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## **Ten Thoughts on Reforming Tax Incentives**

After many years of intensive debates, the Philippines appears ready to move forward with reforming its incentives regime. This is a very welcome step as tax holidays weaken revenue without providing much gain for the country at large, which is why other Asian countries are also moving away from incentives. The goal should be to reform the incentives' landscape along four dimensions: (i) streamlining the institutional framework; (ii) enhancing public disclosure; (iii) narrowing the scope of incentives; and (iv) abolishing tax holidays in favor of better targeted incentives. A reform that achieves these objectives would yield significant additional resources, which can be used to scale up public investment in human and physical capital, contributing to higher and more inclusive growth and job creation. Here are ten thoughts on the current incentives regime in the Philippines, based on a recent IMF paper on the topic (available at: <http://www.imf.org/external/pubs/ft/wp/2008/wp08207.pdf>).

First, the number of agencies that are allowed to offer incentives could be streamlined as, among other things, they complicate the system and often end up competing against each other. There are currently about ten investment promotions agencies and several national government agencies involved in managing investment activities and administering tax incentives. This framework governing the granting and oversight of tax incentives should be streamlined.

Second, public disclosure on the costs of incentives could be enhanced. To increase transparency as well as enforcement, every firm receiving tax incentives should file a tax return, even if no taxes are due. The return would show how much the taxpayer would have needed to pay in the absence of the incentives provided. This information can then be aggregated and submitted annually to Congress in the form of a tax expenditure budget. This will allow the legislature to better assess whether this is indeed the most efficient and fair use of public resources.

Third, incentives should be well targeted to a limited number of firms. Incentives should only be provided to attract firm-specific and not location-specific, internationally, mobile capital. This would clearly not include investments in mining or property development, as some have been lobbying for.

Fourth, income tax holidays are particularly harmful by causing redundancies. Although all forms of tax incentives carry some disadvantages, tax holidays are particularly damaging as profits are exempted regardless of their amount. The most profitable investments, which would have taken place in any event, benefit the most. Estimates for the Philippines indicate that the revenue loss from redundant incentives could be as large as 1 percent of GDP, providing a windfall gain to receiving firms. These resources could be used to scale up public investment, which is low by regional standards at around 3.5 percent of GDP.

Fifth, tax holidays are most attractive for footloose industries that tend to exit the country at the end of the holiday period. In the extreme, effective tax rates are zero on investment projects in short-term capital that fully depreciates before the end of the holiday. These industries are likely to bring the smallest benefits to the overall economy.

Sixth, firms investing in long-lived assets, the ones you would like to attract, but whose revenues may not fully recover costs during the period of the holiday, benefit the least from tax holidays. For these firms, effective tax rates under the tax holiday are not as low as you would imagine and increase rapidly as the holiday expires.

Seven, tax holidays invite tax avoidance through the indefinite extension of holidays via creative redesignation of existing investment as new investment or by encouraging transfer pricing or other devices to shift earnings into holiday companies. This is especially true for countries with weak revenue administrations. Leakage from special economic zones is another concern.

Eight, by not taxing a subsector of the economy, the rest needs to pay more, leading to further weakening of tax compliance. Indeed, the wedge between effective tax rates faced by companies with and without tax incentives is one of the largest in the Philippines compared to neighboring countries as well as compared to many advanced economies. Nine, tax holidays create competitive distortions between old and new firms.

Ten, a survey of foreign investment decisions of Fortune 500 companies found that nontax factors were the main determinants of their location decisions. Such factors include good transportation systems, good governance and enforcement of property rights, a skilled labor force, low power costs, and a supportive regulatory environment. To improve the score on some of these factors, it is essential to raise government revenue. At the moment, incentives provide money to something that is less important to foreign investors, at the expense of factors that are more critical to their investment decisions.

Recognizing these pitfalls, several countries, including some in the region, have started to move away from providing incentives through income tax holidays. For the Philippines too, it is much preferable to replace the tax holiday with a reduced corporate income tax or low gross income tax, targeted to firm-specific internationally mobile capital, administered through a simple institutional framework, and with annual disclosure of the resulting revenue losses to the legislature. This would in fact lower effective tax rates more than the income tax holiday for most incentive-receiving firms, thereby maintaining regionally attractive incentives, while stimulating investment and job growth as well as government revenue. Such targeted support could be combined with other incentives such as double deductions for training and R&D.

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