

Next Generation Tax Reform in the Philippines

RENATO E. RESIDE, JR.*

Abstract

The Department of Finance of the Philippines has recently proposed legislation which seeks to reform the tax system in the Philippines. This paper describes the new initiative, pointing out how the proposal differs from attempts at tax reform in other periods. While the new initiative is generally consistent with good principles of tax reform, several weaknesses remain. Many suggestions for improvement are made.

Keywords: tax reform, taxation, public policy

* Email: renato_reside@hotmail.com

Introduction

A recent paper by myself and Lee Burns (2016) has reviewed the history of tax reform in the Philippines as well as the motivations of past reforms. That paper was in reaction to the Philippine Department of Finance's (DoF) proposed tax reform bill currently filed in Congress whose objective is to amend currently perceived weaknesses in tax laws. This paper seeks to comment on that proposed bill.

Apart from the traditional motive to raise government revenues, motives for tax reform include the desire to enhance equity, efficiency, and simplicity in the tax system (the textbook attributes of a good tax system). Add to these the desire to reduce the tax system's vulnerability to abuse (on both sides—the taxpayers and the tax collectors) and to strengthen the quality of tax administration and they comprehensively describe the bases for undertaking tax reforms globally.

The country's finance officials have usually emphasized the revenue-generation motive for undertaking tax reforms. This is understandable considering the country's past experiences of running fiscal deficits. At the root of the country's deficits in the past have been perennially low levels of tax and revenue effort. Low revenue effort, in turn, has often made the country very vulnerable to economic shocks. Hence, one of the main motivations for implementing tax reform is a fiscal crisis. These were strong drivers for tax reforms during the administrations of Corazon Aquino and Gloria Arroyo. Unfortunately, the fact that tax effort levels have only risen marginally and not remained buoyant with respect to growth suggests that past tax reforms have been ineffective in achieving overall revenue objectives in the long run. The revenue ineffectiveness can be traced to a combination of shortcomings in tax administration and tax policy.

Apart from not achieving revenue targets, there is little evidence that tax reforms and other initiatives relying on tax instruments in the past have achieved other economic objectives such as equity, efficiency, and simplicity. Concerns over lack of equity, efficiency, and simplicity in the tax system have only persisted (or even intensified) ever since the last comprehensive tax reform in 1997. The level of inequality in the country, as manifested in its Gini coefficient, has gone down, but only marginally, and the reduction cannot be traced to taxation. This suggests that there may be room for the tax system to play its redistributive role especially as richer taxpayers have proven to be extremely difficult to tax. Because they have the means to do so, richer taxpayers have proven to be increasingly adept at tax planning, tax arbitrage, and transfer pricing.

Prior to the 2012 sin tax reform, excise taxation had also proven to be a very blunt instrument in promoting economic efficiency. Instead, policymakers saw excise taxes more as an instrument for raising revenues (even if they were not very good at it) and to achieve equity ends (lowering petroleum excise taxes as a means to offset the potential regressive effects of the VAT reform in 2005). The resulting structure of excise taxes was prone to arbitrage, and not buoyant. It meant that the social and public burdens of pollution, traffic, cigarette smoking, and drinking appear to have only increased over the years because the tax system failed to adjust the private costs of such phenomena or activities closer to their true social costs.

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The efficiency of the tax system has been undermined in other ways. Large capable firms tend to benefit more intensively from income tax incentives thought to be redundant and inefficient; there are hardly any claims on tax incentives offered under the Clean Air Act and other laws with environmental intent. Furthermore, tax-reducing legislation has often tended to offset the gains of tax-revenue-generating laws. Tax exemptions and concessions suffer from mis-targeting and have proven to benefit the non-poor more than the poor, are fiscally costly, and have not been very good tools in attaining their desired objectives (e.g., stimulating investment, addressing the needs of the poor, etc.).

Simplicity has also been compromised. Tax forms have only grown more complicated, and returns still need to be filed on a more than frequent basis. All these problems are the target of the current tax reform proposal of the DoF.

Tax Reform: Current Proposal, Emerging Trends

The Department of Finance recently launched an effort to reform the tax system of the country.¹ It structured the process into several phases, front-loading the reforms expected to yield the greatest revenue returns (which also happen to be among the most radical reforms).

In general the packages aim to increase the progressivity, efficiency, and simplicity of the tax system. The first package of the reform proposal restructures the personal income tax brackets, raising the tax-free income threshold to cover more taxpayers, increasing the threshold for the top marginal tax rate from the present 32 percent to 35 percent, and reducing marginal tax rates for all other taxpayers in between the lowest and the highest income brackets. While this is expected to lead to a more progressive tax system, it is also expected to reduce tax revenues overall since a large number of individual taxpayers will have incomes below the tax-free threshold. The DoF expects to recover losses primarily by reducing VAT exemptions, raising excise taxes on vehicles and fuels, and introducing new excises on sugary drinks.

The middle stage of the reform proposal includes the rationalization of fiscal incentives for investment and a lowering of the corporate tax rate from the current 30 percent to 25 percent. This is being proposed to reduce inefficiency and to align the country's corporate regime with its Asian counterparts.

As it stands, what is known about the current tax reform proposal of the DoF is that it is broadly consistent with recent trends in the department's other recent tax legislation initiatives. In the last five years, the DoF has pursued a legislative agenda characterized by

1. Increased reliance on indirect taxation versus direct taxation to raise tax revenues with several important implications (such as, the need for greater flexibility of taxes through explicit indexation provisions);
2. Greater emphasis on economic motivations for pursuing tax reform, including the use of instruments of indirect taxation to achieve greater progressivity in the tax system given the ineffectiveness of progressive direct taxation;
3. The replacement of socially-oriented but inefficiently-targeted tax expenditures with better targeted and transparent forms of direct public expenditures to achieve the same social objectives;

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4. And increased participation by civil service organizations in the conception, development, and refinement of DoF-sponsored tax reform legislation.

This strategy represents a departure from approaches to tax reforms in the past. The current proposal also makes it incumbent on the DoF and its partner agencies, the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BoC), to set up a VAT refund system and to undertake complementary reforms in tax administration, including an examination of laws and other circumstances that may create or lead to perverse incentives for tax administrators. These, as well as items (1) to (4) above, will be discussed in the following section.

Moving from Direct to Indirect Taxation

Motivation

By raising the tax-free threshold for personal income taxation (PIT) so that a (very) large fraction of low income individual taxpayers become effectively exempt and combining this with reductions in all except one marginal PIT rate and increases in select excise taxes, the DoF is simply reinforcing its shift towards greater explicit policy reliance on indirect taxes over direct taxes in raising tax revenues. This trend began with the 2012 passage of the sin tax law which updated long untouched excise taxes on alcohol and tobacco products. The restructuring of the PIT brackets is also perhaps tacit acknowledgment of the persistently deep inequities among taxpayer incomes which mirror the inequities within society in general, as well as acknowledgement of the relatively small size of the effective taxable income tax base. By deliberate exclusion of large numbers of lower income taxpayers, combined with higher indirect taxes on consumption goods purchased by richer taxpayers, the proposal achieves its progressivity objectives.

Even prior to the passage of the sin tax law, much of the major tax legislation had already been focused on indirect taxes. Personal income tax brackets have been unchanged for several decades. Apart from legislated changes in the corporate income tax rates (raised from 32 percent to 35 percent in 2006, and reduced from 35 percent to the present-day level of 30 percent in 2009), exemptions of minimum wage earners from PIT (2008), and increases in the tax-free bonus threshold (2016), there has been little by way of significant legislation affecting direct taxation.

In contrast, indirect taxation has seen major legislation over the years. The VAT was introduced to replace the old system of retail taxes in 1988, but many VAT exemptions were introduced to the VAT system in 1996 (and continue to be introduced), effectively undermining collections. In response to a looming fiscal crisis that the University of the Philippines School of Economics faculty had warned might happen (De Dios, et al. 2004), the VAT base was broadened by legislation in 2005 to include sectors formerly excluded from the base (such as, electricity, petroleum, medical, and legal services), and the rate raised from 10 percent to 12 percent. Despite these efforts, many sectors remained excluded from the VAT base.

With respect to excise taxes, rates have either gone down or stayed the same, without indexation for inflation. Excise taxes on select petroleum products have either not

changed since 1997 or were reduced in 1997 (LPG, diesel, bunker fuel oil have been at zero nominal excise rates since 2006). Excise taxes on tobacco and alcohol products were restructured in 2012 and indexed to inflation in response to the need to raise real tax revenues and reduce the negative public externalities brought about by smoking and drinking.

The trend policy shift towards indirect and commodity taxation appears to be explicit acknowledgement of the shortcomings of the system of direct taxes in the Philippines with respect to the objective of revenue generation. While increases in the values of direct tax collections over the years can be explained by rising incomes and incremental improvements in tax administration in the country over the years, the system of direct taxes has not been sufficiently buoyant. Efforts to reform the tax system to enhance revenue performance of direct taxation over the years have been blunted by factors that have undermined and reduced the tax base and collections for direct income, including periods of low economic growth, sectoral transformation of the economy and of the labor force (away from primary and industry sectors towards the service sector); persistence of a large underground economy with large numbers of taxpayers who voluntarily choose to be noncompliant; unregistered workers and businesses motivated by a lack of trust of government expenditures and tax administrators; continued outbound migration of workers, depriving the tax system of numerous taxable individuals above the tax-free threshold; persistent and pervasive use of income tax incentives for investment; and increasing legislation of income tax exemptions and other concessions of direct taxes. The overall effect is that compliance levels for direct taxes, as well as the direct tax bases themselves, have declined over time, and the country has been forced to rely more on bases for indirect taxes instead. Meanwhile, the technology for tax avoidance and tax planning has become much more accessible over time, especially to richer taxpayers, further reducing the buoyancy of direct taxes.

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In theory the lowering of taxes on income has several implications. One might think it may stimulate labor supply and raise tax collections. But the DoF still needs to account for this potential effect (or non-effect) on the economy. The likelihood that lower taxes stimulate increased labor supply may rise if taxpayers are heterogeneous—so that some taxpayers could be more sensitive to lower tax rates than others. But even if labor supply might increase to increase taxable incomes, the level of tax compliance also still needs to be sufficiently high for tax administration to extract incremental taxes from incremental taxable income (more on this problem later).

The policy shift towards consumption taxes, such as the VAT, could make the tax system more regressive. This risk could be mitigated, however, if consumption taxes were spread broadly across as wide an array of goods and tax bases as possible, including, and especially, goods consumed relatively more intensively by richer taxpayers. The current DoF tax reform proposal attempts to do just this by cutting down on VAT exemptions and raising excise

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taxes on selected fuel products and cars (the bigger the vehicle, the higher the marginal excise rate).

The policy shift towards indirect taxation has the added benefit of having a broader tax base (each with independent enforcement) compared to the smaller variety of bases for direct taxes (even more so now with the proposed restructuring of the PIT) so that the former is subject to lower risk of revenue losses. When tax collections are undermined by the inability to collect taxes from hard-to-tax or untaxable taxpayers, indirect taxes are the next best instrument as they can serve as an alternative tool to recover income escaping taxation.

Risks in the VAT and Excise Systems and Mitigation

As with all forms of taxation, the efficacy of indirect taxes lies in the preservation of a broad tax base. The problem over time, however, is that numerous concessions—tax expenditures—were introduced in VAT legislation, undermining the intended broad nature of the indirect tax. This, along with concessions and lack of indexation in excises, has resulted in uneven performance of indirect taxes as a share of GDP. Chart 1 shows that, as a percentage of total revenues, the revenues raised from indirect taxes have fluctuated over time. Indeed, the fraction of total revenues raised from indirect taxes was in fact higher on average during the 1990s than at the present period.

The current VAT system is not broad-based insofar as exemptions abound. But there remain excluded sectors (e.g., gaming, education, and health). VAT and excise collections have proven to very sensitive to rate changes, base inclusions, and other concessions. Exemptions and exclusions not only lead to leakages and reductions in the VAT base but also break the chain of VAT paid on sales and reclaimed on purchase of inputs. Chart 2 suggests that growth in indirect taxes in the past has been very sensitive to the passage of significant legislation raising rates (e.g., VAT in 2005), broadening (or reducing) the VAT base (e.g., broadened in 2005), or eliminating and restructuring (or not restructuring) excise taxes (e.g., sin taxes in 2013) on select products.

VAT base broadening could be further facilitated if transfer instruments funded alternatively out of direct and more visible budgetary appropriations that are also better targeted towards poorer taxpayers could be found to replace the VAT tax expenditures. The DoF has talked about these alternative instruments, but it would be better if the Department of Social Welfare and Development (DSWD) and other agencies capable of implementing them could demonstrate more explicitly that they are on board the current tax reform.

Excise taxes also have a potentially productive role to play within the DoF proposal. In phase 1 of its tax reform proposal, the DoF is pinning the primary role of revenue generation on the increases in differential commodity excise taxation on fuels and cars. In the case of fuel, the increases in excise taxes are meant to correct for reductions in excises that took place during the Arroyo administration to cushion the effects of the increase in VAT rates. Excise taxes address multiple objectives in the DoF proposal. Not only do they address revenue generation, they also seek to address negative externalities from traffic congestion and pollution.

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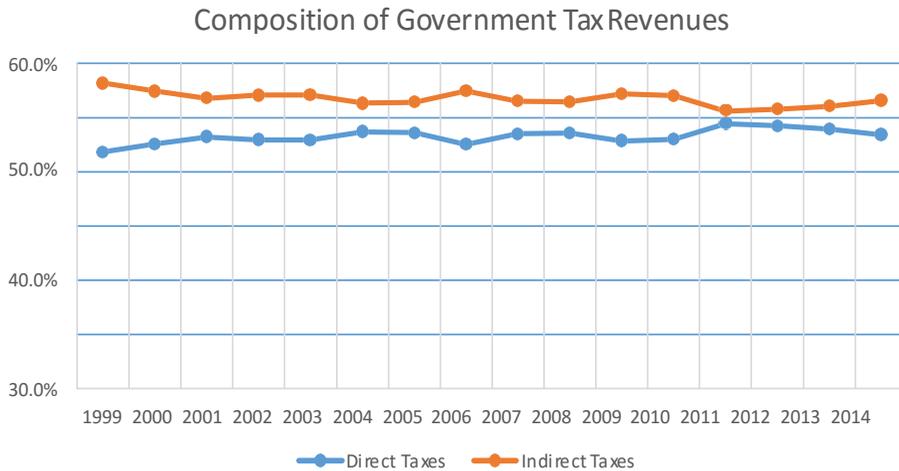


Chart 1: Composition of government tax revenues, 1999-2014

Source: Department of Finance

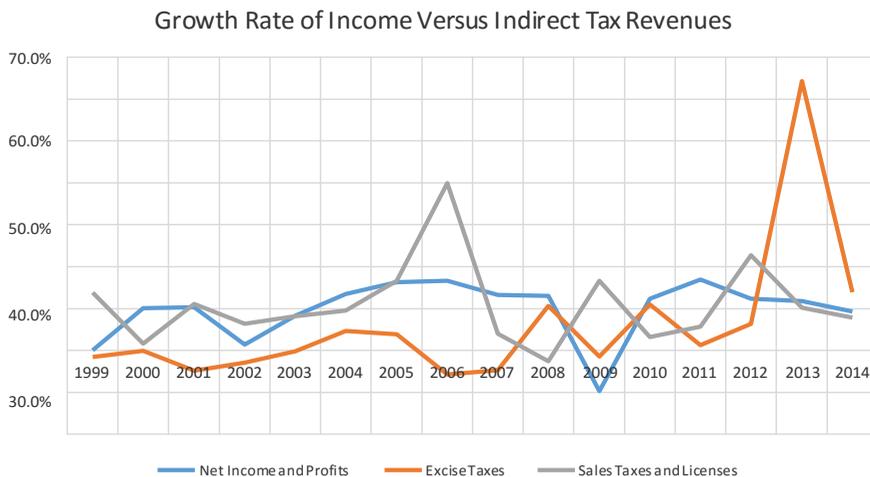


Chart 2: Growth rate of income tax revenues and indirect tax revenues

Source: Department of Finance

For fuels, this addresses the tax concessions that have been granted on these goods since the last times taxes were raised on them. The move to emphasize the productive role of excise taxes may also justify differential tax treatment across consumption of selected goods if it can be shown that, beyond the conventional social costs of negative externalities, taxpayers display a lack of rationality and self-control in the consumption of alcohol, tobacco, and other products, such as sugary drinks.

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In light of the proposed increase in excises for fuels and cars, requisite emphasis must be given to the putting in place of adequate complementary mechanisms to increased excise taxes to prevent smuggling and other undesired effects of increasing consumption taxes. While previous episodes of implementation of fuel marking systems have not been successful in the past, they ought to be revisited and the flaws addressed.

In addition, potential substitution effects and other behavioral changes emanating from increased taxation of the excised products should be analyzed further (for example, demand for used or second hand (used) goods). All these imply that tax administration should be strengthened to mitigate compliance and revenue risks in the VAT and excise systems, and the capacity of tax policymakers to analyze data must also be enhanced.

An example of a tax reform proposal in need of complementary action by policy authorities to enhance the quality of tax data generation and tax administration is that of the setting up of a credible VAT refund mechanism. Since the DoF has not yet developed a specific proposal for one, this author has taken the liberty to draft a proposal for doing so. More on this later.

Greater Emphasis on Economic Rationales for Reform

While tax reforms into the mid-2000s emphasized raising tax revenues, newer generation initiatives, such as the sin tax reform of 2012 and the recent tax reform proposal of the DoF, represent newer approaches to reform. Traditional economic motivations—namely, efficiency, equity, and simplicity—are becoming the underlying (even main) justifications for undertaking tax reform. The economic motives now carry almost equal (if not more) weight as revenue objectives. This is a direct effect of tax reform not taking place because of a fiscal crisis.

For the first time in many years, the PIT income brackets are being restructured. The DoF proposal sees a reduction in the number of brackets, a nod to simplicity, as well as a reduction in most marginal PIT rates, but a rise in the top marginal rate, which is a nod towards greater progressivity or equity. The increase in excise taxes aims to enhance efficiency as it aims to address road congestion and pollution issues.

The shift in emphasis on economic motives for tax reform was first evident in the passage of the new sin tax law in 2012. That saw the DoF pursue a strategy of justifying reform from the standpoint of achieving greater economic efficiency through a taxation of activities that tended to generate negative social and fiscal externalities. It was argued that a restructuring of sin taxes could contribute to better health outcomes and to less adverse impacts of smoking and drinking on public health, and hence also on public finances. The DoF sought to build alliances with the Department of Health as well as with nongovernmental organizations in order to lobby for the reform. The restructuring of excise taxes on sin products was done through a rationalization of tax tiers, an increase in tax rates on the consumption of targeted products, and the introduction of tax indexation provisions to protect real collections.

Meanwhile, the weakening of the ability of the personal income tax system to achieve equity and revenue goals has opened opportunities to use other tax instruments to achieve progressivity goals, for instance, to argue for increasing excise tax rates on luxury goods

that richer taxpayers can afford, such as cars. Indirect taxation may also be used to achieve greater efficiency of road use as it is possible to restructure current road user fees to adhere more closely with the ideal of congestion-based pricing. The increasing move away from dependence on progressive direct taxation towards more dependence on indirect taxation to raise revenues has also highlighted the need to scrutinize the role played by excise taxes in enhancing equity and efficiency, and on policy instruments that can offset any increased regressivity of commodity taxation. While the VAT (and the elimination of VAT exemptions) retains its traditional role of generating revenues, excise taxes are now being relied upon to achieve multiple objectives—revenue, progressivity, and efficiency goals of taxation.

Replacing Tax Expenditures with More Transparent On-Budget Transfers

The arguments in favor of eliminating certain tax concessions are now emphasizing that the tax system is not a good substitute for other, more efficient, and well-targeted policy tools in delivering social assistance. Hence, there is a need for developing new or for strengthening existing modes of social service delivery through the regular government budget.

The proposed elimination of VAT-related tax expenditures for senior citizens, cooperatives, PWDs, and other sectors has prompted the DoF to seek alternative instruments to replace these. The motive, of course, is to develop certain types of transfers or augment existing ones that can improve upon tax expenditures in terms of efficiency of service delivery and targeting.

There appears to be strong anecdotal and data-based evidence that the senior citizens' VAT exemption is not progressive. First, it is available to all seniors, and the income profile of seniors tends to closely match that of society's overall so that close to 70 percent of seniors are above the poverty line. Second, richer seniors will obtain greater tax benefits from the VAT exemption than poorer ones because they have the means to spend greater absolute amounts on luxury consumption goods, such as restaurant meals, and other consumption goods that are close complements of leisure (movies and theatrical plays). Moreover, the senior citizens' VAT exemption has proven to be prone to abuse.

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Another aspect of the economic impact of the senior citizens' VAT exemption that bears further analysis is the possibility that it will reduce the existing level of funding for senior entitlements. Effectively, current non-seniors are already bearing the burden of financing the tax endowments of current seniors. As more people age and advances in health care ensure longer life spans for more and more people, therefore, the absolute size of the entitlement endowment will increase. Hence, over time, the underlying structure of the senior citizens' VAT exemption will also take on the same actuarial attributes and risk as a pay as you go pension system (where the currently young finance the pension requirements of the currently old).

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During hearings with lawmakers, senior citizen groups voiced mixed opinions regarding the elimination of the senior citizens' VAT exemption. Some groups expressed a desire for a universal social pension to replace the VAT exemption. The economic tradeoffs and other potential behavioral effects of such a scheme must be weighed against the behavioral changes induced by VAT exemption. For example, how do VAT exemptions affect the savings rate (if at all)?

Despite their proposal to broaden the transfer system as part of tax reform, the DoF has not yet indicated that the DSWD and other agencies capable of helping develop such instruments agree in principle to such tasks. More explicit demonstrations of support from such agencies could go a long way towards increasing the political acceptability of abolition of certain tax expenditures.

In general, a more viable system of well-targeted transfers can help tax authorities argue against inefficient tax concessions. In this regard, complementary reforms that may reduce the temptation to use the tax system for inefficient tax concessions include strengthening the existing social public agencies and their programs (health, education, and social welfare) and transfer mechanisms (pension and the conditional cash transfer program) and the setting up of a national ID system to facilitate transfer targeting and delivery.

VAT Refund System: A Proposal

With increased demands on the administration of both direct and indirect taxes brought about by the proposal for tax reform, the BIR should respond adequately. One critical aspect of the proposed tax reform that requires the BIR to deliver is the requirement to provide quality data about taxpayers and their compliance histories in order to build a profile taxpayers (to enable risk-based refund facilitation). An accurate taxpayer risk-profiling system will not only facilitate the setting up and systematic operation of a credible cash-based VAT refund system as envisioned by the DoF-sponsored tax bill for zero-rated taxpayers, it will also help rationalize tax audits for income taxes. Refinements in the estimation of tax expenditures will also be made possible through more accurate taxpayer data.

Because the VAT system is destination-based, exports should be zero-rated. Thus, the sector should be eligible for refunds of input VAT. However, VAT refund systems are also very vulnerable to fraud. Hence, the proposal to establish a VAT refund mechanism should be carefully considered.

A credible VAT refund mechanism tends to help the DoF reduce tax leakages insofar as it eliminates the need to also zero-rate indirect exporters (the present practice) who can now charge exporters an output VAT (recoverable by exporters since they will still be zero-rated). They would then simply go back to a system of deducting their input VAT from their output VAT and then relying on the refund system to recover any excess input VAT.

A working VAT refund mechanism can also discourage industries from lobbying for VAT exemptions instead of VAT zero-rating; VAT exemptions reduce the VAT base but also break the VAT chain and may lead to undesirable effects on prices as input VAT will no longer be refundable. A VAT refund system will also eliminate the present tendency for refund claims to be settled at the Court of Tax Appeals.

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Delays in refunding legitimate VAT claims will impose costs to firms, especially on exporters who may have a large backlog of refunds and may discourage investment. In order to reduce perverse incentives faced by opportunistic tax administrators, the following systematic classification scheme for registered VAT taxpayers could be adopted:

1. Analyze BIR data to classify VAT-registered taxpayers as high-, medium-, and low-risk for potential VAT fraud. The basis for classification may be exporter status (or non-exporter), quality of bookkeeping, or history of tax compliance. It may be possible to enhance acceptance of the new refund system if during an initial phase the new refund procedures can be first be applied to the highest risk taxpayers.
2. To facilitate the process of refund processing, those classified as low-risk, perhaps exporters with excellent compliance records for the last five years, will be entitled to faster refunds without need for pre-approval (this would include tourists), whereas high-risk taxpayers will be subject to pre-approval audits. Initially, a way must be found to limit audits to administratively manageable levels.
3. Alternatively, an automatic refund level may be assigned to each taxpayer at the time of VAT registration (à la New Zealand). Claims are screened only if the refund claim exceeds the automatic refund level; otherwise, automatic refunds are made.
4. VAT refunds could be initially limited to zero-rated supplies for export sales of exporters with a history of excellent compliance. For their domestic sales, their excess input VAT credits can be carried forward (the ratio of reported and verified export sales to total sales will be the basis for refundable amount of excess VAT credits).
5. Initially, for VAT zero-rated non-exporters and non-zero-rated non-exporters, the amount of refunds of VAT on intermediate inputs will be limited to the level of VAT on output in each period, and the remaining balance will be carried forward to subsequent periods (or all excess input VAT will be carried forward to offset output VAT in future periods).
6. After administrative experience has been developed with the refund process, the eligibility for VAT refunds under step (3) can be broadened to VAT zero-rated non-exporters. Non-zero-rated non-exporters will continue to be treated in accordance with (4).
7. Refund audits should focus on VAT-able sales levels, the share of exports to total sales, reconciling such figures with BoC data and verifying input VAT credits from purchases. When a proper profile of VAT-registered firms is made, sampling techniques may be used in the conduct of audits.
8. To prevent revenue targets from motivating opportunistic behavior by tax administrators wishing to enhance their revenue-generation accomplishments, outstanding VAT refund claims will not count towards the achievement of current revenue targets.
9. Refund claims may be made on regular VAT returns.

To further enhance the credibility of the new refund mechanism, initial funding for refunds may come out of appropriations by Congress. The size of initial funding is to be based on an estimate of refundable excess input VAT credits. The refund mechanism should be run by dedicated staff in the BIR and the BoC, i.e., by statisticians, auditors, and clerks. It will require a statistical analysis of compliance by taxpayers.

As a matter of policy, one month could be the maximum refund period for registered exporters. Two months could be the maximum refund period for other VAT-registered

enterprises. Beyond these prescribed periods, any claim for refund is deemed final. Quicker refunds could be granted to exporters and other VAT-registered with a history of excellent compliance subject to a ceiling based on average excess input tax credits in past periods.

The Need to Reform Tax Administration

Throughout this paper, numerous citations have been made regarding the crucial role played by tax administration in support of the DoF tax reform proposal. Tax administration and enforcement have a role in facilitating compliance with any tax so its performance has a direct bearing on the achievement of the revenue and economic objectives of tax reform. This is the reason why fuel marking and intensified anti-corruption and anti-smuggling efforts are also important complementary elements of tax reform.

Although there is a noticeable shift towards greater emphasis on indirect taxes and the concomitant need for beefing up administration of VAT and excises, this should not preclude improvements in the administration and compliance for income taxes. Indeed, one of the most striking observations from the recent tax reform roadshows is the disconnect between the perceptions of tax reform by income taxpayers and the DoF. The former are primarily concerned with reducing abuses by opportunistic tax administrators, while the DoF is primarily concerned with achieving economic objectives. Hence, credible reform in tax administration is critical not only to achieve the objectives of tax policy but, even prior to that, to facilitate acceptance and popular support for the DoF proposal.

Laws that influence behavioral incentives for tax administrators may also need to be reviewed. In this regard, reforms may consider addressing the perverse incentives on tax administrators that can come out of the lateral attrition law. The current law may put too much emphasis on revenue generation (sometimes at the cost of rational tax administration and properly serving the taxpayer) and less emphasis on promoting a culture of taxpayer compliance. There is anecdotal evidence that tax administrators may be so overly focused on achieving their narrow district revenue collection targets that this precludes potentially useful innovations, such as enabling taxpayers to conveniently file their tax returns and pay their taxes anywhere in the country using modern technologies.

To address perverse behavioral incentives in tax administration, perhaps the BIR targets should be a composite of indicators, such as revenue generation, level of taxpayer satisfaction, and the attainment of other observable objectives, such as reduction in time spent and costs of filing and paying taxes. This might make the BIR more open to reforms that support voluntary compliance. This will strengthen incentives to enhance taxpayer service. Taxpayers should be able to rate the quality of their regional district offices (RDO), and these ratings should be a key performance indicator of tax administrators.

The BIR may need to reconsider the design of tax forms in order to simplify compliance, yet balance the need to extract quality information that will enable the DoF to still estimate a wide variety of tax expenditures. Data-sharing protocols among the Securities and Exchange Commission (SEC), the BoC, the BIR, and the DoF should be developed in order to properly govern the transfer of information for policy formulation without undermining privacy rights.

Consultative Approach to Tax Reform

The current approach by the DoF in pushing its legislative agenda has been to engage taxpayers in consultative meetings, whether through roadshows in the provinces or through meetings with civil society organizations. This democratic approach to tax reform certainly ensures that the proposal goes through a rigorous vetting process, with numerous potential veto players reviewing it. This system of checks and balances allows taxpayers to provide suggestions and criticisms; it lowers the risk of public dissatisfaction later and increases the chances that equity and efficiency objectives will be achieved.

The phased approach chosen by the DoF, however, comes at the cost of reducing its room to maneuver and bargain across a wider set of potentially interrelated policy handles, leading to potentially time-inconsistent outcomes. For example, if PIT commitments are already made and signed into law at the end of Phase 1, it will no longer be possible to use the PIT as a tool to calibrate the corporate income tax (CIT), the dividend rate, and other taxes. Finally, the country's public procurement system should be strengthened to improve the government's absorptive capacity and reinforce the grounds for tax reform.

Additional Food for Thought

The last time a comprehensive tax reform was undertaken in this country was in 1997. Since that time, economic circumstances have changed. The Philippine economy is now more open and more interdependent with the rest of the world. Both capital and labor are more mobile now. An offshoot of mobile labor is the OFW remittance flows which have helped generate persistent current account surpluses. In turn, such surpluses have transformed the Philippines from a net borrowing economy to a net lending economy. This also implies that Filipino companies are increasingly investing overseas and earning profits overseas. Domestic growth is also on more solid footing than ever before, and the country appears to be less vulnerable to external shocks. In addition, the service sector has grown to be the dominant component of the economy. The transformation of the Philippine economy since the last comprehensive reform in 1997 may prod one to question whether the current tax system is still appropriate, as well as the proposed changes to it.

Specifically, one might be tempted to ask, considering that a sizeable potential income tax base is due to mobile factors of production, whether it is still appropriate for the Philippines to continue taxing income on the basis of source instead of worldwide income. *The Philippine tax system follows the territorial principle in taxing incomes. This means that only the return to capital invested in the Philippines (the source country of the returns) is taxed. Returns to factors of production not mobilized in the Philippines are not taxed.*

In a world where capital is much more mobile than before and economies are more interdependent, theory suggests that a source-based income tax will lead investors to require a higher pre-tax return on investment so that it will generate a compensating higher after-tax return. Hence, investment falls and capital flows to other countries until cross-jurisdictional returns are equalized. But this leaves immobile factors of production (land and labor) with less capital, making them less productive and, hence, bearers of the incidence of the source-based tax on income. Government intent on avoiding this perverse result would

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be better off taxing immobile factors directly rather than through the capital income tax. With increasing capital mobility globally, theory suggests that source-based taxes should be gradually eliminated. Mere observation suggests, however, that source-based taxes on capital income have not disappeared despite capital being increasingly mobile globally.

One of the explanations for the pervasiveness of source-based taxes provides intuitive guidance for the appropriate tax policy response to highly mobile capital: source-based taxes persist because countries find it desirable to continue to tax on source basis, activities that produce location-specific rents.² A source-based tax will not create distortions if it is levied on immobile or location-specific rents (Griffith, Hines and Sorensen 2010). Hence, countries should tax more intensively activities that are likely to be less mobile. Conversely, tax incentives should not be granted to investments that produce location-specific rents.

Also, fortunately, the proposed tax reform aims to lower, not raise, source-based taxes on income. So the opposite should occur: the pre-tax return required by investors should decline. This means that capital flows into the economy and immobile factors would benefit with production becoming more capital-intensive.

A significant part of the base for personal income taxation has also shifted towards harder to tax service sectors, such as self-employed workers and those engaged in e-commerce.

Given the complexity of the current schedular system of taxation (where tax rates are based on a schedule or table of various types of income or transaction), a move towards a global system could be contemplated as it might simplify the tax system and make it easier to administer. Under a global system, various incomes would now be aggregated and taxable under the progressive rate scale of the PIT. This could make the tax system simpler,

but certain imputations would still need to be made. For example, to avoid double taxation of dividends, a credit might be given. There also must be sufficient transparency of incomes for the global system to work.

The transformation of the Philippine economy from one driven by the primary sector to one driven by the tertiary sector has not made taxes any more buoyant since a significant part of the base for personal income taxation has also shifted towards harder to tax service sectors, such as self-employed workers and those engaged in e-commerce. Moreover, the incomes of overseas Filipino workers are not taxed and tax incentives have been targeted towards the income earned by service-exporting corporations.

Synthesis and Other Suggestions

The proposed DoF bill is generally consistent with important economic principles guiding most tax reforms worldwide. It aims to lower marginal tax rates for most taxpayers, broaden the tax base, and simplify the tax system. The aims of achieving desirable attributes of a good tax system consistent with economic norms are mutually-reinforcing as well as self-reinforcing. As with any tax reform, trade-offs among achieving greater revenue

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generation, greater equity, simplicity, and efficiency in the tax system are implicitly being made in the proposed bill.

By lowering personal income tax rates faced by most taxpayers and increasing the threshold on the lowest tax-free income bracket, the bill preserves and tries to reinforce the progressivity of the tax system which seeks to impose the greatest burden on paying taxes on those with the greatest ability to pay them. Other components of the bill consistent with the ability to pay principle include the elimination of preferential tax treatment for alien employees and their Filipino counterparts working in multinational corporations and the increase in the highest marginal tax rate. The increase faced by the top bracket from 32 percent to 35 percent, however, comes at the risk of increasing tax arbitrage and avoidance by taxpayers already highly capable of doing these as it will lead to a non-trivial gap between the desired corporate income tax rate of 25 percent and the top personal income tax rate.

The DoF bill tries to broaden the tax base through conventional means—the elimination of those exemptions and other tax expenditures that are least justifiable on economic grounds. This includes eliminating tax expenditures that tend to benefit those with greater ability to pay and, hence, are regressive (such as the senior citizens' VAT exemption). It also includes eliminating tax expenditures that constitute nonstandard approaches to addressing societal needs. This has been done in recognition of the limited ability of the tax system to deliver well-targeted social assistance to the neediest (referring to the elimination of the VAT exemptions for seniors, socialized housing, cooperatives, etc., which are prone to abuse and leakages), eliminating VAT exemptions with no basis at all (e.g., the Boy Scouts and the Girl Scouts), and limiting unduly large tax breaks (limiting the extent of the optional standard deduction to at most 20 percent of gross income or gross receipts). Meanwhile, transactions formerly zero-rated on VAT, such as those made by suppliers to exporters, which are without economic basis, will now be subject to the regular VAT rate.

Broadening the tax base strengthens the government's hand in lowering tax rates further and helps attain other desirable economic features of a good tax system as this also helps simplify the tax system and reduces motives for evasion and avoidance. Eliminating exemptions prone to abuse enhances the efficiency of the tax system. Reintroducing excise taxes on fuel products and updating them on vehicles may help in alleviating traffic congestion and reducing pollution, which enhances economic efficiency. Meanwhile, regular indexing of tax brackets for the personal income tax and indexing the values of excise taxes are consistent with making the tax system more flexible.

Some nonstandard forms of preferential tax treatment remain in the proposed bill however, including continued income tax exemption of fringe benefits granted to rank-and-file employees, exclusion from gross income of gains from sale of long-term instruments and mutual funds, and VAT exemptions of: (a) sale, importation, printing, or publication of books and any newspaper, magazine review, or bulletin which appears at regular intervals with fixed prices for subscription and sale and which is not devoted principally to the publication of paid advertisements; (b) sale, importation, or lease of passenger or cargo vessels and aircraft, including engine, equipment, and spare parts thereof for domestic or international transport operations; and (c) sale of power or fuel generated through renewable sources. Note that VAT exemptions imply that input VAT credits on exempt supplies cannot be claimed and, hence, may raise firm costs which may be passed onto consumers.

While some of these tax measures can come at the cost of increasing costs for less capable taxpayers, the DoF must work with other agencies of government to come up with appropriate mitigating measures. Perhaps the DoF could come up with more explicit mitigating measures at this point to be more convincing before legislators review its proposals. The same is true for VAT zero-rating in the export sector being limited only to direct exporters (so that indirect exporters lose their zero-rating). As has been pointed out before, the DoF must come out with a credible refund mechanism. It is unclear at this point how credible the shift to cash-based VAT refunds for exporters will be. At this point a description of systems that have been tried in other countries (refund process expedited based on risk profile of exporter, based on some threshold, etc.) may be described in the bill. Notwithstanding this, I have taken the liberty to draft a proposal, based on what I know to be best practice.

In any tax reform, administrative measures and policy measures should go hand-in-hand since improvements in tax administration should aim to facilitate compliance and lower the incidence of abuse and, thus, deliver the tax structure intended by law. The bill tries to significantly improve and empower tax administration by waiving bank secrecy, but it may not go far enough as the waiver only applies to cases of suspected fraud. The government's goal in the long run should be to aim for full unconditional waiver subject to checks on abuses in tax administration. Perhaps the bill should include a requirement for eventual transition towards that standard if only to stimulate legislative thinking on the matter. The bill is also silent on the need to reformulate the attrition law which creates perverse behavioral incentives for opportunistic tax administrators and erodes, if not undermines, the protection of taxpayers. In addition, the bill can also include rewards for voluntary compliance on the part of well-behaved taxpayers (instead of rewarding non-compliance, as is the case with tax amnesties).

The move towards indirect and away from direct taxes has one other implication—that part of income that is saved now escapes income taxation. Hence, one must look closely at how the flow of savings is taxed—through passive income taxation of bank interest and investment income as well as dividend income. While this matter is left for future phases of tax reform (for now), some notable issues include the existing differential taxation across maturity of debt instruments (interest from long-term securities are taxed lower than those on short-run bank deposits) and across currencies (interest income on peso-denominated savings is 20 percent while that on FCDO accounts is 7.5 percent). There does not appear to be any good economic justification for these differences, and they can certainly be open to arbitrage effects on progressivity in the tax system and to other consequences. The low tax on FCDO deposits, for example, combined with OFW remittances certainly increases the level of dollarization in our economy, with corresponding effects on the efficacy of monetary policy.

Taxes on other forms of income should also be reviewed. The tax rate on dividend income is 10 percent. Given the preponderance of redundant tax concessions on corporate income, one way to recover some of the income that goes untaxed may be to consider raising the dividend tax rate. While it may potentially increase the tax take, increasing the dividend rate may also encourage greater levels of retained earnings (for financing future investment), but this needs to be analyzed further. Similarly, tax treaties negotiated with other countries

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may need to be revisited. They need to be reviewed to determine if tax concessions are granted with sufficient economic basis.

Despite the consistency of the tax reform proposal with economic principles, the reform remains inconsistent with the demands of a vast majority of taxpayers that tax administration abuses and weaknesses be addressed. Abuses of and weaknesses in tax administration undermine support for tax reform, so all options must be explored to reduce these. The DoF should explore ways of improving behavioral incentives at the BIR, such as reorganizing the institution and strengthening pay.

In subsequent phases of tax reform, the tax regime for non-stock, non-profit corporations should be revisited. We do not need another pork barrel scandal with massive revenue leakages and money laundering taking place because of the lack of oversight into this sector. In principle, the DoF should make sure that the income tax exemptions and tax deductible status of donations for this sector should only be made available on the basis of legitimate, non-profit-seeking, truly social welfare-enhancing, positive externality-producing activities.

Meanwhile, the introduction of legislation creating tax expenditures and tax concessions should be more rigorously vetted. One may consider the system adopted in South Korea where all potential tax concessions are vetted by a highly skilled economic think-tank associated with the government. This vetting agency is endowed with the capacity to veto any proposed legislation lacking in basis. Economic analysis must be empowered to offset ad hoc temptations to introduce opportunistic legislation. The DoF could also do well by codifying all laws granting tax concessions. This would make tax law more transparent and less complicated.

The Department of Finance has also made it known that they intend to propose future legislation that seeks to reform the current system of property taxes and small business taxation (through the implementation of a gross receipts-based system of taxation). Both initiatives have the potential to enhance the allocation of and broaden the sources of fiscal resources in the country. In the former, a new system of property valuation at the national level is going to be introduced. Hopefully, this will reduce political distortions on local tax systems and rationalize local taxation and revenue mobilization.

Also, because the administrative needs and the relative capacities of small firms are different from their large counterparts, there is a real need for tax policy and administration to discriminate between large and smaller businesses. Doing this can enhance the efficiency of the tax system. A simple tax on gross receipts or turnover can suffice. Thresholds should be determined on the basis of the ability of the tax administrator to oversee taxpayers beyond the tax. The optional standard deduction (OSD) could also discriminate between large and small businesses (with larger enterprises only eligible for smaller OSD). Small businesses should also have reduced and simplified reportorial and filing requirements. The proposed bill makes no mention of rationalizing taxes at the local level.

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Reside

However, future components of the reform will include measures to improve the national land registry so that proper zonal value taxation will be implemented. That is a good sign.

Finally, the latest version of the proposed bill seeks to rationalize donor, estate and capital gains taxes. A unification and lowering of tax rates and simplification of processes in this regard is also very helpful.

Notes

1. Several versions of proposed legislation exist, but the latest version is as of end-January, 2017 and includes the name of House Ways and Means Committee Chairman Dakila Carlo E. Cua but has not been officially filed and hence has not been numbered.
2. The other reasons why source-based capital income taxation has persisted include capital not being fully mobile across borders, the CIT serving as a backstop for the PIT, and the CIT being perceived popularly as a progressive instrument.

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