

Rebuilding Public Revenues

Tax revenue has fallen sharply over the past six years, undermining the sustainability of public finance and depriving the government of resources needed to provide high quality public services. The decline in tax revenue is attributable to three factors - shifts in tax policy, changes in economic structure, and increases in tax evasion. Bold actions are now needed to rebuild tax revenue through a blend of policy action and administrative improvement. Such actions need to include restoring the real value of excise tax of alcohol, tobacco and petroleum products to their 1997 level, reducing exemptions to broaden the tax base, and modernizing tax administration.

Background

Over the last six years, public revenue in the Philippines fell from its peak of 18.7 percent of GNP in 1997 to 13.4 percent in 2003. The decline stems largely from lower tax collection, which fell from 16.3 percent of GNP in 1993 to 11.5 percent in 2003. In turn, the erosion in tax revenue resulted primarily from lower Bureau of Internal Revenue (BIR) collection of taxes on income and profit, as well as weaker excise tax collection—both fell by 1.3 percentage points during this period. Bureau of Customs (BOC) revenue, consisting mostly of import duties, also fell by 1.5 percentage points during this period (table 1).

Table 1. Change in public revenue (percent of GNP)

	1997–2003
Total revenue	-5.3
Tax revenue	-4.8
BIR	-3.4
Taxes on income and profit	-1.3
Excise tax	-1.3
BOC	-1.5
Nontax revenue	-0.5

Source: Department of Finance.

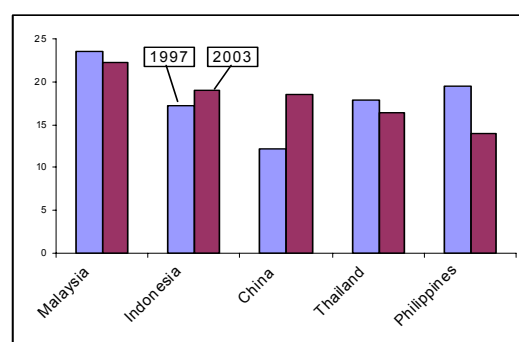
The decline in public revenue for the Philippines has been unprecedented. In 1997, the revenue effort of the Philippines was better than China, Indonesia, or Thailand. Six years later, it ranked poorly relative to these countries as the ratio of total revenue to GDP fell by 5 percentage points.

In terms of share to total tax revenue contribution, BIR contributes the bulk of total

revenue, at 70 percent, while BOC contributes 17 percent, and nontax revenue sources account for 13 percent.

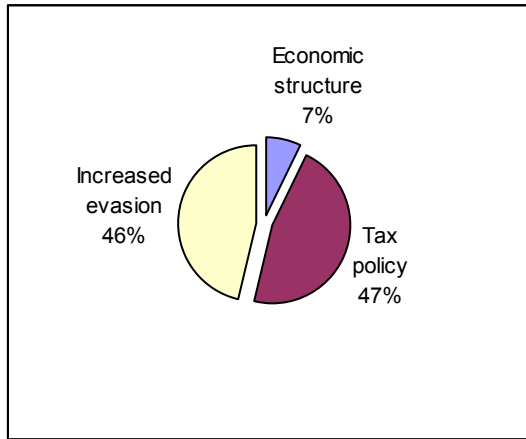
The decline in tax revenue is attributable to three factors: (i) shift in tax policy, (ii) change in economic structure, and (iii) increase in tax evasion. For BIR, Manasan (2002) estimated that the fall in tax effort relative to 1997 was primarily due to changes in tax policy and tax administration, and to a lesser extent to changes in economic structure. Further decomposition by tax type show that main reasons for the decline in revenues was policy for excise taxes; administration and evasion for VAT; and a mix of changes in economic structure and increased evasion for profit and income taxes (figure 2).

Figure 1. Current revenue, excluding grants (1997 and 2003, percent of GDP)



Source: World Development Indicator

Figure 2. Decomposing the fall in BIR's tax effort (percent of total decline)



Source: Manasan (2002)

For BOC, Manasan (2002) noted that almost all of the reduction in tax effort in 1999 to 2001 was due to the cutback in tariff rates because of the trade liberalization program.¹

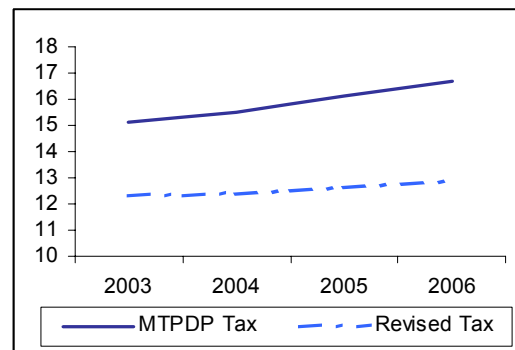
Another reason for the fall in tax effort is the proliferation of tax incentives to various industries and business activities. Many of these incentives significantly distort economic activity by discriminating between different types of businesses. In addition, by making the corporate tax system more complicated and nontransparent, they also increase opportunities for tax avoidance and corruption. Thus, phasing out the most distortionary of these incentives, e.g., tax holidays, could significantly boost revenue. Manasan estimated that as much as 2 percent of GDP could be gained in revenue if key fiscal incentives are removed.

Studies done by the National Tax Research Center (NTRC) provide more detail on the sources of leakages for various tax types. For income taxes, the NTRC noted the following primary sources of leakages: (i) nonreporting of second/third employment income, (ii) underdeclaration of business and profes-

sional income and/or overstatement of expenses, and (iii) nonfiling of tax returns among self-employed individuals. For VAT, the NTRC noted the following key sources of leakages: (i) exorbitant claims and/or fraudulent applications of input tax credits, (ii) underdeclaration of sales, and (iii) non-issuance of official receipts and/or issuance of unofficial or fraudulent receipts.

The poor revenue effort appears to have been taken for granted in government planning and projections. Figure 3 illustrates that for the period 2004–2006, government revenue targets have been reduced from the original targets contained in the Medium-Term Philippine Development Plan, 1999–2004 (MTPDP) by an average of 3.5 percentage points of GDP in the 2004 budget framework. With the increase in the nonfinancial public sector deficit to about 6.3 percent of GDP in 2003 and rising public sector debt, a more aggressive revenue effort is called for.

Figure 3. Tax Effort: MTPDP vs Revised (percent of GDP)



Issues

The Government must confront the following three major issues to reverse the decline in revenue collection performance and bring it back to a more sustainable path.

¹ Manasan, Rosario. (2002). "Explaining the Decline in Tax Effort." PIDS Policy Notes No. 2002-14. The Manasan study was cited in the BIR presentation "BIR Accomplishment and Blueprint Towards 2010," dated October 2003.

The proliferation of exemptions has further narrowed the tax base. They fall under three main categories:

- Expansion of the list of items, exempted under the Expanded Value Added Tax (EVAT), to a wide range of products, including printing, publication, newspapers, operators of taxicabs, rent-a-car companies, and operators of tourist buses.² Moreover, nonstandard VAT exemptions include exemptions for coal, natural gas, and petroleum products; the importation of vessels of more than 5,000 tons; and sales of electric cooperatives. Nonstandard zero ratings include services paid in foreign currency and good and services provided to exporters.
- Provisions under the Tax Reform Act of 1997, such as the net-loss carry-over (NOLCO); accelerated depreciation using double declining balance; increase in the amount of income tax deductions for individuals; phased reduction in corporate income tax rates from 35 percent to 32 percent.
- Fiscal incentives for export-oriented enterprises (e.g., export processing zones, duty drawbacks, and bonded warehouses), including special tax breaks and duty exemptions now available through some 150 special laws. These grant statutory exemptions to special groups, including tourism, shipping, iron and steel manufacturing, and cooperatives. Issues involving fiscal incentives include (i) the forgone revenue of 1 to 2 percent of GDP, (ii) the multiple opportunities for unscrupulous businesses to evade taxes, and (iii) their questionable effectiveness in promoting investment.³

² See Manasan, Rosario. (2002), Analysis of the President's Budget for 2003, PIDS Discussion Paper Series No. 2002-24. See also "Explaining the Decline in Tax Effort," PIDS Policy Notes No. 2002-14, by the same author.

³ See World Bank (2000), "Philippines, Growth with Equity: The Remaining Agenda."

Tax buoyancy has fallen due to the absence of revaluation and nonindexation of excise tax rates.

The excises for alcohol and tobacco products (also known as "sin taxes") were shifted to specific (per unit basis) terms from ad valorem (ex-factory value basis) terms under the Tax Reform Act of 1997. The rationale for the shift was to reduce the incentive for undervaluation in excises under ad valorem for alcohol and tobacco products. However, unlike other countries, the law only allows a one-time adjustment in the specific tax rate and does not provide for any adjustment thereafter.⁴ There was a one-time 12 percent increase in alcohol and tobacco excises in 2000, but since then the rate has not been adjusted. As a result, the real value of tobacco and alcohol excise tax rates has fallen by 30 percent from 1997 to 2003.

Moreover, BIR has not kept pace with monitoring tobacco and alcohol product prices, or new products introduced in the market. The law has classified products into three categories with three different excise tax rates. New products, as well as increases in prices per unit value, allow BIR to reclassify these products to a higher excise tax rate. Recent efforts by BIR to implement this policy was met by law suits and restraining orders by large firms.⁵

Petroleum excise tax rates have not been revised since the law setting the specific tax rate was enacted in 1996 (Republic Act No. 8184). As a result, the real value of petroleum excises are estimated to have fallen by 43 percent over the period 1997 to 2003.

⁴ In the United Kingdom for example, distilled spirits are subject to a specific tax rate that is usually increased annually under the government budget to reflect inflation or other economic factors.

⁵ For example, BIR claimed that some fermented liquor and tobacco products introduced recently in the market are new products. The firms, however, claimed that these are just variants of the original product, thus should not be classified as new. This allows the firms to maintain a lower tax bracket on their products than mandated by law.

Higher excises on “sin” products and petroleum can be justified on efficiency grounds. It can be argued that such excises are useful because they (i) are levied on goods that have low elasticities of demand, so that they result in less excess burden than taxes on other products; (ii) are easy to administer since they are levied at the point of production or importation; and (iii) may internalize the negative externalities that tobacco, alcohol, and petroleum consumption imposes on the rest of society.

Box: The CTRP experience

The Comprehensive Tax Reform Program (CTRP) provides a concrete illustration of some of the possible pitfalls of tax reform efforts.

In 1996 and 1997, the Government launched a series of tax reform measures known as the CTRP. The envisaged reform had five broad objectives: (i) broadening the tax base; (ii) minimizing areas of discretion by taxpayers and examiners; (iii) simplification of the tax system; (iv) capturing hard-to-tax incomes; and (v) promoting productivity and investments.

However, Congress adopted a CTRP version that set aside key revenue-generating features of the reform program, lessening the effectiveness of the tax measures. For example: (i) the indexation of “sin taxes” in the original proposal was not included in the final version; (ii) the allowable deduction for individual income was increased from the proposed P20,000 to P32,000 in the final version; (iii) the tax base for the Minimum Corporate Income Tax was changed from gross assets, as proposed, to gross income in the final version. There were also proposals to strengthen BIR, such as access to bank records in aid of prosecution for tax evasion; establishing an independent ombudsman for tax cases, and other safeguards against corruption. All these were omitted in the final version.

Since 1998, there has been no serious breakthrough in amending the CTRP to correct its deficiencies.

Tax administration capacity has not kept pace with changes in tax policies.

The series of tax reforms since the 1980s , put a strain on the administrative capacity of BIR to implement new tax regulations. The CTRP also created complex tax rules (e.g., three-tiered rate structure for alcohol and tobacco excise taxes), making it harder for tax examiners to monitor and assess tax obligations. The regular market survey that needs to be done to monitor products and prices is an added burden to the limited operational budget of the bureau.

The Large Taxpayers Service (LTS) was created to focus on key revenue sources. However, further effort is needed to provide adequate staffing to the LTS, expand its coverage, and improve audit performance to increase compliance incentives. Present efforts to enhance tax audits and increase the size of special audit teams should be encouraged.

Suggestions

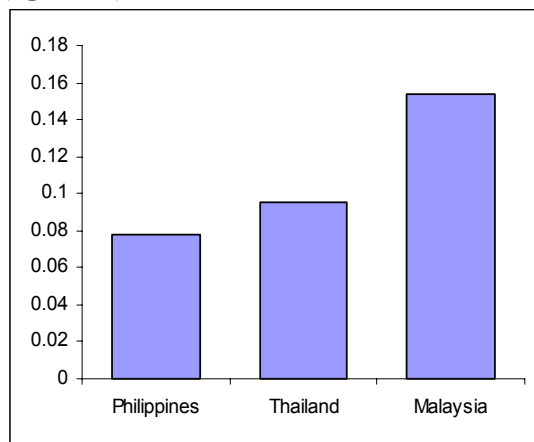
Given these issues, the following tax policy reform and administrative improvements are needed to raise public revenue and help bring public finance to a sustainable level.

Expand the tax base by reducing exemptions. VAT in particular could be broadened to cover professionals and the informal sector. The Government may also want to consider lifting VAT exemptions for petroleum and repealing the zero rating of services paid on foreign exchange. The Government may also want to resist the temptation to offer new tax amnesties and a cap on exemptions could be applied. Government efforts to rationalize fiscal incentives must be encouraged and focused on industries and activities that generate large positive externalities, such as research and development, and pioneering investments. The process of granting incentives should also be made more transparent. Should efforts to expand the VAT tax base and improve administration yield insufficient revenue, the government may wish to

consider other options such as increasing the VAT rate.

Increase revenue buoyancy. Restoring the proportion of alcohol and tobacco excises to their 1997 level and indexing them to inflation will generate revenue. There is also room to increase petroleum excises, to the extent that gasoline excises are still below those in Malaysia and Thailand (figure 4). Moreover, the buoyancy of nontax revenue could also be improved through a review adjusting key fees and charges.

Figure 4. Specific excise on unleaded gasoline (\$ per liter)



Source: Philippine Department of Energy, country sources.

Modernize revenue administration through a combination of technology upgrading, organizational adjustments, and a stronger governance program. Ongoing efforts of BIR to improve tax administration should be encouraged, such as computer audit systems, benchmarking, database cross-referencing of taxpayer information, IT-based detection systems, further strengthening of the LTS, enhancement of tax campaign, simplification of tax procedures and regulations by codification of BIR rulings, and well-researched “lifestyle checks” for tax officials. These measures will need to be taken regardless of what institutional setup is pursued. While the government will need to consider whether or not to move to a new Internal Revenue Authority, what is most important is to decide on a course of action, comple-

ment these with needed policy and administrative changes, and pursue these efforts vigorously.

Ongoing efforts by BOC to modernize and improve its collection efforts need to be supported, including:

- *Improving customs productivity.* This requires continued efforts by BOC to (i) reduce cargo clearance time and (ii) develop its IT facilities, both to meet increasing cargo demand and promote noncontact customs transactions (to reduce scope for rent-seeking activities).
- *Improving performance management systems.* This entails programs that will (i) provide greater incentives to help professionalize BOC staff; (ii) shield staff from political influence in appointments and promotions; and (iii) enhance the conduct of an independent audit system to monitor transactions and activities of customs employees.

Rebuilding public revenue will require not only a blend of tax policy reforms and administrative improvements, but also—importantly—a supportive institutional framework that creates the proper incentives for the various stakeholders. Otherwise, reforms run the risk of being undermined, and improvements in revenue effort will not be sustained.