

Rating the president's tax reform agenda

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I. Introduction

The Philippines faces what could be a severe economic crisis in the next two years due to its unsustainable fiscal position. A quick look at the statistics reveals the extent of the problem and gives ideas on how the situation came to be. Figure 1 shows that from modest surpluses posted from 1994 to 1997, the economy's overall budget deficit as percentage of Gross Domestic Product (GDP) has increased from 1.9% in 1998 to 4.6% in 2003. It is alarming how the government steadily incurred deficits despite some economic growth during the recovery period from the Asian Financial Crisis.

Similarly, national government debt to GDP ratio as shown in table 1.1 has steadily increased from 1996 to 2003. The national debt to GDP ratio rose from 53% in 1996 to 75% in 2003 (Medalla, 2004). The consolidated public sector debt¹ paints an even more dismal picture. The figure has ballooned to 128% of the GDP in 2003 from 103% back in 1996. A scenario such as this raises alarm bells in financial markets since it implies that the government will be hard pressed to service the debt in the coming years. As it is now, 42.6% of the government's

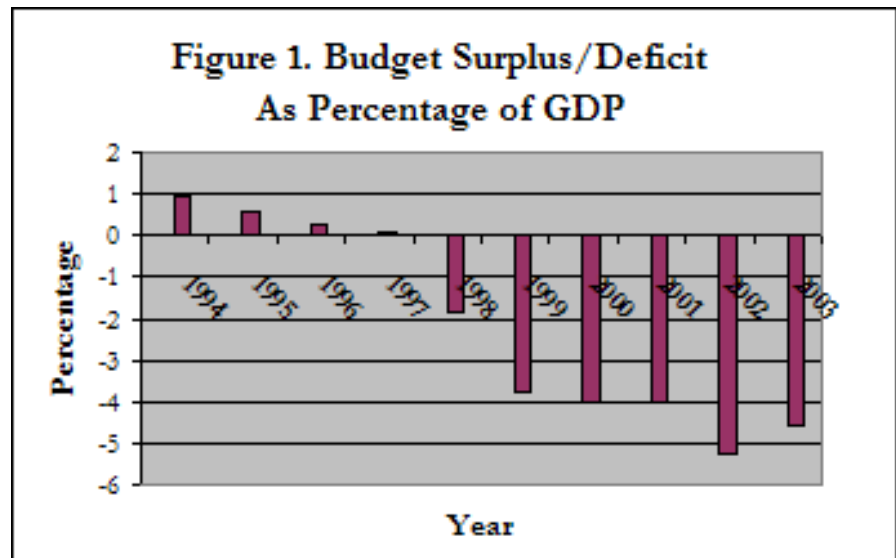


Table 1.1: Philippine Debt As Percentage of GDP 1996-2003

	National Gov't Debt	Total Public Debt
1996	53	103
1997	56	110
1998	56	111
1999	60	123
2000	65	131
2001	65	120
2002	70	128
2003	75	126

Source: Medalla, 2004

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¹ This includes non-budgetary accounts, assumed liabilities of government, and lending to corporations.

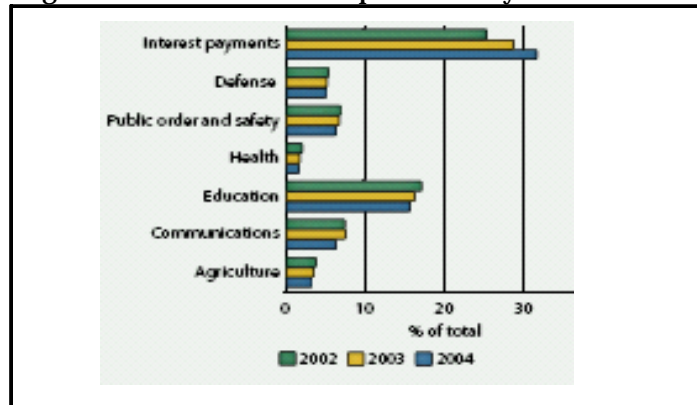
annual revenues go to interest payments (Diokno, 2004). This means that any negative shock that hampers the government's revenue raising capability can potentially lead to a default.

How did the country arrive at this problem? Were there large increases in public spending during the past few years? Statistics reveal that this has not been the case. Government expenditures have stagnated at around 19% of the GDP from 1998 to 2002, and fell to 18.8% last year. Interest payments comprise of the biggest share in government spending to the detriment of spending for social services. The share of education to total expenditure has diminished these past three years, while health spending has stagnated as seen in figure 1.2. It is doubtful that the government can still cut expenditures significantly without significant social backlash.

There were several factors that contributed to the fiscal problem. Other than the huge debt incurred by the government and government owned and controlled corporations through the years, one of the main culprits was poor tax collection. Tax collections started to decline in 1998 after the Congress passed the 1997 Comprehensive Tax Reform Program. The tax effort continuously declined as shown in Figure 1.3 even during the years when the economy was experiencing some growth. This implies that there are inherent flaws in the tax system other than corruption and tax evasion, and as a result, tax collection has failed to catch up with economic expansions.

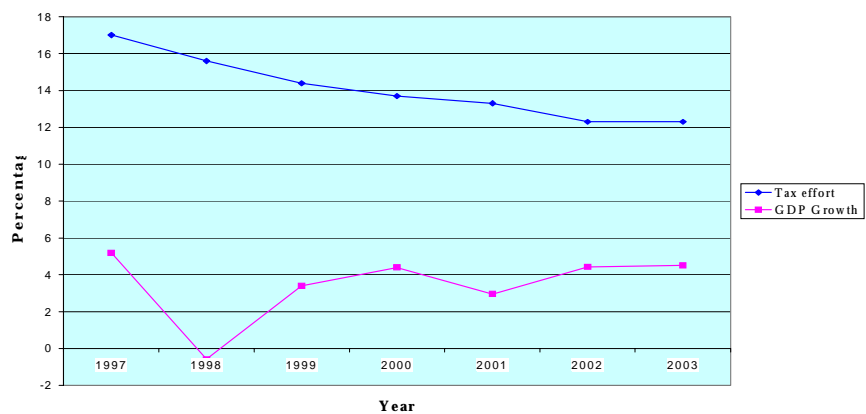
Given this scenario, the government is hard pressed to address the issue of the crisis through the revenue side. Since huge budget cuts are already out of the question, the only resort of the government is to increase revenues tremendously to cover the deficit. The President has released an eight-point tax reform measure that seeks to address the fiscal problem. These measures include a wide range of tax reforms meant to bring in huge revenues

Figure 1.2 Government Expenditure by Sector



Source: Asia Development Outlook 2004

Figure 1.3 GDP Growth and Tax Effort 1997-2003



in the next two years. Since there are no rooms for mistakes at this point, it is essential to evaluate the measures the President intends to implement. These reforms after all, are supposed to reverse the grim situation that the nation faces, and not further contribute to economic deterioration.

II. Rating the tax reform proposals

The eight point tax reform proposal of the President includes the two-step increase in the VAT rate, windfall taxes on telecommunications companies, increase in the excise tax on petroleum products, shift to gross income taxation for corporate and business income

individuals, indexation of excise tax on sin products, rationalization of fiscal incentives, targeted tax amnesty with submission of statement of assets and liabilities and net worth, and creation of a performance-driven system for revenue agencies by institutionalizing lateral attrition system. The fiscal agenda of the President defines each proposal and gives the expected revenue contribution when applicable.

The proposals will be evaluated in terms of its efficiency, administrative simplicity, flexibility, political responsibility, and fairness. Efficiency refers to both the measure's ability to raise revenues with minimal distortions. Administrative simplicity means the

Table 2.1 Summary of Results								
	Two Step Increase in VAT	Windfall Tax on Telecoms	Increase in Excise Tax of Petroleum Products	Shift to Gross Income Taxation	Indexation of Excise Tax for Sin Products	Rationalization of Fiscal Incentives	Targeted Tax Amnesty	Lateral Attrition System
Efficiency (3 units)	1.5	2.5	2	2.5	1.25	1.25	3	3
Administrative Simplicity (4 units)	1.5	1.75	1.25	3	1.25	2.0	3	3
Flexibility (3 units)	2	3	1.75	3	1.25	1.75	3	3
Political Responsibility (3 units)	1.75	3	2	3	2	1.25	3	3
Fairness (3 units)	2.5	2	2	2.5	1.25	1.25	3	1.75
Overall Assessment	1.83	2.41	1.72	2.81	1.39	1.53	3	2.77

amount of tax should be determined and collected easily. Flexibility refers to how easy the tax system adapts to economic changes. This includes how well the affected goods and services respond to the new or increased taxes. Political responsibility refers to the transparency of the tax system, meaning it should easily be pinpointed who bears the tax burden. Lastly, the tax measure should be and be deemed fair to people of the same circumstances. People with a higher capacity to pay should bear more of the tax burden.

The tax proposals are graded in a scale of one to five for each item in the criteria; one being the highest and five being the lowest. Each item is assigned a weight of three units, except for administrative simplicity which carries four units. This is because it is generally known that taxes should be easy to implement in developing countries, and this is even aggravated by the fact that the Philippines needs to raise revenues at the soonest possible time. The overall assessment is computed by multiplying the score of each item to its number of units, after which the points for each item are added, and the sum is divided by the total number of units. The computation

of the overall assessment is much like the computation of a grade point average.

The results listed in Table 2.1 show that the top scorers among the eight measures are: indexation of sin taxes, rationalization of fiscal incentives, increase in the excise tax for petroleum products, and the two step increase in the VAT rate. The proposals that gained low scores were the following: windfall tax on telecommunications companies, the lateral attrition system, and the targeted tax amnesty. The top scorers are obviously what the government should implement at the soonest

possible time. These measures based on the scoring are more sound and possibly more effective than the others. The other four should be subject to more examination since they might bring more harm than good to the economy. The remaining discussion for this section gives justification to the scores given to each proposal. The discussion provides more insights on the proposals.

Increase on the excise tax for petroleum products

The plan to increase the specific excise tax rates of petroleum products except for LPG by two pesos is expected



to generate P29.7 billion worth of revenues. On the one hand this tax is efficient since the consumption of petroleum products produces negative externalities for the environment. On the other hand, an increase in the petroleum tax can trigger cost-push inflation. The tax will be simple to administer though, and since the demand for petroleum products tend to be inelastic, then this measure is also relatively flexible. The increase in the tax though can be easily passed to the consumers. The tax measure is fair since it is the upper class that consumes a lot of petroleum products except of course for the commuters. It would be fairer if rebates could be given to public transport operators, however this is not a feasible proposal as of the moment since one would need an efficient tax administration that will distribute the rebates.

Indexation of excise tax for sin products

This is defined as the indexation of the excise tax of tobacco and alcohol products to the real tax rate. This scores high in efficiency since it is estimated to bring in seven billion pesos on the first year. At the same time, since these products are not used as inputs to essential commodities, then the increased taxes will not cause a lot of distortions in the economy. The tax is also simple to implement and flexible since the rate will just automatically adjust to inflation without any legislation. The tax is fair and is acceptable because it is general knowledge that these commodities generate negative externalities to society. It only scores a bit low in political responsibility because the manufacturers easily pass on the tax to consumers since the demand for these goods tend to be inelastic.

Two-step increase in the VAT rate

This proposal is expected to yield revenues worth P19.9 billion for the government. This appears to be efficient

Table 2.4 Score Card for the Increase in the Excise Tax of Petroleum Products					
Efficiency	Administrative Simplicity	Flexibility	Political Responsibility	Fairness	Overall Assessment
2	1.25	1.75	2	2	1.77

Table 2.6 Score Card for Indexation of Excise Tax for Sin Products					
Efficiency	Administrative Simplicity	Flexibility	Political Responsibility	Fairness	Overall Assessment
1.25	1.25	1.25	2	1.25	1.39

Table 2.10 Score Card for the Two Step Increase in VAT					
Efficiency	Administrative Simplicity	Flexibility	Political Responsibility	Fairness	Overall Assessment
1.5	1.5	2	1.75	2.5	1.83

Table 2.7 Score Card for Rationalization of Fiscal Incentives					
Efficiency	Administrative Simplicity	Flexibility	Political Responsibility	Fairness	Overall Assessment
1.25	2	1.75	1.25	1.25	1.53

Table 2.3 Score Card for Windfall Tax on Telecoms					
Efficiency	Administrative Simplicity	Flexibility	Political Responsibility	Fairness	Overall Assessment
2.5	1.75	3	3	2	2.41

Table 2.5 Score Card for the Shift to Gross Income Tax for Corporate and Business Income Earning Individuals					
Efficiency	Administrative Simplicity	Flexibility	Political Responsibility	Fairness	Overall Assessment
2.5	3	3	3	2.5	2.81

Table 2.8 Score Card for Targeted Tax Amnesty					
Efficiency	Administrative Simplicity	Flexibility	Political Responsibility	Fairness	Overall Assessment
3	3	3	3	3	3.00

Table 2.9 Score Card for the Lateral Attrition System					
Efficiency	Administrative Simplicity	Flexibility	Political Responsibility	Fairness	Overall Assessment
3	3	3	3	1.75	2.77

since a two-step increase will not result in drastic changes in consumption and production. Since the VAT structure is already in place, this will be relatively easy to implement. Its flexibility again will depend on demand elasticity of the commodities, and in some cases the firms might be able to pass the increase to consumers, while not in other cases. However, this measure is not deemed to be so fair considering that there are so many people and businesses exempt from the VAT such as doctors, lawyers, and law firms. VAT payers will certainly complain about having to pay more taxes, while others are totally exempt. The possibility of limiting the exemptions instead of raising the rate is something worth studying.

Rationalization of fiscal incentives

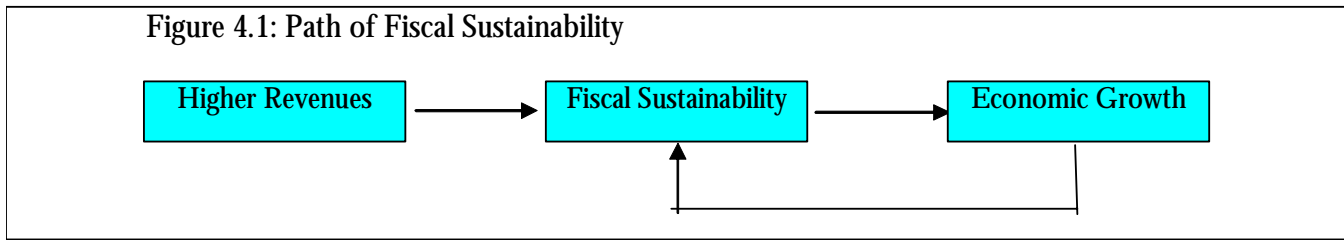
This proposal is defined as phasing out fiscal incentives inconsistent with WTO

rules, adopting a single fiscal incentives law, and limiting the list of industries qualified for incentives. It is expected that this measure will bring about P5 billion in revenues to the government. This proposal is indeed efficient since evidence show that foreign investors largely consider economic and political stability when choosing an investment destination rather than incentives (World Investment Report 1998). In terms of administrative simplicity, it will be a bit difficult to streamline the incentives and it might take time since this needs legislation. However, once a single law administered by a single agency is implemented, it will be easy to administer the incentives. This measure will also lead to a more transparent and fair incentive system.

Windfall Tax on Telecoms

This measure reimposes the franchise tax on telecom companies as

Figure 4.1: Path of Fiscal Sustainability



defined in the President's fiscal agenda. This ranks low in efficiency even if it is projected to bring P5 billion in revenues since imposing a franchise tax means higher costs for new entrants in the markets and for those firms renewing their franchise. Telecommunication is an important part of business, and imposing higher taxes will affect the structure of the market (the franchise tax might hinder new players from entering the market) and increase the price of telecommunication services. The tax is simple to administer, but there is no information on how it will affect the market and if telecoms firms can pass the tax to the consumers. The tax appears to be fair though because it is just right these firms pay a franchise tax. Firms like Globe and Smart have received fiscal incentives from the Board of Investments these past few years despite their high revenues. However, the business community might perceive this act of the government as cashing in on the gains of a booming sector.

Shift to gross income taxation for corporate and business earning individuals

This proposal is to replace the net income taxation with gross income taxation of corporations and self-employed individuals at a rate of 10% to 15%. It is expected to bring in P16.8 billion in revenues. This measure is supposed to simplify taxation and make it easier for the BIR to collect taxes. However, Manasan (2004) states that gross income taxation does not mean that firms or businessmen will not be allowed to deduct expenses from their income.

Taxpayers will be allowed to deduct direct costs from their gross sales/receipts when computing for their tax liability. Thus, there will be more haggling between the taxpayers and tax collectors, this time on whether costs are direct (meaning deductible) or indirect (meaning non-deductible). Shifting to gross income taxation might make corporations and professionals increase their prices if they have to pay more taxes. This system will not also be highly transparent. Lastly, the tax might not be deemed fair since firms have different cost structures and some firms will bear the burden of such a tax system disproportionately (Manasan, 2004).

Targeted tax amnesty with submission of statement of assets and liabilities and net worth

This proposal merits the lowest score of all because the government, in the past, has proven to be inefficient in granting tax amnesties. There has been several tax amnesties before and it might be that taxpayers are intentionally evading paying taxes knowing that they can avail of an amnesty. The submission of assets and liabilities and net worth might make it difficult to administer and the target tax evaders might not participate. This measure will only be fair and transparent if the government will make use of the information to go after tax evaders in the future. However, the government's performance in the past show that tax amnesties have not been productive in the Philippines.

Lateral Attrition System

This is defined in the President's fiscal agenda as a reward and incentive system for revenue generating agencies. An amount will be earmarked for those agencies which exceed performance standards. This proposal gets a low score on all four categories since it is relatively unknown how the tax system will respond to such a reward and incentive system. The mechanics for such an incentive structure will have to be carefully set up before the government can proceed with this plan. Although the measure may be fair, it would be difficult to achieve without introducing significant reforms in the tax administration.

III. Conclusions

Four of the eight tax measures proposed by the President appear to be economically sound. These four measures are: a two-step increase in the VAT rate, increase in the excise tax of tobacco products, indexation of the specific tax of sin products, and rationalization of fiscal incentives. The other proposals need further examination since their impact in the economy is either ambiguous or even harmful.

The biggest hurdle of the administration is getting the Congress to pass these tax reform measures. Proposals that make people pay more or higher taxes are definitely unpopular, and thus are unlikely to be passed into law. Efforts to make the public understand the importance of reforming the tax system must be undertaken. The tax measures are not only meant to combat the crisis, but more importantly to ensure long term economic stability. Higher revenues lead

to fiscal sustainability which in turn leads to economic growth. Sustainable economic growth, however, also ensures fiscal sustainability in the long run. Thus, the government has all the reasons to implement the correct tax reforms since both the twin goals of fiscal sustainability and economic growth are dependents on these measures.

As painful as it may be, the public must accept that paying higher taxes is a must for economic growth and stability. Some sectors are proposing other solutions to the crisis such as re-negotiating the debt or increasing tariffs on imported products. As popular as they may be, these solutions are unsustainable in the long run. Re-negotiating the debt will just give a temporary relief, while increasing tariff rates is difficult in the light of the country's commitment to free trade agreements. Although there might be a chance that the country will be able to escape the crisis with these popular solutions, the fiscal problem will re-

surface again in the next few years as long as poor tax collection is not addressed. Thus, it is necessary to pass the tax reforms not only to avert the crisis, but to guarantee fiscal and economic sustainability in the long run.

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