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Fiscal Reform Agenda: *getting ready for the bumpy ride ahead*

*Rosario G. Manasan**

As shown in the analysis and picture drawn in the preceding *Policy Notes* (PN No. 2004-07), the Philippines' fiscal position, in particular its public sector fiscal situation, is the country's most critical problem today and the urgency of addressing such problem cannot be overemphasized.

A number of areas of reform have been identified to help resolve this fiscal fix. Two of them refer to reforms on the revenue side (tax policy and tax administration reforms) and one, to reforms on the expenditure side (public expenditure management reforms). There are also reforms to be established regarding the management of government-owned and/or -controlled corporations (GOCCs).

In this regard, it must be noted that based on the analysis, the burden of adjustment should rest more on the revenue side. Thus, *both* tax policy and tax administration reforms are of utmost importance and must be undertaken in tandem with one another.

On the other hand, there is no room for further cuts in national government expenditures in the aggregate. Government spending for infrastructure and human capital investments is severely inadequate and this lack acts as a drag on the country's economic growth prospects. Still, this does not mean that reforms are not needed on the expenditure side. With or without a fiscal problem, reforms in public expenditure management are essential in ensuring that the government gets the biggest bang out of every peso that it spends. Consequently, minimizing waste and curbing corruption should be on top of the agenda. At the same time, it is crucial that the fiscal problems of the GOCC sector are attended to.

How do we get there? This *Policy Notes* discusses the areas of reform in detail.

Tax policy reform

Numerous proposals for amending the tax structure have been put on the table by various groups. President Gloria Arroyo herself unveiled eight new Palace-backed tax measures in a speech before the members of the Makati Business Club and the Philippine Chamber of Commerce, namely: (1) shift to gross from net income taxation for corporations

*The author is Senior Research Fellow at the Philippine Institute for Development Studies (PIDS).

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and self-employed individuals, (2) a two-step increase in the VAT and, possibly, a repeal of the VAT, (3) indexation of the excise tax on sin products, (4) indexation of the excise tax on petroleum products, (5) limiting of fiscal incentives, (6) imposition of a tax on the windfall income of telecommunications companies, (7) targeted tax amnesty, and (8) institutionalization of a performance-driven system for revenue collection agencies (*BusinessWorld*, July 23-24, 2004, p. 1). Prior to this, the government already approved an increase in the duty on petroleum products from 3 percent to 5 percent.

Meanwhile, other sectors have also put forward other tax measures that include, among others: (1) reduction in the exemptions from the VAT, (2) use of presumptive income levels for self-employed individuals, (3) imposition of an across-the-board import surcharge, (4) imposition of an excise tax on text messaging, (5) increase in the motor vehicle registration fees, otherwise known as the road user tax, (6) imposition of a franchise tax on telecommunication firms in lieu of the VAT, (7) wider coverage and increase in the rate of excise tax on luxury consumption, (8) increase in minimum gross receipts applicable to common carriers tax, (9) reduction in the corporate/individual income tax rates, (10) creation of an independent revenue authority, and (11) increase of the fees for government services.

The merits and demerits of these proposals will have to be evaluated on the basis of four criteria: (1) their ability to raise revenues, (2) ease of administration, (3) tax neutrality/ horizontal equity, and (4) vertical equity. In the near term, the first and second criteria will have to take precedence over the others because of the severity of the fiscal problem. However, while the need for "quick fixes" cannot be denied, it should be stressed that the structural problems that continue to eat away at the tax system would have to be addressed squarely.

The need for additional revenues is immediate but the requirement is by no means short-term in nature. The well-defined downward trend in tax effort in 1998-2002 indicates that government cannot rely solely on measures that result in a one-off increase in government revenues (e.g., privatization). It is important that government also adopts tax policy changes that will not hinder the attainment of the longer term goals of tax reform and those that will yield some permanent improvement in the tax-to-GDP ratio.

...All the proposed tax measures will be painful and none will be popular...However, because the magnitude of the fiscal consolidation that is needed is not small, it is inescapable that tax policy reform, regardless of the specific measures that will be implemented, will necessarily have to cost the administration a considerable amount of political capital.

On the other hand, recent experience in tax reform around the globe tends to put less weight on vertical equity considerations particularly in countries where tax enforcement is poor. The lesson learned in these places suggests that the focus should be on fiscal (i.e., tax and expenditure incidence taken together) rather than tax incidence alone. The shift in emphasis comes from a recognition of the fact that well-designed progressive taxes may not be worth much when they are not evenly enforced. In these countries, it is argued that government's redistribution function may be better served by a progressive expenditure program that is ably financed by a not-so progressive tax system.

Using these criteria, the following tax measures rank high on the list: (1) indexation of excise tax on both sin and petroleum products, (2) rationalization of fiscal incentives, (3) imposition of an across-the-board-import surcharge, (4) imposition of excise tax on text messaging, and (5) increase in the VAT rate. All of these measures yield substantial revenue with low downside risks (Annex Table 1). Needless to say, all will be painful and none will be popular. In the final analysis, choosing which of these measures to pursue will be decided essentially on political grounds. However, because the magnitude of the fiscal consolidation that is needed is not small, it is inescapable that tax policy reform, regardless of the specific measures that will be implemented, will necessarily have to cost the administration a considerable amount of political capital.

Indexation of excise tax on sin products

The indexation of the excise tax on sin products is clearly a must-do if one wants to stop the continuing erosion of the tax effort. It is notable that the Philippines' tax rates on sin products are significantly lower than those in many places around the world. Moreover, an increase in these rates is justifiable because of the social costs (in the form of resultant additional expenditures on health care services) that are associated with the consumption of these products.

Indexation of excise tax on petroleum products

In principle, the same arguments that are used to justify the indexation of the excise tax on sin products are applicable to the indexation of the excise tax on petroleum products. Increasing said tax would tend to curtail the environmental costs (i.e., traffic congestion and air pollution) that are associated with the consumption of petroleum products. However, the indexation of the excise tax on petroleum products presents an additional complication due to the fact that an increase in petroleum product taxes tends to set off a round of wage and price increases. This problem could be mitigated if the tax increase is coupled with tax rebates to public transport and if its implementation is timed with the softening in the world market price of crude oil.

Other high yield tax measures

If an increase in petroleum product taxes is not deemed to be acceptable, then government may have to pursue one or more of the following measures: (1) an across-the-board import surcharge, (2) an increase in the VAT rate, and (3) the imposition of excise tax on text messaging. These measures are by no means perfect candidates for what constitutes a "good tax" but all of them will assure government of a well-defined revenue stream.

On the one hand, an across-the-board import surcharge will not affect relative protection across sectors but will likely turn the terms of trade against exports and lead to some increase in prices. On the other hand, the increase in the VAT rate may be difficult to justify given the prevailing leakage from the system.[1] Increasing the levy on those that are already caught in the VAT net may in fact discourage tax compliance. At the same time, the imposition of an excise tax on text messaging is seen by some as regressive while others aver that the sumptuary nature of text messaging is not clear.

Rationalization of fiscal incentives

An important reform that was originally part of the Comprehensive Tax Reform Program (CTRP) but which was bypassed in the legislative mill in 1996/1997 is the rationalization of the fiscal incentives system. This is unfortunate considering that the diminution in the tax take arising from the reduction in the effective corporate income tax rate under the CTRP was meant to be compensated for by the potential revenue gain from the curtailment of fiscal incentives. In the near term, limiting the coverage of the Investment Priorities Plan (IPP) of the Board of Investments (BOI) by administrative action will go a long way in generating additional revenues. However, the first best approach would require legislative action and would involve the harmonization of incentives provided under various tax incentive laws (numbering about 100) through the use of a Tax Expenditure Budget.

Broadening of the tax base

Meanwhile, the government should seriously consider the following proposals that are aimed at broadening the tax base even if the associated revenue may not be high initially. These include the use of presumptive income levels in the computation of the individual income tax liability of professionals, traders and individual nonwage income earners and the reduction in the number of VAT-exempt products and transactions. On the one hand, any analysis of the individual income tax system invariably points to the very uneven tax burden between wage income and nonwage income, thereby indicating the need for the tax system to effectively expand its ambit to cover so-called hard-to-tax groups (e.g., professionals, traders, small businessmen).[2] The use

[1] Estimates indicate that between 26 percent - 38 percent of potential VAT revenue is not collected.

[2] While household income is about evenly split between wage and nonwage income, the tax take from wage income accounts for about 80 percent of total individual income tax revenue.

of presumptive income levels has yielded creditable success in other countries and its application should seriously be considered in the Philippines. This may or may not require further legislative action since Section 6 of the National Internal Revenue Code (NIRC) already allows it. On the other hand, limiting the number of VAT-exempt products and transactions will not only broaden the tax base but will also simplify the administration of the VAT.

Proposals that may be counterproductive

Three of the eight tax measures that are proposed by the administration are not likely to be helpful. These include: the adoption of the gross income tax, the imposition of the windfall tax on telecom companies, and the tax amnesty. The same is also true of the proposal to reduce the corporate and individual income tax rates in order to stimulate supply side effects.

The shift to gross income taxation is perceived by many sectors (business community, tax practitioners and members of academe) to be a bad tax (Box 1). This measure will not reduce the scope for negotiations between taxpayers and tax examiners as its proponents aver; rather, it will widen it. Instead of plugging loopholes, it will create more. Moreover, if the proposal is meant to put a limit on excessive claims for tax deductions, the NIRC even now permits the BIR to establish and enforce caps on oft-abused expense items. Gross income taxation also tends to violate the tax neutrality principle. Under this scheme, the effective tax burden of firms will vary according to their cost structures, with firms in the services sector likely to be hardest hit.

Meanwhile, the imposition of a tax on the windfall profits of telecommunications firms is another problematic measure. First, is the sector lightly taxed? It is subject to the income tax, the value added tax and the percentage tax on overseas calls/dispatch of messages. Second, how does one define "windfall profits/income?" Third, assuming windfall profits is somehow determined, why penalize a profitable sector?

With regard to the tax amnesty, the Philippines has granted tax amnesties much too often and in an almost periodic fashion in the recent past. The experience has not been encouraging in terms of its longer-term impact on revenues. Worse, it may be that these amnesties have come to be anticipated, thereby sending the signal to taxpayers that government is unable to enforce taxes. Thus, the practice creates a disincentive for taxpayers to pay the right taxes on time.

On the other hand, proponents of the new tax amnesty proposal argue that, unlike previous tax amnesties schemes, it will provide government with a potent means to build and widen the tax base because it mandates the filing of a statement of assets, liabilities and net worth (SALNs) by all taxpayers. The challenge then lies in actually making use of such information to help improve tax enforcement in the future. In previous tax amnesties, hopes were likewise raised that the exercise will allow the BIR to get better information on the gross receipts/income of taxpayers. However, it appears that these aspirations did not materialize.

On the proposal to cut the corporate and individual income tax rates, proponents argue that this will broaden the tax base because taxpayers will be encouraged to pay the correct amount of taxes if tax rates are not prohibitive. However, the proposal is not likely to work unless enforcement is significantly improved. Moreover, the reduction in the income tax rates under the CTRP has not been found to yield supply side effects.

Tax administration reform

The improvement of BIR's tax effort in 2003 resulted primarily from a number of procedural/systems reforms in tax administration that have been initiated by the incumbent Commissioner. These consist of the implementation of the (1) Third Party Information Matching System including the VAT Reconciliation of Listings for Enforcement (RELIEF) which helped the BIR identify patterns and discrepancies in taxpayers' records, particularly the underdeclaration of their sales, (2) taxpayer benchmarking, (3) rationalization of the audit process through the "no-contact audit" scheme and the conduct of pro-active audits based on deviations from benchmarks, (4) tax mapping of business establishments, (5) e-filing and e-payment, and (6) Text-BIR Campaign which encourages end-consumers to demand official receipts for goods purchased. The challenge now lies in the institution-

Box 1. Gross income taxation – why not

Proponents of the shift to gross income taxation aver that changing the tax base from net income to gross income will improve tax collection by simplifying the system and removing the opportunities for overstating expenses for tax purposes. And precisely because of this, they say, the move will minimize corruption at the BIR inasmuch as the scope for negotiations between taxpayers and tax examiners (and the likely harassment of the former by the latter) will be eliminated. Consequently, they argue that the system will become not only fairer because there is less evasion but will also induce a positive impact on revenue as supply side effects come into play.

However, the very premises on which the arguments are based in favor of gross income taxation are faulty. First, gross income taxation does not mean that taxpayers will not be allowed to claim any deductions. In principle, the tax base will be equal to "gross sales/gross receipts less cost of goods sold/cost of sales." That is, gross income taxation will still allow taxpayers to deduct their direct costs from their gross sales/receipts when computing for their tax liability. This means that there will still be as much room for haggling between taxpayers and tax examiners, if not more under this system. This time, though, they will haggle on which costs are direct (and therefore, tax deductible) and which costs are indirect (and therefore, not tax deductible). Firms engaged in the services sector will tend to be more inconvenienced in this regard because the distinction between direct and indirect costs is not as clear-cut in their case compared to manufacturing enterprises.

Second, a gross income tax is not fair. Because the cost structure of firms in different sectors/industries is widely disparate, the application of a single rate on their gross income is seen as highly inequitable. The business community[1] says that it is not against the gross income tax system provided it applies a revenue-neutral rate[2] for each sector/subsector. Thus, they argue for the adoption of different rates for different sectors/subsectors. Needless to say, this will make the system more unwieldy and complex.[3] Experience everywhere shows that unfair tax systems breed more evasion. The same is true of more complicated tax systems.

And third, the bigger source of evasion is not overstatement of expenses but underreporting of sales. From this perspective, therefore, the policy prescription (shifting to gross income taxation) fails to address the real policy problem.

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[1] Based on a statement in a paid advertisement of Raul Concepcion's Consumer and Oil Price Watch in *Philippine Star*, 19 July 2004, p. 7.
[2] A revenue-neutral rate is one that will ensure that a sector's tax payments will remain the same compared to what it pays under the current net income tax method.
[3] Now, dishonest taxpayers will have the wiggle room to decide not only on how much to pad their expenses but also on which tax rate should apply to them.

alization of these new procedures and systems in the bureau so as to ensure the continued improvement in its collection efficiency.

Presumptive income levels/expanded withholding tax system

Prospectively, the use of presumptive income levels essentially by extending the benchmarking exercise as well as the use of third-party information to individual nonwage income earners will have to be put in place. Ways of expanding the withholding tax system to include the hard-to-reach groups should also be explored.

Performance-driven tax administration

The institutionalization of performance-based contracts not only for the tax collection agencies but also for its employees, together with some flexibility in their compensation structure, will create the appropriate incentive structure in these agencies. The adoption of the lateral attrition scheme may help achieve this.

However, the challenge lies in the way the revenue targets are set and monitored. Alternatively, this could also be achieved by the creation of an autonomous revenue authority. The experience in other countries suggests, though, that the success of the latter depends on the degree of independence that is provided (Manasan 2003).

Improved management internal control systems

There is also a need to tighten controls in order to ensure that tax payments made by the public actually reach the government's coffers. It is bad enough that the tax collection agencies are unable to collect the correct amount of taxes. It is even worse when voluntary tax payments are waylaid by tax scams.

Public expenditure management reform

The government has prided itself in having pursued and is pursuing reforms that promote the operational efficiency of government agencies. These initiatives include the following: (1) procurement reform, (2) the installation of the New Government Accounting System, (3) the establishment of a Medium-Term Expenditure Framework (MTEF), (4) the shift towards performance-based budgeting under the Organizational Performance Indicator Framework (OPIF), and (5) the institutionalization of the Sector Effectiveness and Efficiency Review (SEER). These are important reforms and should be sustained.

The passage of Republic Act (RA) 9184 (or the Procurement Act) is laudable and is expected to enhance transparency and public accountability in government procurement. At this point, it is important to continuously monitor its implementation and impact.

On the other hand, progress on the other reforms mentioned above has been rather slow, stymied perhaps by the uncertainty in the government's fiscal situation. For instance, it should be noted that the success of the MTEF is greater when revenues are predictable. Conversely, the MTEF is difficult to implement in an unstable environment precisely because trying to extend the budget horizon when there is severe revenue uncertainty leads to frequent changes in expenditure ceilings, thereby discrediting the MTEF exercise itself (Schiavo-Campo and Tommasi 1999).

On the other hand, the operationalization of both the OPIF and SEER are hampered by the difficulties in defining what "results" for which government agencies should be made accountable. Oftentimes, the confusion centers on the distinction between outputs and outcomes.

In this regard, studies that will help establish the link between outcomes and specific outputs as well as those that will shed light on the relative effectiveness of alternative interventions (i.e., those that establish the link between outcomes and the outputs of alternative interventions) are needed. The determination of standard unit costs should likewise be strengthened. In this way, cost-benefit analysis and/or cost effectiveness analysis can be undertaken to better inform the performance budgeting process.

GOCC reform

Reform in the GOCC sector, meanwhile, may include: (1) depoliticization of rate setting (e.g., NPC, MRT/LRT, PNCC, etc.), (2) regulatory reform (e.g., MWSS), and (3) divestment of government ownership in activities that are patently private in nature (e.g., commercial banks, television stations).

Other proposals

In addition, other proposals aimed at containing the fiscal deficit have been advanced. These include: (1) reduction of the IRA share of LGUs, and (2) creation of an Infrastructure Corporation that will leverage funds from the private sector to finance public infrastructure.

The reduction of the LGUs' IRA share is risky for two reasons. First, the Local Government Code provides that such a reduction can only be done if the national government has an "unmanageable fiscal deficit." If the national government admits to this, negative reactions from the market would be forthcoming and may result in higher interest payments for the government. Second, horizontal imbalance characterizes the IRA distribution which means that some LGUs (about half) get more IRA than they need to fund the functions that were devolved to them while other LGUs receive less IRA than they need. An across-the-board cut in the IRA will adversely affect the ability of many LGUs (particularly those with small local tax base) to provide devolved basic services.

Finally, the creation of an Infrastructure Corporation is not necessary to encourage private sector participation in the financing of public infrastructure. The BOT law already defines such arrangements although some refinements might be in order.[3] "Corporatization," especially if the new entity

[3] This is especially true in reference to the provisions governing the availability of national government debt guarantee to loans of BOT projects and the setting of reasonable rate of return for unsolicited and negotiated projects.

is undercapitalized, may create moral hazard and result in even larger contingent liabilities.

Conclusion

Reforms, while meant to put things in order, are always painful. More so when a large number of sectors are affected in the process. The proposed measures outlined in the above discussion all have their painful repercussions. But the country's precarious fiscal position is something that calls for drastic and radical solutions.

And only a government with an adequate political will and the willingness to "bite the bullet" despite being faced with unpopular decisions to make, can pass the grade in overcoming such a problem.

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For further information, please contact

The Research Information Staff
Philippine Institute for Development Studies
NEDA sa Makati Building, 106 Amorsolo Street
Legaspi Village, 1229 Makati City
Telephone Nos: 892-4059 and 893-5705
Fax Nos: 893-9589 and 816-1091
E-mail: rmanasan@pidsnet.pids.gov.ph; jliguton@pidsnet.pids.gov.ph

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Annex Table 1. New tax measures

Tax measure	Revenue Impact (billion PhP)	Remarks
Indexation of excise tax on alcoholic products	4.7	relatively easy to collect; small number of collection points; can be justified on the grounds that consumption impose social costs on rest of economy in the form of additional health care/police services
Indexation of excise tax on tobacco products	7.4	
Indexation of excise tax on sin products to 1997 levels	12.1	
Indexation of excise tax on petroleum products		politically sensitive product; price increase tends to trigger increase in wages and prices of other products; current wave of price increases in international market make this reform doubly difficult; question of timing – should government wish to impose it, doing so should be timed with softening of prices in world market; may be coupled with rebates to public transport to improve social acceptability; can be justified because of environmental costs (i.e., pollution and congestion) associated with its use
(a) 25% increase - P1.10/ P0.40	5.3	
(b) 50% increase - P2.20 / P0.80	10.7	
(c) 100% increase - P4.4/ P1.60 (full indexation to 1997 levels)	21.3	
(d) across the board PhP1 per liter	17.0	
Rationalization of fiscal incentives	14.0[a]	focus on limiting coverage to exports and one or two industry groups; harmonize various tax incentive laws thru tax expenditure budget
Imposition of excise tax on text messaging		sumptuary nature of text messaging unclear; easy to collect; small number of collection points

Annex Table 1 (cont'd.)

Tax measure	Revenue Impact (billion PhP)	Remarks
(a) 1 centavo (b) 10 centavos (c) 20 centavos	0.9[b] 9.1[b] 18.3[b]	
Imposition of across-the-board import surcharge (a) 1% (b) 2%	 8.0 16.0	would not affect relative protection across industries; may be inflationary; may be implemented by administrative action without need of legislation
Increase in VAT rate (a) from 10% to 12% (b) from 10% to 14%	 14.9 29.8	may be hard to justify given prevailing evasion at existing tax rate; but may be needed given difficulty in raising revenues from other sources
Reduction in number of VAT- exempt products including petroleum products	4.0[c]	broadens the VAT base; will tend to ease VAT administration; in line with international practice
Use of presumptive income levels for professionals/traders		broaden tax base to include hard-to-tax groups; make individual tax system more equitable
Shift to gross income taxation		not consistent with neutrality of tax system, i.e., one that avoids interfering with resource allocation decision of private sector; does not really reduce venue for tax negotiation between taxpayers and tax examiners
Imposition of tax on windfall profits of telecommunication firms		Is the sector lightly taxed? If not, why penalize a profitable sector
Imposition of franchise tax on telecommunications firms in lieu of the VAT	5.0[d]	frequent tax regime change will not sit well with industry
Increase in motor vehicle tax (or road users tax) (a) 25% increase (b) 50% increase	 1.6 3.2	Revenue earmarked for road maintenance; increase partly explained by inflation adjustment
Imposition/increase in tax on luxury items	0.8[e]	improves progressivity of tax system; may take the form of higher excise tax on automobiles; coverage may be expanded to include other items; is it worth the effort?
Increase in minimum gross receipts for common carriers tax	4.1	levels set in 1976 yet
Reduction in corporate/individual income tax rate		tricky; not likely to work unless enforcement is significantly improved; reduction in CIT and IIT under CTRP did not yield supply side effects
Grant of tax amnesty		Philippines granted 16 amnesties in last 14 years; results not encouraging; disincentive effects on timely payment of correct taxes
Institutionalize performance-driven systems in tax collection agencies		may be linked with creation of autonomous revenue authority but not necessarily; application of lateral attrition
Creation of autonomous revenue authority		experience elsewhere shows mixed result with respect to revenue effect negative revenue impact in first year likely; long-term revenue impact unclear
Increase fees and charges	4.3[f]	

[a]revenue loss from BOI-approved incentives in 2003 (National Tax Research Center)
[b]assumes 200 million text messages sent per day
[c]revenue estimate refers to petroleum products alone
[d]assumes 7% franchise tax
[e]refers to 50% increase in rates but same coverage
[f]assumes 10% increase