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* Author: Dennis Botman, IMF Resident Representative to the Philippines

A Fair, Simple, and Efficient Tax System

Recently an active debate has emerged over the future of the tax system, particularly whether there is a need to modify tax rates. That the tax effort needs to increase is beyond any doubt, however. And not by a little bit, but substantially. Only then can the Philippines match the growth rate in neighboring countries and achieve lasting poverty reduction.

Before the Asian crisis, the tax effort stood at 17 percent of GDP, but we finished 2009 at around 12½ percent. Tariff reform and non-indexation of excises played an important role in reducing revenue throughout this period. Despite the success of the various fiscal reforms over the last few years, including the landmark EVAT reform, the tax effort was further wounded by legislative revenue-eroding measures and the cyclical downturn following the global financial crisis.

We have now reached the point where civil service wages and debt service costs eat up over eighty percent of tax revenue, leaving little room for priority spending. This year, with the economy and imports gaining traction, revenue should recover, but it looks like these gains will be offset by new legislated measures including the further proliferation of exemptions and incentives. To bring the tax effort back to pre-Asian crisis levels, an additional effort of at least four percent of GDP is still required. This is no easy task, but it can be done and it should be done.

Let's start why it should be done. After all, growth is expected to remain below potential for the time being, so would raising the tax effort not undermine the recovery? Quite the contrary. First of all, to support growth, it will be important to keep interest rates relatively low, not only for the government, but for firms and consumers as well. This requires reining in the deficit to entrench investor confidence. Reducing the deficit to more manageable levels should not only come from the revenue side, but from the spending side as well, in particular by compressing growth in lower-priority spending programs such as the civil service wage bill.

Second of all, apart from deficit reduction, higher revenue is needed to replenish the public capital stock to address the investment shortfall relative to neighboring countries. The Philippine investment ratio continues to be the lowest in the region, even after factoring in the more service-oriented nature of the economy, which requires lower investment rates. Corruption is often cited as the most problematic factor for doing business in the Philippines. Improving governance should therefore remain a top priority. However, without commensurate investment in physical capital (roads, electricity, ports, irrigation, storage facilities among others), social safety nets, and human capital (education and health) progress in the governance area is unlikely to raise growth to seven percent per annum, which is the regional average, and reduce poverty rates substantially.

Combined, deficit reduction and creating fiscal space for public investment and other priority spending require a quantum leap in the revenue effort. Can it be done? Yes. With administrative reforms only? Possibly, but that should not stop us from making the tax system simpler, more efficient, and fairer. Of course, as a start, further revenue-eroding measures should be resisted.

Accelerating tax administration reforms remain a key part of the revenue-enhancement strategy. Tackling tax evasion, including smuggling, would raise revenue quickly and expand the formal business sector. In contrast, a large number of other tax administration reforms are only expected to yield higher revenue over the medium term, but are critical nonetheless. These include strengthening taxpayer registration, audit capacity, arrears management and collection, taxpayer services, and information and management systems in the revenue agencies. International experience suggests that progress in these areas requires a large reform team, consisting of several dozens of full-time employees, running for several years to be effective. It also requires not only removing the BIR and BoC from the salary-standardization law to provide the illustrious carrot, but also a stronger stick.

Even if these efforts would raise sufficient additional revenue, it would be a mistake to stop there. There is an urgent need to abolish tax holidays and end the proliferation of special incentives and exemptions. This is not to say that the Philippines should not provide tax incentives. Every country does to some extent. However, there are better ways to attract meaningful investment, including through accelerated depreciation or through a lower corporate income tax rate or a tax on gross receipts. Harmonizing tax treatment will also create a level-playing field among firms and make it easier for the revenue agencies to administer the tax system both across companies and over time.

Similarly, there is a need to reform “sin taxes”, specifically to unify, raise, and index to inflation the specific excise rates, which are currently well below international levels. This will not only raise and protect the revenue effort, but unified rates are also easier to administer. Furthermore, streamlining the list of optional deductions for the self-employed will tighten tax enforcement. Besides generating more revenue (taxation is below international levels) raising excise rates on petroleum products would be fair (the rich consume disproportionately more than the poor) and efficient. Currently, there is a plethora of taxes on financial instruments depending on the type, its maturity, and owner, complicating tax assessment and hampering capital market development. Over the medium-term, the mix between direct (corporate and personal income taxes) and indirect (VAT and excises) taxes should be reviewed, not only to increase the revenue effort, but also to make the tax system more supportive of investment and job creation.

Besides other reforms, growing at a sustained seven percent, as targeted under the Medium-Term Philippine Development Plan, requires much higher public investment to enable private sector development. Besides strengthening tax compliance and administration, revenue agencies will need all the help they can get from a simplified, fair, and efficient tax system.

The Author is the IMF Resident Representative for the Philippines