, Charles P., 1978, "*Manias, Panics, and Crashes: A History of Financial Crises*," (New York: Basic Books, Inc., Publishers).
- Nellor, David C.L., 1998, "The Role of the International Monetary Fund" in *East Asia in Crisis: From being a miracle to needing one?*, Part V, 15, pp. 245-265, 1998, ed. by Ross H. McLeod and Ross Garnaut (London, Routledge, 1998).
- Organization for Economic Cooperation and Development, 1998, *Harmful Tax Competition: An Emerging Global Issue* (Paris).
- Rodrik, Dani, 1993, "Taking Trade Seriously: Export Subsidization as a Case Study in Policy Effectiveness," *National Bureau of Economic Research Working Paper No. 4567* (Cambridge, MA: NBER).
- Tanzi, Vito, 1998, "The Impact of Economic Globalization on Taxation," *International Bureau of Fiscal Documentation: Bulletin* (August/September), pp. 338-343.
- Volcker, Paul, 1998, "Can we bounce back?," *Financial Times*, October 7.

