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Policy Notes

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Will Shift to Gross Income Taxation Help Generate More Revenues?

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The fiscal outlook for 2001 and 2002 highlights the urgency of improving the revenue performance of the national government. The government's revenue performance has shown definite signs of weakening since the onset of the East Asian financial crisis, with the revenue effort sliding from 18.7 percent of the gross national product (GNP) in 1997 to 14.7 percent of GNP in 2000.

While the slippage in nontax revenues is largely explained by the dimunition in the Bureau of Treasury's income following the decline in domestic interest rates, the slide in tax revenues has been a major source of concern to analysts inside and outside of government circles.

In this regard, a number of proposals aimed at having a positive impact on revenues and at improving the overall tax system have been put forward. One of these is the proposal to shift the current system of taxation in the country to *gross income taxation*.

What is gross income taxation? Will a shift towards such system help generate more revenues for the national government? This *Policy Notes* looks more closely into the issue and provides an answer.

Proposal to shift to gross income taxation

The Department of Finance (DOF) has recently come up with a proposal to tax income on corporations and self-employed individuals on the basis of their gross income at the uniform rate of 15 percent.[1] At the same time, it proposed that hand in hand with this, the individual income tax on salaries and wages be amended to replace the present rate schedule with one that varies from 0 to 32 percent. Said proposal also disallows individuals to claim personal exemptions in computing their income taxes.[2]

In contrast, under the present system, the corporate income tax is 32 percent of net income. This same rate schedule is applied to individual income from salaries and

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[1] *There are various formulas being considered by the DOF. This* Policy Notes *discusses the formula included in the DOF draft dated October 15, 2001.*

[2] *In lieu of the personal exemptions, the proposal will tax the first P75,000 of individual income at 0 percent.*

wages and to individual income from business and exercise of profession, with the latter being taxed on the basis of net income.

What would the effects of the proposed shift be? What is its overall impact on the tax system?

First, the potential good news

The proposed shift to gross income taxation is a bold and radical innovation that has not been implemented anywhere in the world. It entails high risk but it may very well yield high returns.

It has the potential to broaden the tax base. By purging the opportunities on the part of taxpayers to claim excessive deductions when they compute their tax liability and by eliminating the discretion that tax collectors have in deciding which deductions to allow when they audit tax returns, the proposed taxation on gross income clearly seeks to plug the leakages in the system arising from the overstatement of deductions.

Revenue gains are also expected from improvements in compliance with the corporate income tax and the individual income tax on the self-employed.

But…

Further analysis indicates that revenues from the tax on compensation income will decline by P33 billion in 2002 if this proposal is implemented. The probability of experiencing this revenue loss is close to 100 percent given the fact that the tax on compensation income is covered by the withholding system.

The expected gains to be brought about by the improvements in compliance, meanwhile, are associated with just a small probability so the expected value of the revenue impact may be negative even under generous assumptions.[3]

[3]*For example, if the government is able to capture all the leakages that existed prior to the proposed reform, it may be able to generate additional revenue of P45 billion from corporate income taxes. Now, even if one assumes that the government is able to double its take from the individual income tax on the self-employed and raise an additional P13 billion and if a probability of ½ is attached to these tax gains, the expected value of the reform would still be negative P4 billion (-33*1.0+[45+13]*0.5).*

[4]*For example, marketing/selling expenses and certain overhead expenses.*

What may explain for these negative effects?

One, despite its basic premise, the proposal will, in reality, have to allow for the deduction of other costs that are directly related to the conduct of business.[4] To do otherwise will introduce unparalleled inequity in the system given the wide variation in the cost structure of various activities and sectors. Moreover, in the case of "sales of services," delineating what constitutes cost of services is not that straightforward.

As such, these considerations will just put discretion back in the equation and the promised simplicity, ease of administration and increased compliance that gross income taxation is expected to bring may not materialize at all.

And *two*, the proposed amendments to the income tax provisions of the tax code accompanying the proposal for the shift will introduce other inefficiencies and inequities. First, the proposal tends to discriminate against families with children and families with only one income earner. This comes about because the tax will no longer differentiate taxpayers according to status. And second, the proposal also tends to discriminate against the self-employed (assuming that there is no evasion), thereby leading to a situation where these hard-to-reach taxpayers are further driven out of the tax net.

Conclusion

Based on the above, it is therefore clear that the proposal to shift to gross income taxation is NOT likely to generate more revenues for the government. While, as mentioned, the proposal at first blush appears to be attractive, a closer look at its accompanying implications negates whatever potential benefits it had initially aimed for.

As such, it will be prudent for the government to reconsider said proposal and study further its effects.

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