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Comprehensive Tax Reform in the Philippines

Principles, History and Recommendations

by

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The expert peer review panel provided very helpful comments and insights. We would like to thank the expert panel for their important contribution to this report. However, all errors and omissions are those of the authors, who enjoyed full academic freedom and independence.

Foreword

For the past several years, the Philippines has enjoyed strong economic growth which has been validated by improved credit ratings. However, in spite of the Government's successful economic management and strong performance, a large tax gap continues. The Philippines' tax regime continues to be overly complex and this is contributing to the tax gap.

There have been numerous attempts to reform taxes over the past 30 years, as outlined in Section 2 of our report. Rather than incremental tinkering with small tax amendments, a comprehensive fundamental tax reform is needed. As experienced with the fundamental and successful *Sin Tax Reform of 2012*, a similar reform of income taxes, other excise taxes and VAT is needed in the Philippines. Moreover, administrative reforms are also required. Such fundamental tax reform will protect and grow the domestic tax base, enhance efficiency and equity of the tax system and spur economic growth.

ITIC has had the privilege and pleasure of working in the Philippines since 2005. Our inaugural Asia-Pacific Tax Forum was hosted by the Department of Finance in Manila in October 2005, and again in 2012. Our programs and engagement with Government and Congressional tax policymakers, lawmakers and administrators have continued over the years.

The objective of this report is to benchmark the Philippines' tax regime with best international practices and provide a series of recommendations to assist tax policymakers, legislators and administrators to embark upon a major tax reform.

As outlined in the recent United Nations Conference on Trade and Development report, private sector investment is essential to create economic growth,

employment and savings to achieve the Sustainable Development Goals. We hope the recommendations in this report will assist the new Administration (under the leadership of President Rodrigo Duterte) and Congress in developing a pro-growth, revenue raising tax regime and also support the BIR with their implementation and enforcement of a new regime.

We hope stakeholders will carefully consider the recommendations contained in Section 3 of this report. Our recommendations cover personal income taxes, company income taxes, the value-added tax (VAT), excise taxes, property taxes, taxes on financial instruments, bank secrecy provisions, legislation given rise to taxes expenditure and the administration of tax laws.

Our co-authors, Professor Renato Reside (University of the Philippines School of Economics) and Honorary Professor Lee Burns (University of Sydney Law School), represent a unique combination of experience working on domestic tax reforms around the world and an understanding of the Philippines' experience and cultural, political and social realities. We hope Professors Reside and Burns provide a useful roadmap for the economic leaders in the Philippines.

We also acknowledge and thank Wayne Barford, ITIC Senior Advisor and former Assistant Commissioner of the Australian Taxation Office, for his superb job managing this project.

We hope that the beneficiaries of our recommendations and tax reform will be the people of the Philippines, who will enjoy enhanced prosperity and equity.

Daniel A. Witt
President, ITIC

Section 1. Principles of Tax Systems

1.1. Introduction

The term “tax system” as used in this report refers to the collection of taxes that a government uses to raise revenue to support its expenditure programs. Tax systems are usually judged against the standard criteria of equity (or fairness), efficiency (or neutrality) and simplicity. Further, tax systems must raise sufficient revenue to meet the needs of government and be sufficiently flexible to deal with short-term economic fluctuations.

Globalization has put additional pressure on tax systems so that they are attractive to foreign investors. Tax systems should foster economic growth through efficient design that limits distortions and attracts foreign investment.

The focus of this report is on the revenue side of the government’s budget. However, there are two aspects of the expenditure side of the budget that are relevant to this report. First, tax concessions provided to a particular taxpayer or class of taxpayers can be properly classified as the equivalent of expenditure measured by reference to the revenue foregone as a result of the tax concession. Tax concessions are referred to as “tax expenditures” and some countries (including the Philippines) now produce a separate budget (“tax expenditure budget”) that reports the revenue cost of tax expenditures. As the Philippines has a long history of using tax expenditures to support particular economic activities, this report includes consideration of tax concessions. Second, the level of cash transfers to individuals under the targeted conditional cash transfer program will have an impact on equity of the system. For example, transfer payments to low-income individuals will offset some of the inequity of consumption taxation. This is mentioned only briefly in this report.

1.2. Criteria for Evaluation of Tax Systems

1.2.1. Equity

The notion of “ability to pay” tax underlies the tax concept of equity or fairness. Equity is usually defined by reference to horizontal and vertical equity. Horizontal equity requires that those individuals with the same ability to pay tax should have the same tax burden. Achieving horizontal equity requires a comprehensive

tax base. If certain types of income are untaxed or lowly taxed, or certain expenditures are treated preferentially, then individuals with similar capacities to pay tax will be taxed differently. Vertical equity requires that those individuals with a greater ability to pay tax should have a greater tax burden. This is most clearly reflected in the progressive marginal rate scale that applies to individuals under the personal income tax. Under a progressive marginal rate scale, as the income of an individual increases, the individual pays proportionately more of their income as tax. Further, defining the tax base comprehensively is also necessary to achieve vertical equity as gaps in the tax base (such as for capital gains) tend to favor high income earners.

The extent of equity in the tax system will depend on ethical choices made by the government and the impact on other aspects of the tax system, and cash transfers that may be made by the government to low income earners. There are limits on the level of vertical equity that can be achieved through the tax system. A tax system that is too steeply progressive marginal rate scale may result in an increase in tax avoidance and evasion activity as taxpayers seek to find ways to limit the impact of the progressive marginal rate scale on them.

1.2.2. Efficiency

In a market economy, taxation involves the transfer of resources from the private sector to the public sector. Efficiency relates to the transfer of such resources and has two broad aspects. First, in a narrow sense, efficiency requires that the “resources available for public use be as nearly as possible equal to the resources withdrawn from the private sector”.¹ This primarily relates to the cost of administering and complying with the tax laws, and is also an aspect of the simplicity criterion discussed below.

In a broader sense, efficiency relates to the impact of tax on decision-making. In particular, tax should not result in resources being directed into less efficient uses than would otherwise have been the case in the absence of taxation. This operates at many levels. Tax should not:

- Distort the relative prices of goods and services that consumers acquire
- Distort the wage rates for different forms of work that may be undertaken

- Influence the choice between work and leisure
- Distort the returns from different forms of investment
- Distort the relative prices of productive assets or discriminate as between different forms of production

The efficiency criterion also implies a comprehensive tax base to avoid these distortions.

1.2.3. Simplicity

The tax system should be simple to administer and comply with. The more complex the tax system, the greater the loss of certainty in determining tax liabilities and the higher the administrative and compliance costs for the tax administration and taxpayer. For taxpayers, in particular, complex tax systems result in the diversion of productive resources into unproductive activities like tax advice, restructuring transactions, and even litigation.

Complexity can arise from different sources. It may arise from poorly drafted tax laws that cause uncertainty in interpretation. Importantly, though, it can arise when the tax system differentiates between different products, activities, or investments. The tax administration incurs costs in “policing” any artificial borders between products, activities, or investments that the tax system may create and taxpayers incur compliance costs in obtaining advice as to the appropriate tax treatment of products, activities, or investments.²

1.2.4. Flexibility

The tax system must include some instruments that can be adjusted quickly to stabilize the economy when economic circumstances require. At its simplest, this requires that there are some taxes the rates of which can be lowered or increased quickly in light of short-run economic fluctuations. The rate changes must be able to be implemented so as to alter government revenue and influence taxpayer behavior with immediate effect. Further, given the politics, small rate increases must be able to generate significant revenue impacts.

1.2.5. Countering Tax Avoidance and Evasion

Tax systems must be designed so as to limit tax avoidance and evasion. A comprehensive tax base is the best counter to tax avoidance activity. The reality is that taxpayers will attempt to take advantage of gaps in the tax base whether the gap is structural (such as no or low taxation of capital gains) or as a result of a

tax concession. The fewer the gaps in the tax base, the fewer the opportunities for tax avoidance.

The OECD’s Base Erosion and Profit Shifting (BEPS) project has highlighted the need for countries to protect their tax systems from international tax planning. The reform of the Philippines tax system should include measures to limit BEPS practices. This includes: measures to counter cross-border tax arbitrage, excessive use of debt financing, planning to avoid a permanent establishment; transfer pricing abuses, and tax treaty shopping. It should also include measures to strengthen the income tax and VAT taxation of cross-border services.

1.3. Mix of Tax Instruments

There is no single tax instrument that achieves all the goals of a good tax system. For example, a broad-based consumption tax, such as value added tax (“VAT”), with few exemptions and a single rate, can be a highly efficient and simple tax, but, because low income earners pay proportionately more of their income as tax, it does not satisfy the vertical equity criterion. Attempts to include some equity in the design of a broad-based consumption tax through exemptions or multiple rates (i.e. the treating of some goods such as goods or services differently [such as basic foodstuffs]) will inevitably involve a loss of efficiency and simplicity, as administrative and compliance resources must be devoted to managing the “border” between taxable and exempt, or low rate and standard rate, goods or services.³ Further, differential treatment of some goods and services will result in business resources being diverted into unproductive tax planning activities to take advantage of exemptions or preferential rates.

Similarly, while the personal income tax can be readily adapted so that the burden of tax varies with the personal circumstances of individual taxpayers so as to achieve equity goals, this comes at the cost of greater complexity. Further, individual taxpayers may attempt to “adjust” their personal circumstances so as to either maximize benefits or avoid detriments under such taxes. For example, the most obvious way that vertical equity is achieved under the personal income tax is through the application of a progressive marginal rate structure, but this can encourage tax planning (such as income splitting) by taxpayers seeking to limit the impact of the rate structure. The inclusion of anti-abuse measures further increases complexity, and administrative and compliance costs.

Ultimately, the design of the tax system will involve a trade-off between equity, efficiency, and simplicity, and this is achieved through a mix of instruments. It

is important that each component of the tax system is designed to its best advantage and allows the interactions between the taxes to achieve overall goals relating to equity, efficiency, and simplicity. For example, the VAT should be broad-based and imposed at a single rate to maximize efficiency with equity achieved through personal income tax. It is also observed that equity goals can be achieved through the expenditure side of the budget, particularly social welfare and other transfer payments to low income earners. This will depend on a country's budgetary capacity to make such payments and there will often be less capacity to make such payments in developing and emerging economies than in developed economies.

1.4. Drivers of Tax Reform

There are some key drivers of tax reform. First, the impact of trade agreements, falls in commodity prices, and financial crises have highlighted the need for revenue diversification, particularly ensuring that there is proper mix of taxes. Relying too heavily on one main revenue source can give rise to revenue shocks.

Second, changes in the global economy have seen countries seek to attract foreign investment to grow the economy. Countries have been revising their tax systems to ensure that they are attractive to foreign investors.

Third, improving revenue to reduce reliance on debt and aid. The need to service government debt can be a serious constraint on productive expenditure. Further, external debt exposes the government to currency exchange risk.

Finally, providing funding for new government projects, particularly infrastructure projects.

1.5. Overview of the Main Tax Instruments

The two broad bases for taxation are income and consumption. A tax system may also include wealth or property taxes. While such taxes may improve the equity of the tax system, generally, they are not large revenue raisers. The broad design issues with income and consumption taxes are discussed below. The discussion is only brief and is intended to provide an introduction to the discussion that follows on reform options.

1.6. Income Tax

The income tax can be divided into the personal income tax and corporate income tax. Special issues arise with the taxation of small business, which are discussed separately below.

1.6.1. Personal Income Tax

As indicated above, the personal income tax is the main taxing instrument to achieve horizontal and vertical equity. This is achieved through a broad base and a progressive marginal rate scale. Gaps in the tax base lead to a loss of equity as persons with the same capacity to pay tax may pay significantly different levels of tax. For example, if capital gains are untaxed or benefit from concessionary taxation, then this is likely to benefit high income earners as they are more likely to derive capital gains. Further, gaps in the tax base encourage tax planning as individuals re-characterize their income as a tax-preferred category. For example, if there is not full taxation of fringe benefits, then employees will substitute taxable cash salary for untaxed fringe benefits. Similarly, if capital gains are untaxed or lowly taxed, then individuals will seek to re-characterize income as capital gains.

While in the past, marginal rate scales were often steeply progressive with many rates, the trend has been to adopt flatter marginal rate scales with a tax free-threshold and no more than two or three positive rates. The flattening of the marginal rate scale has often been "financed" by a broadening of the tax base, i.e. broaden the base and lower the rates. This has put greater focus on horizontal equity and reflects the fact that a steeply progressive marginal rate structure can encourage tax planning.

1.6.2. Corporate Tax

The main issue today with the corporate income tax is the relationship between financial accounting and tax and, in particular, whether greater alignment is possible with resultant savings in administrative and compliance costs.

Companies are required to keep financial accounts for the information of their owners, managers, and creditors, and also future investors and creditors. Profit is a temporal concept requiring measurement for a defined period, namely the company's financial accounting year. For financial accounting purposes, financial accounting standards provide rules for allocating income and expenditure to accounting periods. Taxable income is also a temporal concept requiring measurement by reference to the taxpayer's tax year. The calculation of a taxpayer's taxable income also involves the allocation of income and expenditure to tax years.

Although the basic reason of measuring profit is shared by financial accounting and tax, the purposes of tax and financial accounting are not exactly the same. Because financial accounting is concerned with presenting

owners, creditors, and investors (and future investors and creditors) with an accurate reflection of the ongoing profitability of an entity, financial accounting has developed rules to ensure that the calculation of profit does not present a distorted view of the true long-term profitability of a company when, for example, a company's right to retain income is contingent on the provision of goods or services in the future or the company has potential future liabilities. These financial accounting rules may defer the recognition of income or require the creation of reserves (or provisions) to recognize future expenditure or losses thereby reducing the current year profitability of the company.

Tax, on the other hand, is concerned only with the current year financial performance of companies with a view to collecting a portion of the current year profit as tax. Generally, tax is not concerned with deferring recognition of income that a taxpayer has derived or in providing currently for possible future expenditure or losses. In particular, tax will deal with future financial events if or when they occur. For this reason, it is not appropriate for the tax rules to give complete sovereignty to financial accounting as expressed in the accounting standards.

The advent of an internationally agreed set of financial accounting standards (the International Financial Reporting Standards ("IFRS")), however, offers an opportunity to more closely align taxable income with financial accounting profit, but still recognize the fundamental differences in the calculation. In particular, IFRS resolves some long-standing tax concerns with financial standards by, for example, excluding the last-in-first out (LIFO) inventory valuation method and the completed contract method for accounting for long-term construction contracts. Further, unless accelerated depreciation is to apply for tax purposes, tax depreciation should simply follow effective life depreciation under financial accounting.

1.7. Consumption Tax

Consumption taxes can be broad-based or selective. As stated above, a broad-based consumption tax on goods and services imposed at a single rate can be a highly efficient and simple tax. A broad based consumption tax can be either a multi-stage tax (VAT) or single stage tax (sales tax).

Selective consumption taxes can be both inefficient and inequitable, particularly as they may discriminate against individuals with different tastes and can favor one product over a competing product. They can, however, be an important source of revenue and achieve policy objectives, particularly correcting negative externalities.

1.7.1. VAT

While VAT is imposed on final consumption, it is collected progressively at each stage in the production and distribution of goods and services. Cascading of tax is avoided under VAT through the input tax credit mechanism so that a VAT-registered person charges VAT on their outputs but claims a credit for VAT paid on their inputs. The input tax credit mechanism, therefore, is a critical feature of VAT that ensures that the tax is not imposed on investment. However, some businesses will incur more input tax than the output tax collected. This will always be the case with businesses that primarily make zero-rated supplies (mainly exporters) but can also be the case on a short-term basis for some businesses, such as when a large capital purchase is made. A properly functioning VAT system requires that businesses are able to claim a refund of excess input tax credits to avoid VAT being a tax on investment.

The refund of excess input tax, however, leaves the VAT vulnerable to fraud. Fake invoices and fictitious entities may be used to inflate refund claims. Further, sales may be under-reported or under-valued, or domestic sales may be disguised as zero-rated exports. The experience of some countries, particularly, in the European Union, has been that VAT fraud arrangements have been highly sophisticated. The incidence of VAT fraud has prompted some countries to consider consumption tax alternatives to VAT, particularly a sales tax or turnover tax.

1.7.2. Retail Sales Tax

In contrast to the VAT (a multi-stage tax), a sales tax is a single stage tax imposed at the retail, wholesale, or manufacturer level. While the input tax credit mechanism under the VAT avoids cascading of tax, cascading under a sales tax is usually avoided through an exemption system. Under sales tax, a "ring" is placed around registered producers/suppliers and all transactions between registered persons within the ring are treated as exempt. A transaction by a registered person with a person outside the ring is subject to tax.

In theory, the same revenue should be collected under a VAT or retail sales tax ("RST"); however, in practice, RST is likely to raise less revenue. Initially, it is observed that, as the retail level will often have a large number of small businesses, the RST registration threshold will need to be much lower than under the VAT so as to capture similar revenue levels. Indeed, it may be that all retailers must be registered under RST to ensure an equivalent revenue collection to that under VAT. A higher registration threshold is possible under the VAT because VAT is collected progressively as goods

and services pass through the distribution chain. This means that even goods supplied by small unregistered retailers will bear some level of VAT.

RST poses two revenue risks. First, goods may leak out of the ring of exempt producers through RST fraud. The longer the supply chains, the greater is the exposure to RST fraud because of the large number of points where goods may leak out of the ring of exempt producers. Second, the RST imposes tax at the point in the distribution chain that is most vulnerable to non-compliance because of the cash economy in which many small retailers operate. Importantly, the single stage nature of RST means that any revenue leakage will involve the loss of the whole of the tax. In fact, the fraud risk may be even greater under RST than VAT. Further, the single stage nature of RST limits flexibility in setting the tax rate, as the higher the rate, the greater is the incentive for fraud.

1.8. Turnover Tax

Another alternative to VAT is a turnover tax. In broad terms, a turnover tax is a tax imposed on a periodic basis (such as monthly or quarterly) on the gross turnover of businesses without deduction of expenditure. It differs from a VAT and RST as it is not formerly imposed on individual transactions, although businesses are likely to add the tax to the price of goods or services sold or supplied so that they recover the tax from their customers. A turnover tax can be imposed on all businesses regardless of whether they supply goods or services, and also on whether they are small, medium, or large (although a registration threshold may exclude micro-businesses).

As all businesses in the distribution chain of goods and services are subject to turnover tax, the tax operates as a *de facto* multistage tax and, therefore, overcomes the major weakness of the RST as a single stage tax. However, a major disadvantage of a turnover tax is that there is cascading of tax (i.e. tax on tax). This is because there is no credit (VAT) or exemption (RST) mechanism to allow goods to pass through a chain of registered persons tax-free. The longer the supply chain, the greater the level of cascading. Importantly, unless the rate is set very low, the cascading under a turnover tax is likely to significantly increase the cost of goods and services.

Another disadvantage of turnover tax is that it is not possible to ensure that exports leave the Philippines completely free of tax. Any attempt to do so is not likely to be accurate and will come at increased compliance and administrative costs. While no turnover tax would be charged on exports, this only eliminates the turnover

tax of the exporter and not the embedded tax in the exporter's costs that exists because of cascading. This will mean that Philippines' exports will be more expensive in world markets as their cost will include both embedded Philippines tax and import VAT in the country of import. The advantage of the VAT is that, on export, it removes all local tax up to the point of export. Consequently, the only tax on the exported goods or services will be the import VAT in the country of import and, therefore, the goods and services can compete equally with other goods and services in the import market.

As explained below, a turnover tax may be used to replace both the income tax and VAT for small business.

1.9. VAT vs. RST vs. Turnover Tax

The VAT is used in a very large number of countries and is well established in the Philippines. It has advantages over alternatives. The focus of tax reform should be on improving the functioning of VAT, including reviewing exemptions. In particular, options to limit VAT fraud within the existing VAT framework should be explored rather than moving to a completely new system of taxation that may not necessarily fully solve the fraud problem (particularly in the cash economy) and create other problems through the cascading of tax.

1.10. Selective Consumption Taxes

As stated above, selective consumption taxes can be both inefficient and inequitable. There is, however, a role for selective consumption taxes, in the form of excises, to play in correcting the negative externalities caused by the consumption of certain goods. In broad terms, a negative externality is a cost of consumption that is not reflected in the price of goods and, therefore, may be borne by society generally. The main examples of negative externalities are health and environmental costs. This is why excise taxes are commonly imposed on tobacco, alcohol, petroleum products, and motor vehicles. Excise taxes imposed on these products are, in general terms, non-distortionary because of the absence of untaxed substitutes. The choice is generally as between consumption or no consumption of the excised product.

Excise taxes may also be imposed on products the demand for which is relatively inelastic simply to raise revenue. For example, some countries have imposed excise taxes on telecommunication services (particularly mobile phone services) and banking services. The latter may also be as a substitute for VAT, as financial services are generally exempt from VAT for administrative reasons.

Any proposals to extend excise taxes beyond the standard excisable goods must be based on clear evidence of the negative externality that the tax is correcting and absence of highly substitutable products. This is particularly relevant to the current discussion around the imposition of excise tax on sugary drinks and snack foods.

1.11. Taxation of Small Business

The small business sector is the most difficult sector to tax under accounts-based taxes, such as the income tax or VAT. This is the case for both developed and developing countries, although the problem is more acute in developing countries because of the greater percentage of businesses that are likely to be categorized as “small” and the fewer resources available to the tax administration to enforce the tax.

There has been a trend to having turnover tax replace both income tax and VAT for small businesses. Other businesses are subject to both the VAT and income tax. This system has the advantage of retaining the benefits of VAT for larger businesses, including the input tax credit mechanism to avoid cascading of tax and zero-rating of exports, and also the administrative benefits for the tax administration of VAT record-keeping obligations (which will also assist with administration of the income tax). It also ensures that revenue is collected from the small business sector but with simplified administrative and compliance burdens.

1.12. Property Taxation

Property taxation in the form of regular taxation of real property, such as land tax or rates, has not been a significant revenue raiser. In OECD countries, property tax amounts to little more than 1% of total revenues

and, in other countries, it is negligible. However, there is increased interest in property taxation, particularly in developing countries, as a new or improved revenue source.

Property taxation can improve the equity of the tax system as tax is borne mainly by middle and high income earners. Progressivity can be included in the design of the tax through a threshold. Property taxation is also efficient because land and buildings are largely immobile. This also means that there is limited opportunity for avoidance and evasion. It is more efficient when levied on residential property than commercial property. This is because there is greater burden of the tax on those businesses that require more commercial property as a factor input, such as agriculture. Property taxation can be used to fund subnational governments. Because of its advantages, some commentators describe property tax as the “perfect” tax.

However, property taxation has not been widely used for two main reasons. First, property taxation is often seen as politically unpopular. The unpopularity stems from the advantages of the tax, namely its greatest impact is on the wealthy, it is transparent, and hard to avoid. Second, property taxation can be difficult to implement. There is a need for very significant investment in administrative infrastructure to carry out regular market based valuations of land and buildings. In particular, the system requires a computer-assisted appraisal system. Further, the tax is data-intensive and requires cooperation between government agencies (tax administration, local government, and lands ministry).

If these political and administrative difficulties can be overcome, property taxation has strong revenue potential.

Section 2. Tax Reforms in Recent Philippine History

2.1. Background

The frequency, pace, credibility and quality of recent tax reforms in the Philippines have often been shaped by the times, institutions and people implementing them. Sometimes, reforms have been sweeping, dictated by fiscal exigencies in the aftermath of presidential transitions in need of financing for new programs, or in the aftermath of external or self-inflicted economic shocks. At other times, reforms have been piecemeal, subjected to the vetting within and the idiosyncrasies of the legislative process and/or other political considerations. Reforms have targeted both tax policy and tax administration either separately or as complementary components of a broader package.

Tax reform has been rationalized in the past as a basis for achieving the economic and political motives of policymakers and legislators, be they to enhance the equity, efficiency and simplicity of the tax system. For example, to reduce tax burdens for or encourage desirable or discourage undesirable behavior on the part of taxpayers, or to induce investment and positive spillovers from corporations. Where political and economic motives might also coincide is the use of tax policy to support industrial policy. The Philippines has had a dominantly tax preference-based industrial policy since the 1960s with increasingly generous tax preferences.

Regardless of the tax reforms that have occurred, the Philippines tax system has continued to suffer from chronic weaknesses. Tax rates continue to be high, discouraging investment and perhaps also work effort. Meanwhile, tax effort levels are low and there are persistent calls to reduce corporate and personal tax rates to levels more consistent with comparative nations. Furthermore, administrative efficiency is low and leakages are high. Tax policy combined with industrial policy has also not encouraged investment. In the last four decades, the outcomes of reforms have been mixed - there have been some victories but also serious setbacks. On net basis, the tax system has persistently been unable to raise revenues to levels consistent with known benchmarks. This has constrained its ability to finance and sustain inclusive development. It is time to take stock, learn from the past and plan for future best practice tax reform.

Considering that the current tax system is a stock product of cumulative legislation and that reforms have always been influenced by the past, the events and reforms shaping the Philippine tax system will be reviewed in sequence with emphasis on occasions where change was more sweeping. Two major tax reform programs have taken place since the end of the Marcos regime: the 1986 tax reform program (TRP) and the 1997 comprehensive tax reform program (CTRP). Other notable occasions include the implementation of the value-added tax in 1988 (although it had been approved during the TRP), subsequent efforts to broaden and narrow the VAT base, the efforts to broaden and enhance tax incentives (especially to promote export-oriented growth and domestic investments) and then to rationalize them and enhance their transparency, through to more recent reform of 'sin taxes'. Table A in the Appendix lists the specific episodes of reform and other factors influencing the current tax system.

The roots of the present system of taxation can be found in the system formulated under the revolutionary government of President Corazon Aquino, whose term ran from 1986 to 1992. To understand the basis for tax reform during that era, one must take stock of the circumstances that existed before she rose to power - the troubled latter years of the regime of Ferdinand Marcos.

This section reviews the history of recent tax reforms in the Philippines and uses the lens of economic principles to assess the events that have shaped the recent history of the Philippine tax system.

2.2. Conditions Prior to the 1986 Aquino Tax Reform Program: The Late Marcos Regime

When President Corazon Aquino assumed power during 1986, the Philippines Government was in a fiscal crisis, after having gone through successive years of economic contraction from 1984 to 1985 owing to structural problems with the tax system, the lingering effects of debt, exchange rate issues, financial and political crises that occurred during the latter part of the Marcos presidency. Tax effort, defined as taxes as percent of GDP, was at rock bottom having fallen from

12.8% of GDP in 1979 to 10.71% of GDP in 1985. Expenditures net of interest payments were 11.45% of GDP, the national government fiscal balance was in deficit (-1.94% of GDP) while the consolidated public sector deficit was significantly higher than the accepted norm (-5.61% of GDP).

The structure of the tax system prior to 1986 contributed to the severity of the fiscal crisis

- The tax system was relatively unresponsive (inelastic). From 1981 to 1985, taxes grew at an average annual rate of 15% as against the 18% growth of nominal GDP.
- The tax system generated a low tax yield: tax effort was a low 10.7% of GDP in 1985. Given the country's expenditure needs at that time, tax effort should have been at least 15.0%.
- The country was heavily dependent on indirect taxes. About 70% of total taxes were derived from domestic indirect taxes and international trade taxes, and
- The tax structure was immensely complicated and difficult to administer.

2.2.1. Income Tax System: 1981-85

The pre-1986 individual income tax system was schedular in nature. Two schedules existed. The first schedule was for compensation income – a modified gross income scheme which consisted of nine tax brackets, with tax rates starting from 1% to 35%. The second schedule was for business and professional income, with five tax brackets and marginal tax rates ranging from 5% to 60%. Passive income (interest income, royalties and dividends) was subject to 17.5% and 15.0% withholding tax rates. Corporate net profits were subjected to dual rates of 25% and 35%, where corporations with higher incomes were subjected to the higher corporate income tax rate of 35%. Relatively high marginal tax rates contributed to the practice of business and professional income tax filers understating their incomes. The result was that they generally experienced much lower effective tax rates, usually around lower 20s.

2.2.2. Domestic Indirect Taxation: 1981-early 1986

Most imported and locally produced goods were levied with an ad valorem sales tax. From 1983 to 1985, successive Executive Orders were issued to unify

specific and sales tax rates on imported and domestic cigarettes and alcoholic products.⁴

In October 1985, Presidential Decree 1991 imposed a unified sales tax rate of 3% on essential and non-essential article. The sales tax rate was subsequently lowered to 1.5% in January 1986. Specific taxes were imposed on certain locally produced and imported goods.

2.2.3. International Trade Taxation: 1981-85

The ad valorem peak rate of 100% was reduced to 50%, and tariff rates on other goods were revised to conform to a more uniform tariff structure. In 1982, an additional duty of 3% was imposed on oil imports, and at the height of the political crisis brought about by the assassination of former Senator Benigno Aquino, this was raised to 5% in 1983 and to 10% in 1984. These additional duties were reduced gradually until they were finally phased out in 1986.

Export taxes on particular products were alternatively lifted, re-imposed, raised and decreased according to the performance of each product in the world market. Tax rates differed: logs, 15%; copra, 15%; coconuts, 9%; copra meal and desiccated coconut, 8%; lumber, veneer, abaca, pineapple, 4%; and banana, 2%.

2.2.4. Tax Incentives: 1981-85

In January 1981, up-front incentives (such as duty-free importation of machineries) were replaced by performance-based incentives such as tax credits on value added earned and net local content of exports.

In 1984, all tax exemptions enjoyed by government corporations and private firms were abolished. But a large number of exemptions were subsequently restored. Tax incentives for investors consisted of performance-based tax credits and deductions. These incentives were made available to domestic market oriented corporations via the Board of Investments (BoI) and to exporters registered with the Export Processing Zone Authority (EPZA) and located in any of the four special economic zones in existence at the time (Bataan, Cavite, Cebu, Baguio). Despite the existence of these incentives, the country was not able to generate sufficient investment, primarily because of the severe political and macroeconomic crises prior to the fall of the Marcos regime.

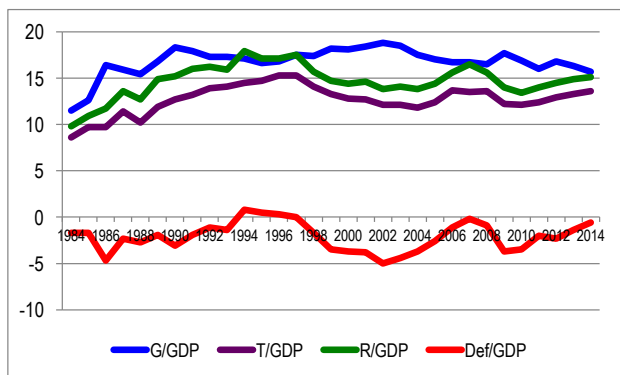
2.3. The 1986 Tax Reform Program (1986 TRP)

The harsh macroeconomic and fiscal realities in 1986 did not leave President Corazon Aquino any option. With the country still heavily indebted, the best way to rebuild the country's finances and also to resume access to concessional credit was to undertake a reform of the country's complicated, unfair, inefficient, and low-yielding tax system. The low revenues, compounded by the high cost of borrowing money at home and abroad, would not allow the administration to finance public infrastructure, invest in human resources and social programs (the increasing emphasis of the Aquino administration) and service its huge and rising public debt. Figure 1 below charts the trajectory of government expenditures, tax effort, revenue effort and deficit starting in 1984. Table 1 below shows the dire statistics which describe the fragile state of fiscal affairs at the time. Both figure and table show the alarming rise in the budget deficit in 1986 and the inconsistency between low tax effort and simultaneous rising government expenditures. Hopes for fiscal sustainability rested on the competency and credibility of the president's revolutionary government to restore confidence so that individual and corporate taxpayers would jump-start the economy along with revenues.

Figure 1. Perspective on Public Finance in Recent Philippine History: 1994-2014

Size of Government, Sources of Financing, Size of Deficits

In percent of gross domestic product



Legend: G = government spending, T = tax collections, R = total revenues, D = deficit

Table 1. Fiscal Indicators Upon Assumption to Office of President Corazon Aquino: Reform or Perish

Years immediately before and during tax reform

In percent of GDP	1985	1986
Revenues (R)	10.9	11.7
Taxes	9.7	9.7
Expenditures (G)	12.6	16.4
Interest payments (IP)	2.3	3.6
Primary surplus [R- (G-IP)]	0.6	(1.1)
National government fiscal balance	(1.7)	(4.7)
Consolidated public sector deficit (CPSD)	-5.61	-6.50
Public sector borrowing requirements (PSBR)	-2.73	-4.20

Source: Department of Budget and Management

2.3.1. Objectives of the 1986 Tax Reform Program (1986 TRP)

Considering the urgent need to sustain fiscal balances as an aid to macroeconomic stabilization and poverty alleviation, the aim of the 1986 TRP was to fix the inherent weaknesses of the tax system that the Aquino administration inherited. The tax system was so bad that the authors of the reform dubbed the 1986 TRP as 'tax reform without tears'. More specifically, the objectives of the 1986 TRP were as follows:

- Improve the responsiveness (elasticity) of the tax system.
- Promote equity by ensuring that similarly situated individuals and firms bear the same tax burden.
- Promote growth by withdrawing or modifying taxes that reduce incentives to work or produce, and
- Improve tax administration by simplifying the tax system and promoting tax compliance.

The formulation and approval of the 1986 TRP took place under a unique policy regime. For 18 months, President Corazon Aquino led a revolutionary government and exercised both Executive and Legislative powers. There was no Congress, hence no need for tedious and time-consuming executive-legislative coordination. This made possible the approval of twenty-nine (29) tax measures (all in the form of Executive Orders, EOs), including the introduction of the value added tax (VAT) into the Philippine tax laws, in one Cabinet meeting on

June 28, 1986. The sweeping reforms included changes in the direct and indirect taxation.

2.3.2. 1986 Reforms in Direct Taxation

On personal income taxation (PIT), the dual tax schedules for compensation and professional income earners were unified with a 0-35 percent schedule adopted for both types of taxpayers to minimize revenue loss and preserve the relative tax burden of individuals, ceilings on allowable business deductions were proposed and adopted. Unfortunately, due to a strong lobby by various professional groups, this complementary proposal was not fully implemented by tax administrators.

Personal tax exemptions were increased to adjust for inflation and to exempt from taxation those earning below the poverty threshold. Married couples, where both wife and husband worked, were given an option to file separate returns which lowered the tax burden on married couples by removing the effect of progressive rates on their combined incomes. Passive income were taxed at uniform rate of 20%, which rendered passive income taxation neutral with respect to investment decisions involving bank deposits and royalty generating ventures.

On corporation income taxation, a uniform 35% rate replaced the two-tiered corporate tax structure. The tax on inter-corporate dividends was eliminated and the tax on dividends was phased out gradually over a period of three years. The exemptions from income taxes of franchise grantees were withdrawn. The imposition of an income tax on franchise grantees put this previously favored group on an equal footing with similarly situated individuals or firms. Uniform franchise taxes were imposed on similar types of utilities.

2.3.3. 1986 Reforms in Indirect Taxation

The value-added tax (VAT), pursuant to Executive Order (EO) 273, was introduced to simplify the tax structure and its administration. The VAT was meant to replace various sales and turnover taxes. The new system had the following features:

- A uniform destination principle VAT rate of 10% on the gross selling price of domestic and imported goods and services and 0% on exports and foreign currency denominated sales (zero-rating).
- 10% in lieu of various rates applicable to fixed taxes (with 60 nominal rates), advance sales tax, tax on original sale, subsequent sales tax, compensating tax, miller's tax, contractor's tax, broker's tax, film lessor and distributor's tax,

excise tax on solvents and matches, and excise tax on processed videotapes.

- A 2% tax on entities with annual sales or receipts of less than PHP 200,000.
- Adoption of tax credit method of calculating tax by subtracting tax on inputs (input VAT) from tax on gross sales (output VAT).
- Exemption of the sale of basic commodities such as agriculture and marine food products in their original state, price-regulated petroleum products and fertilizer, and
- An additional 20% tax on non-essential articles such as jewelry, perfumes, toilet waters, yacht and other vessels for pleasure and sports.

The VAT was signed into law during 1986 and fully implemented during 1988. It provided new avenues for indirect taxation to raise revenue. As cumulative experience with the VAT suggested that it would be a reliable source of revenue growth, its rate would be subsequently adjusted upwards and its base broadened. However, beyond the Corazon Aquino administration, numerous new tax laws would reduce the reliability of the VAT, as legislated exemptions of various groups of final consumers grew in number, resulting in growing revenue losses.

2.3.4. 1986 Tax Incentives

At around the same time that the 1986 TRP was being passed into law, the Corazon Aquino regime broadened and intensified the use of tax incentives as a tool for investment promotion. With the country emerging from deep economic crises, it was thought that tax incentives could help stimulate aggregate demand by attracting foreign and domestic investment and generate needed employment and other spillovers. At that time, neighboring countries were already using tax incentives to fuel industrialization, investment- and export-led growth. While the tax code and several existing special laws already reduced tax burdens for select investors, it was thought that a more aggressive stance was needed, considering the economic jump-starting that was desired in light of the economic crises that the country had gone through.

While the latter part of the Marcos regime relied primarily on performance-based tax incentives such as tax credits and tax deductions to stimulate investment, President Corazon Aquino's industrial policy focused on a ratcheting up of the generosity of tax preferences, with non-performance-based income tax holidays

replacing tax credits and deductions as the tax policy tools of industrial policy. Still using her revolutionary powers, President Corazon Aquino signed into law EO 226, the Omnibus Investments Code, which endowed the Bol with power to grant income tax holidays at its discretion. The Bol would target their discretionary incentives towards pre-identified industries in the annual Investments Priorities Plan. The Investment Priorities Plan represented Bol's effort to assemble a list of industries thought to have the greatest potential to lift the country's competitiveness and generate the greatest positive externalities. Through the passage of other laws, Congress would also make Bol tax incentives available on a mandatory basis to other favored industries. The practice of extensively targeting income tax holidays to select industries would play a role in later reducing the efficiency of the tax system as it marked a shift towards using non-performance-based tax incentives as the primary tool for investment promotion. This resulted in the quantum of the tax relief benefit the investor not being tied to the size of the investment. It also contributed to a gradual weakening of the control by authorities responsible for fiscal policy over revenue generation, as it intensified the ability of investment promotion agencies to influence the revenue collection system. Subsequent destabilization plots and other extra-constitutional challenges that occurred during the latter part of President Corazon Aquino's term in office also undermined the efficacy of the tax incentives in spurring capital formation as investors generally shied away from a politically unstable country.

Along with tax policy reforms, a number of important administrative reforms were also implemented during the Corazon Aquino administration.⁵ The Department of Finance (DoF) along with its attached agencies, including the Bureau of Internal Revenue (BIR), were restructured under EO 127. The BIR was restructured to implement the changes in the tax system and improve service and efficiency. This was accompanied by a tax amnesty and a reduction in arrears. Employee compensation at the BIR was enhanced and efforts to improve the quality of tax audits were intensified. Along with increased efforts to improve the level of computerization in the organization, reduce corruption and restore trust in the organization, BIR commissioners attempted to implement reforms to increase compliance.

2.3.5. Analysis of the 1986 TRP

In the years following the implementation of the 1986 TRP, both tax effort and revenue effort rose steadily. The latter increased from 10.7% in 1985 to 15.4% in 1992, peaking at 17.0% in 1997. This was partly due to the simplification of the tax system, the introduction

of the VAT and general economic growth during that period. Administrative reforms complemented the policy reforms, as the Tax Identification Number was also launched. The number of registered taxpayers doubled during the Corazon Aquino administration and the level of tax compliance also grew, influenced in part by greater confidence in the government.

The overall responsiveness of the tax system to changes in economic activity improved from an average of 0.9% from 1980 to 1985 to an average of 1.5% from 1986 to 1991. The buoyancy coefficient for import duties rose from 0.5% before the reform to an average of 1.89% from 1986 to 1991.

The success of the 1986 TRP can be attributed to several factors. It was crafted by a team of experts, was fully supported by the president and was the result of a credible process free from undue external influence. Furthermore, the tax reforms were complemented by stability and continuity of the top executives at the BIR. The 1986 TRP succeeded in simplifying the system of taxation and making it more buoyant and more responsive to the changing times. It could have been improved, and the tax fairness enhanced, if the BIR had fully implemented the approved reform that would have imposed ceilings on allowable deductions. Furthermore, the introduction of income tax holidays and other targeted tax preferences towards select industries would later undermine the efficiency and buoyancy of the tax system. Despite the misgivings of the DoF about the tax incentives' inability to encourage investment, the system has been generally tolerated and has remained part of the law. Their continued existence was rationalized on the basis of not further undermining investor confidence in the country.

2.4. 1992 - 1997

The start of the Fidel Ramos presidency in 1992 marked a transition into a period marked by greater political normalcy and stability for the Philippines. Succession took place constitutionally, and the new government set out to more clearly define the country's economic thrusts and priorities. In the context of an increasingly competitive regional and global market place for capital, tax policy would serve the needs of industrialization based on models thought to reflect best practice.

In the years immediately preceding tax reforms during the Ramos administration, the government embarked on a vision to pursue export-led growth. In the early- to mid-1990s, a slew of new laws were passed to enhance the country's investment and export competitiveness. Although the Marcos regime helped develop the country's first special economic zone in the late 1960s

and four other zones devoted to export production, the country still lagged behind its more export-led neighbors. The desire to follow its neighbors along the path of export-led growth led lawmakers to legislate more generous tax incentives for exporters.

1995 marked a year in which much landmark legislation was passed with the aim of promoting further capital formation in the country. In an effort to stimulate foreign investment and export-led growth, the PEZA Law was passed in 1995. With this law, Congress restructured the old Export Promotion Zone Authority (EPZA) and renamed it the Philippine Economic Zone Administration (PEZA) and conferred on it more powers to develop special economic zones. This included the ability to grant tax incentives to encourage investment by private developers in special economic zones. The law continued the practice of granting registered exporters preferential tax treatment on corporate income and imports of capital goods and raw materials and greatly reduced their tax burdens by providing some of the most generous tax incentives in the region that greatly reduced the impact of direct and indirect taxation. The former US military bases in Subic and Clark, as well as two other large tracts of land in Zamboanga and Cagayan provinces, were converted by law into freeports, where consumables were also sold duty free (effectively distinguishing them from special economic zones, in which only capital is tax free). The new laws enabled registered exporters to receive the most generous preferential tax treatment. This included income tax holidays at the start of operations for PEZA-registered investors, a low 5% tax on gross income earned after expiry of the income tax holiday, VAT zero-rating and duty free status on imported inputs. Freeport-registered investors would be eligible for the same incentives enjoyed by PEZA locators except the income tax holiday. After legislation on freeports and the PEZA, the domestic tax regime even more ostensibly favored exporters over other investors.

Tax incentives continued to be granted to domestic market-seeking investors. The Board of Investments (BoI) tax package consisted of income tax holidays but no other preferential treatment for registered investors after the tax break beyond tax and duty free importation of capital equipment and other minor incentives.

The gradual opening up of more areas granting location- and non-performance based tax incentives along with the continuation of BoI incentives with little or no influence from the fiscal authorities was increasingly viewed with concern by the Department of Finance. Policymakers at the time recognized that to prevent tax effort from declining in the long run due to the tax

incentives, higher personal exemptions for individual taxpayers and falling import duty revenues given intensified trade liberalization, some policy adjustments needed to be made. It was decided that tax incentives would have to be reviewed and perhaps rationalized (selectively eliminated or reduced in scope or intensity) as they might be reducing the buoyancy and increasing the complexity of the tax system and possibly also being abused by taxpayers.

Not lost during the transition from the Corazon Aquino to the Ramos regime was the recognition of these new and related sources of fiscal fragilities. High regular tax rates discouraged investment and encouraged tax evasion and avoidance. Meanwhile, the high tax rates also led to political pressure to pass laws that would lead to tax expenditures. Tax expenditures are defined as laws which confer special tax status and deliberately reduce the cost of production (or consumption) of certain goods and services and reduce the tax burden on designated taxpayers and therefore creates a legal deviation from normal tax treatment (DBM, 2011). Tax expenditures are called such because such laws delivering targeted assistance through the tax system have a similar budgetary impact as actual expenditures and also shrink the tax bases. Contingent liabilities meant that government exposures necessitated more tax revenues. Furthermore, the country was also further liberalizing trade, meaning that the country would have to rely less on trade taxes and more on other sources of tax revenues to finance expenditures. New tax measures were needed to address the need for national financing.

2.5. The 1997 Comprehensive Tax Reform Program (CTRP)

Compared to the circumstances facing President Corazon Aquino, President Ramos faced a very different fiscal regime at the time of his tax reform program given that both tax and expenditures were relatively sound as a percent of GDP. The primary surplus was high and the budget deficit was close to zero.

The consolidated public sector deficit, as percent of GDP, was slightly positive (0.3%) in 1996 and was less than one percent in 1997. The public sector borrowing requirement (PSBR), the amount needed to finance national government deficit was 0.5 in 1996 and 1.5 in 1997, both tame by international standards. The tax system wasn't broken, so what was the rationale for reform?

The 1997 Comprehensive Tax Reform Program (1997 CTRP) was implemented to broaden the tax base, which would allow lower tax rates, and to plug the

perceived loopholes in the indirect tax system. Other motivations included simplification of the tax structure, minimization of leakages from undeclared revenues, overstated deductions and corruption and to make the tax system more elastic and ease tax administration and enhancement of the progressivity of income taxes to achieve better income redistribution (DBM, 1996).

Apart from changes to the marginal tax rates for the personal and corporate income tax, the 1997 CTRP also included the restructuring of excise tax rates on oil products (RA8184), as well as on alcohol and tobacco products (RA8240). The excise tax on alcohol and tobacco products was changed from ad valorem to specific. However, inflation indexation was left out of the law, making the tax less elastic (Manasan, 1997). While the motive for the change into specific taxes may have been driven by perceptions of the weak state of tax administration, the non-indexation would also prove costly over time. It would take more than 15 years for these excise taxes to be updated by Congress.

Officially, the objectives of the 1997 CTRP were:

- Make the tax system broad-based, simple and with reasonable tax rates,
- Minimize tax avoidance allowed by existing flaws and loopholes in the system,
- Encourage payments by increasing tax exemptions levels, lowering the highest tax rates, and simplifying procedure, and
- Rationalize the grant of tax incentives, which at that time was estimated in 1994 to be worth equal to P31.7 billion.

The 1997 CTRP was also one of the important requirements for the Philippines' exit from the International Monetary Fund's supervision.

2.5.1. 1997 Tax Reform Formulation and Legislative Strategy

On February 10, 1994, President Ramos issued Administrative Order 112 creating the Presidential Task Force on Tax and Tariff Reforms. The task force was multi-sector in composition and chaired by the Secretary of Finance. A technical secretariat headed by an Undersecretary of Finance was likewise created.

2.5.2. 1997 Reforms in Income Taxation

The personal income tax system reverted to a uniform rate schedule for both compensation and business and professional income. This came after a brief experiment with the 1992 legislated Simplified Net Income Taxation System.

The rate structure was reduced to seven brackets. Personal and additional exemptions were increased and it allowed deduction of premium payments for health and/or hospital insurance from gross income.

The corporate income tax rate was reduced from 35% to 34%. Additionally, on 1 January 1999, it was reduced to 33% and on 1 January 2000 it was reduced to 32%. A minimum corporate income tax was imposed on the fourth year from the time a corporation starts its business operations. Fringe benefits granted to supervisory and managerial employees were taxed, equivalent to the applicable company income tax rate of the grossed-up monetary value of the fringe benefits.

2.5.3. 1997 Reforms in Indirect Taxation

The VAT base was broadened to include services including those rendered by professionals by RA 7716. The Expanded VAT was subjected to a Temporary Restraining Order for one year. To minimize opposition, the Improved VAT law was enacted with the following features:

- Restored the VAT exemptions for all cooperatives (agricultural, electric, credit or multi-purpose, and others provided that the share capital of each member does not exceed P15,000.
- Expanded the coverage of the term "simple processes" by including broiling and roasting, effectively narrowing the tax base for food products
- Expanded the coverage of the term 'original state' by including molasses, and
- Exempted from the VAT the following:
 - Importation of meat
 - Sale or importation of coal and natural gas in whatever form or state
 - Educational services rendered by private educational institutions duly accredited by the Commission on Higher Education (CHED)

- House and lot and other residential dwellings valued at P1 million and below, subject to adjustment using the Consumer Price Index (CPI)
- Lease of residential units with monthly rental per unit of not more than P8,000, subject to adjustment using CPI
- Sale, importation, printing or publication of books and any newspaper.

The tax on the downstream oil industry was restructured from ad valorem to specific taxation. In general, taxes on oil products were lowered and the tax on liquid petroleum gas (LPG) for cooking was set to zero.

The tax on cigarettes and liquor was restructured from ad valorem to specific. The proposed law provided for indexation to take care of inflation. Unfortunately, Congress, which was supposed to initiate the indexation process never did so.

2.5.4. Assessment of the 1997 CTRP

Congress failed to act on the proposed rationalization of fiscal incentives, arguably the best part of the 1997 CTRP. The situation was made worse by the Tenth Congress approving nine new tax laws granting incentives and increasing exemptions. As use of income tax holidays persisted, this impaired the efficiency of the tax system and reduced its buoyancy for moving forward. Studies would show several years later that tax incentives also impaired economic efficiency in other ways beyond the inefficiencies associated with income tax holiday (Reside, 2006, Medalla, 2006).

Several aspects of the 1997 CTRP were passed but not implemented such as

- The minimum corporate income tax, and
- The VAT on banks and financial intermediaries was not implemented at all. It was subsequently repealed and replaced by the Gross Receipts Tax. This did not result in serious economic damage since it was considered to be a mindless proposal in the first place.

The 1997 CTRP marginally increased the contribution of taxes on fuels, tobacco and alcohol to total taxes. It rose from 12.0 percent (from 1992-97) to 12.5 percent (from 1998 to 2003). While the effect of the 1997 CTRP on tobacco products was positive, its effects on alcohol products and fuels and oils were negative.

2.6. Fiscal Issues Faced by the Estrada (1998-2001) and Arroyo (2001-2010) Administrations

By 1998 when Joseph Estrada assumed presidency, the Philippine Government had accumulated large amounts of fiscal liabilities. The Asian financial crisis in 1997 triggered much of these contingent liabilities' conversions into actual fiscal liabilities as the discrete depreciation of the exchange rate and the ensuing contraction in aggregate demand triggered claims from public-private partnership investors whose risks were contractually assumed by government. The government quickly inventoried existing public-private partnership contracts and over time, renegotiated terms with investors, occasionally buying out some. The Estrada government did not last for long as public protests forced the president out of office during 2001.

In January 2001, then Vice President Gloria Macapagal Arroyo was swept into power when then President Joseph Estrada was extra-constitutionally ousted. The Arroyo administration increased government spending without any adjustment to tax collections. This resulted in large deficits from 2002 to 2004. After winning the 2004 presidential elections, President Arroyo realized that her administration's pattern of expenditure was not sustainable. The inadequacy of revenues led to episodes of expenditure compression, as spending was deliberately curtailed to keep budget deficits under control. Academics identified the unsustainability of the country's tenuous fiscal position and suggested tax reform as a way to address fiscal pressures (De Dios, et al, 2004).

2.6.1. 2005 Expanded Value Added Tax (E-VAT)

To prevent further undesirable effects of budget deficits, President Arroyo had to look for additional sources of revenues to sustain basic social services. This gave birth to the November 2005 E-VAT (expanded VAT) reform, RA 9337. The measure broadened the VAT base, by subjecting to VAT energy products (for sales of coal and petroleum products and electricity generation, transmission, distribution) and select professional services. It also increased the VAT tax rate from 10 to 12 percent in February 2006.

To mitigate the potential effects on the poor and on key transport prices and fares, and increase the progressivity of the reform, select exemptions from VAT were also legislated (although some exemptions were nonstandard) and some petroleum excise taxes

were reduced. In addition, 50% of the incremental VAT revenues would be earmarked for infrastructure and (targeted) social services expenditures, mostly in education and health. Furthermore, VAT minimum marginal thresholds for exemption were also increased.

The E-VAT law also changed the rules for claiming VAT credits. After passage of the E-VAT Law, firms could no longer immediately claim full credit for the VAT they paid on capital goods. Instead, claims on capital good-related credits would have to be spread over five years. Apart from this, the E-VAT law also placed a limit on the amount of claimable VAT input credits to 70% of output VAT (abolished in 2009). Both of the rule changes would have potential distortionary effects on production decisions of producers with high levels of intermediate inputs, especially capital goods (the cost of capital having effectively risen).

The E-VAT law also tweaked other tax laws. It raised the corporate income tax from 32% to 35% to be applied until 2009 and thereafter it was reduced to 30%. It also raised the gross receipts tax on select income items and eliminated income tax exemptions of many government-owned and controlled corporations.

Analysis of the effects of the E-VAT reform suggest that while the mitigating measures and the overall effects of the reform were progressive, without large adverse distributional consequences, a large amount of benefit also accrued to richer households (International Monetary Fund, 2007). This was particularly true for the cuts on excise taxes on diesel products where benefits were expected to be shared by richer households. This notwithstanding, the incremental proceeds of the VAT were spent to kick-start the government's flagship anti-poverty conditional cash transfer program, the Pantawid Pamilyang Pilipino Program (4Ps) of the Department of Social Welfare and Development.

In 2006, the first full year of implementation after the expanded VAT was passed, BIR VAT collections rose by 60.40% (NTRC, 2011). Bureau of Customs collections rose by 72.75%. By 2010, aggregate VAT collections had more than doubled pre-E-VAT VAT collections. This was despite the effects of the global financial crisis on trade- and consumption related collections in 2009. The growth in revenues also contributed to increasing the share of the VAT to total revenue collections. By 2010, VAT revenues had gone from 22.20% share to 30.25%

share. As a revenue-raising measure, the E-VAT had succeeded. Figure 1 suggests that E-VAT law changes resulted in increases in overall tax effort and reduction in the national government deficit.

Table 2. Growth Rate of VAT Collections 2006-2010

Years immediately before and during tax reform

Year	BIR	BOC	Growth rate of aggregate collections	Peso Total (in billions)
2005	9.52%	16.86%	12.63%	156.67
2006	60.40%	72.75%	65.83%	259.80
2007	2.90%	8.54%	5.48%	274.03
2008	-3.23%	21.17%	8.25%	296.65
2009	19.93%	-14.35%	1.87%	302.19
2010	2.97%	17.63%	9.46%	330.78

Source: NTRC

Although the E-VAT enabled the government to raise more tax revenue, VAT efficiency (e.g., the ratio of VAT revenue to the VAT base divided by the standard VAT rate) statistics would suggest that the post-E-VAT VAT base (consumption) commenced being compromised after 2006 because of the increasing number of legislated non-standard exemptions in subsequent years (i.e., for power transmission, for cooperatives, senior citizens purchases, etc.). Such exemptions are inconsistent with international practice, and hence, non-standard. Rough estimates of the cooperative and seniors' VAT-related tax expenditures amounted to close 0.20 percent of GDP in 2009, with the senior citizens' and cooperatives VAT exemptions being among the largest VAT-related exposures for government (Reside, 2011). While the original motivation for the E-VAT reform was to broaden the tax base, which is consistent with best practice, the additional legislated non-standard exemptions post E-VAT undermined the buoyancy of the VAT, created distortions and also led to undesirable cascading effects on tax burdens along the VAT chain as the inability to deduct input taxes down the line becomes incorporated into selling prices and cannot be recovered by taxpayers in subsequent parts of the chain.

2.6.2. Efforts to Rationalize Tax Incentives Since 2006

In 2006, the Arroyo administration recognized the need for additional reforms in the tax system beyond the 2005 E-VAT reform. This was to further fortify the government's fiscal position and sustain increases in tax effort. This led to renewed efforts to rationalize tax incentives, as previous attempts in the past had been stalled by lobbies and a lack of rational approaches for such a reform. A study by Reside (2006) argued that many of the tax incentives were redundant (i.e., investors would have invested anyway even without them) and hence inefficient. He estimated the cost of redundant income tax holidays at around 1 percent of 2004 GDP in the Bol alone, which bolstered the push for reform. The same study argued that the current incentives provision system was inefficient, that many investors were not very sensitive to them, that investors were instead more sensitive to access to markets and political and legal stability and suggested that a reasonable approach to rationalizing tax incentives would be to:

- Classify investors by primary motive and base the grant of incentives on such a system and hence emphasize the grant of tax incentives to (mostly efficiency-seeking) exporters
- Reduce, if not eliminate the role played by the Bol in providing tax incentives to domestic market-seeking non-exporters;
- Shift primarily out of non-performance-based tax incentives, such as the income tax holidays towards performance-based tax incentives such as tax credits, allowances, deductions and similar instruments (also emphasized by Medalla, 2006); and
- Enhance the role played by the Department of Finance in vetting and providing a check on tax incentives.

Senator Ralph Recto, head of the Ways and Means Committee at the Senate, introduced a Senate Bill to rationalize tax incentives, which was based on many of the suggestions of the study. Initially, the Recto Bill showed promise of passage, as deliberations on the structure of the Bill reached advanced stages. However, during the latter part of the process of pushing the Bill, provisions were also introduced which greatly undermined VAT privileges exporters had been enjoying. Recto's version of the rationalization Bill would require all exporters to pay VAT on imports first, then get reimbursed later, exposing exporters to the

government's credit risk. Persistent exporter opposition to the provision effectively led to non-passage of the Bill and rationalization stalled again.

Despite the political setback, this episode to reform tax incentives would sow the seeds for future reform. The Department of Finance (DoF), BIR and the investment promotion agencies agreed to a Memorandum of Agreement for information exchange regarding the provision of incentives. Under the Memorandum of Agreement, which commenced in 2006 and ended in 2010, the DoF would receive select detailed information regarding individual applications for investor registration at the Bol. This would allow the DoF to review some applications for Bol incentives and comment on them. The Memorandum of Agreement also required for the Investment Promotion Agencies to provide the BIR a detailed list of investors enjoying tax incentives, giving the BIR better basis for tax audits and the DoF access to more detailed taxpayer information to allow more in-depth studies regarding the incentives. The DoF also began to exert much greater effort into gathering, and analyzing information about tax expenditures from both the BIR and the Bureau of Customs. Deeper analysis of the administrative process for tax incentives and all other forms of tax relief were conducted. The effort even extended to the of analysis information about tax expenditures not related to investment (Reside, 2011). The DoF also renewed its push to exert pressure on the BIR to enforce its own ruling requiring investors benefiting from incentives to file tax returns electronically, part of a broader effort to encourage e-filing by most taxpayers. The efforts to ensure greater transparency of tax incentives and tax expenditures would bear fruit later with passage of a law in 2013 requiring vetting of the tax incentives by the economic planning department and regular publication of the tax expenditure report as part of the annual budgetary process.

2.7. The Administration of Benigno Aquino Jr (2010-2016)

By the time President Benigno Aquino, Jr. succeeded President Arroyo in 2010, tax effort was still very low by international standards. The adverse effects of the recent global financial crisis on tax collections meant that additional revenues were necessary to improve the quality of the country's infrastructure and to expand existing or develop new social service programs. However, President Benigno Aquino had promised that he would not impose new taxes so additional revenue would have to result from adjusting existing taxes.

2.7.1. 2012 Sin Tax Reform

In 2012, excise tax on liquor and cigarettes (referred to as sin taxes) was adjusted upward. The motivations for the adjustment of sin taxes were fiscal and public health and social order-related considerations. Excise taxes on these products had not been updated since the 1997 CTRP. As a result, government revenues from these products resulted in an erosion in real value over time. Furthermore, the country's tax regime for distilled spirits was at the time non-compliant with World Trade Organization rules.

The Department of Finance sought to restructure the sin taxes by addressing their structural issues.

- Removing the price classification freeze where older brands are subject to different tax rates than new ones – this encouraged consumers to shift to cheaper cigarette and alcohol brands (which did not discourage consumption);
- Migrating into a unitary tax structure by 2017;
- Leveling the playing field by removing grandfathering provisions for certain brands;
- Reducing the number of tiers of products; and
- Indexing tax rates to inflation (based on price indices for both alcoholic products and tobacco products) starting 2017, to stem the reduction in real tax burdens.

The resulting law, RA 10351, preserved allocations to and introduced safety nets for tobacco farmers, with the balance earmarked for health and split into 80% for the National Health Insurance Program (for enhancing universal health care), attainment of Millennium Development Goals and health programs and 20% for medical assistance and the health enhancement facilities program. Despite strong lobbies against it, the law updating sin taxes narrowly passed legislative approval. In its first year (as an adjustment for non indexing since 1997), the excise tax on cigarettes in the low tier alone was increased by 341%, with annual increases thereafter until 2017 ranging between 20% and 40%. The next increase of 20% in the low tier is effective January 2017. Beyond that, the stipulated annual increase of 4% is above expectations for inflation and consistent with World Bank recommendations for increases on specific excise taxes to be linked to the consumer price index. This would void the need for discrete changes to tax rates in the future.

Government revenues from alcohol and tobacco excise taxes raised significantly while at the same time simplifying tax collection. By 2015, combined excise

collections from tobacco and alcohol totaled 1.1% of GDP, with tobacco accounting for close to 80% of the total collected. The increased collections contributed to the Philippines' attainment of a credit rating upgrade (to investment grade status). Meanwhile the budget for the Department of Health tripled between 2012 and 2015 and the national government dramatically increased its allocation for free health insurance premiums for the poor, as the number of poor people enrolled in PhilHealth increased from 5.2 million to 15.4 million from 2012-2015. The sin tax reform also enabled the government to expand the coverage of the conditional cash transfer program which had been initiated by the previous Arroyo administration. However, the abrupt increase of tax rates saw the rise in popularity of low price cigarettes and increased observations of illegal cigarettes. To counter this, the Administration introduced tax stamps on cigarettes in 2014 to provide physical proof of taxpayer compliance.⁷

2.7.2. 2016 Tax Incentive Management and Transparency Act and Efforts to Enhance the Transparency of Tax Expenditures

Recognition of the need to rationalize tax incentives during the 1997 CTRP brought with it a need to also quantify government's exposure to them in more transparent manner. Earlier estimates of the cost of tax incentives, such as those of Reside (2006) relied on making many assumptions about firm profitability and the cost of investments to determine taxes that should have been paid but for the incentives because the data on individual registered investors was either kept in confidence by some agencies or simply not available from tax returns at the time. Hence, data-sharing protocols for tax incentives from 2006 – 2010 embedded in the Memorandum of Agreement between agencies were very helpful in allowing incentives policy to further be analyzed. In 2013, the move to enhance the transparency of the exposure of government to tax incentives led the BIR to redesign the income tax returns for corporations, making taxpayers claim explicitly the peso value of any tax incentives on their tax returns and state the laws that form the bases for their claims. The information available from corporate taxpayers filed under the new BIR tax returns in 2011, as well as from the new computerized database created by the Bureau of Customs pooling together information from import and export declarations enabled the DoF to finally have a clearer picture of the extent of tax expenditures, as well as their breakdown by sector, by type of taxpayer, by investment promotion agency, etc., all without

prejudicing taxpayer anonymity. The redesign of the tax forms however, introduced additional complexity in the filing process. Notwithstanding this, it was clear from this episode that efforts at computerizing records facilitated data gathering to create the tax expenditure report and sectoral analysis immensely.

Beyond the information gleaned from estimating the value of tax expenditures, it was recognized that the setting up a system to monitor tax expenditures and to provide enhanced taxpayer information from individual tax returns would be useful as a policy tool for estimating future gaps in tax collection and for micro-simulation purposes on the effects of future tax policy and as a legislative tool for allowing Congress as a means of comparing alternative means of government support (visible vs. invisible) and providing some sort of a check on their provision by institutions and their use by recipients. It could also potentially help tax administrators more effectively deal with increasingly aggressive and sophisticated forms of transfer pricing, tax arbitrage, tax planning and tax avoidance and tax incentive abuse.

The legal basis for developing a system to account for tax incentives was addressed by the passage of the Tax Incentive Management and Transparency Act (TIMTA) in 2016. The TIMTA law mandated the DoF to annually publish estimates of the country's tax expenditures, based on tax returns and which reflect the government's fiscal exposure to tax incentives and other laws seeking to exempt, eliminate, defer tax payments by taxpayers. The annual tax expenditure statement would henceforth be published as part of the annual Budget of Expenditures and Sources of Financing of the Department of Budget Management. The TIMTA also mandated the National Economic Development Authority, the country's economic planning ministry, to regularly evaluate the costs and benefits of granting tax incentives.

2.8. Lessons Learned from Tax Reform Programs in the Philippines

Tax reforms in the Philippines have always been exercises colored by both the politics and the economics of the time period. While economics has usually provided the rationale for reform, politics has often shaped the outcomes. Unfortunately, a review of recent experiences with tax reforms suggests that incoming administrations often cannot rely on previous tax reforms in order to finance new programs. Tax reforms have generally not generated sufficiently persistent increases in revenues over time for various reasons. This section identifies the

lessons drawn from the tax reform experience in the Philippines.

Based on its ability to achieve some or many of the goals of a good tax system, it would appear that the most major successful tax reform in recent Philippine history has been the 1986 TRP. The 1997 CTRP fell short of generating sufficient revenues over time and failed to rationalize tax incentives. Other reforms had relatively lesser and varying degrees of success. This includes the opportunities to update existing taxes, such as the broadening of the VAT in 2005 and the indexation of sin taxes in 2012.

The common aspects of successful tax reforms in the Philippines from the Marcos era to the present include the following:

- To ensure the best outcomes, tax reform should be done at the start, instead of towards the end, of any administration. With a fresh mandate from the voters, bolder rather than watered-down versions of the reform bills have a higher probability of being approved by Congress. The implication for the new administration is that it should be ready with a core of tax reform proposals within months of its assumption to office. The experience with the reforms in the last few decades is that they are predictable. Every administration will require at least one structural change to the tax system to generate revenues because past reforms often lack buoyancy and new and envisioned programs often require incremental tax financing as the country continues to reduce its debt stock and upgrade or maintain its investment grade credit rating.
- The economics of tax reform can also be correlated with the politics. The stronger the political positions of the personalities involved, the more likely have been for tax reforms in the past to be more efficient and equitable. Conversely, weaker administrations have allowed more nonstandard revenue-eroding measures to pass legislation as has been true for many of the recent VAT-related exemptions. This has led to distortions in the VAT system as well as inequities in other taxes.
- Strong support from the president and top executives in the cabinet and the legislature is a critical component of any tax reform.
- The probability of success of a tax reform program is enhanced if it is presented as a critical component of a comprehensive public sector reform program. This includes using the

incrementally generated revenues for expansion of social programs and critical infrastructure.

- Reform will be more effective with a reduction, if not offsetting of external influence on reforms by organized lobby groups whose positions are inconsistent with best global practice or first principles. Lobbies have tended to undermine all or portions of past reforms. Future tax reforms will benefit from more effective organization and more sophisticated use of media and civil society to build alliances to push for the correct reforms to be legislated.
- Future tax reforms will have to rely on more creative and refined development of approaches to and conceptualization of the process and sequencing of reform, with the rationale for and aspects of reform carefully vetted by experts.
- To ensure greater buoyancy and efficiency of the tax system and to ensure the reliability and adequacy of the flows of government financing over the long run, future reforms must be designed to include provisions for annual indexation for inflation (especially for excise taxes). Also, nonstandard exemptions (from direct taxation and the VAT system) and incentives should be minimized or avoided. This again enhances buoyancy of the tax system.
- Reforms must be backed up with concomitant enhancement of and support from tax administration to provide education to the taxpayer community on changes in tax laws, implementing cultural/behavior changes within government and the taxpayer community that will result in good voluntary compliance and improving technologies for supporting taxpayers and addressing poor or deliberate compliance.

- It is important to legislators to codify all laws that lead to tax expenditures to enhance transparency and to continue to provide for competent bodies to vet new proposals for and review the outcomes of current tax laws on a regular basis, to set end dates for laws providing tax exemptions and incentives (to force congress to vet updates on such laws).

The shortcomings of some of the past tax reforms owe as much to political considerations as they do to the failings of tax administration. But where tax administration has been strong and the leadership stable, it has complemented reform.

The time path of past tax reforms has not been smooth and often been discrete. Congressional neglect and inertia in the Philippines has often led to the postponement of adjustments to important tax rates, leading to the buildup of fiscal pressures over time, even at the expense of hindering the country's competitiveness. Hence, the tax system often undergoes large discrete changes, and only when there is the political will to do so. Legislation should be more responsive and timely in the future, without waiting for fiscal emergencies before acting on them.

Appendix A

Year	Tax	Reform or Significant Law or Event
1981	Tax Incentives	Tax and duty-free import privileges replaced by tax credits based on value-added earned and net local content on exports
1984	Tax Incentives	Tax exemptions enjoyed by government corporations and private firms abolished
1986	General	Tax Reform Program (TRP) enacted; dual tax schedules for individual taxpayers adopted with 35% as the top marginal rate; dual corporate rate was also unified at 35%
1986	General	Many duties on imports (e.g., oil) phased out
1986	Executive Order (EO) 226 Omnibus Investments Code	Provides the rules by which foreign investments in the Philippines may avail of incentives.
1988	VAT	VAT Law introduced; VAT rate set at 10%
1990	BOT Law	
1991	RA 7042 Foreign Investments Act	Governs the entry of foreign investments without incentives decreasing the minimum paid-in equity from Five Hundred Thousand dollars (US\$500,000.00) to Two Hundred Thousand dollars (US\$200,000).
1992	RA 7227 Bases Conversion Development Act	Provides for incentives to enterprises located within the Subic Bay Freeport Zone.
1994	RA 7844 Export Development Act	Provides for incentives to enterprises in export business.
1994	VAT	Restructured VAT Law to broaden the VAT base
1995	RA 7903 Zamboanga City Special Economic Zone (CSEZ)	Provides for incentives to enterprises located within the Special Economic Zones.
1995	RA 7916 PEZA Law	Provides for incentives to enterprises located within the Special Economic Zones.
1995	RA 7917 Amendment to Bases Conversion and Development Act	
1995	RA 7918 Amendments to Omnibus Investments Code	Provides for incentives to enterprises located within the Special Economic Zones.
1995	RA 7922 Cagayan SEZ	Provides for incentives to enterprises located within the Special Economic Zones.
1995	RA 7888 Amendment to Omnibus Investments Code	Allows the President of the Philippines to suspend the nationality requirements under the Omnibus investments Code in the case of equity investments by multilateral financial institutions such as the International Finance Corporation and the Asian Development bank.
1996	VAT	VAT exemptions introduced

1996	RA 8179 Amendment to Foreign Investments Act	
1997	NIRC (Net Operating Loss Carryover)	
1998	PIT	CTRP set PIT tax brackets; top marginal tax rate set at 34%
1998	Downstream Oil Industry Deregulation Act	
1999	PIT, CIT	Top marginal tax rate set at 33%
1999	RA 8748 Amendment to PEZA Law	
2000	PIT, CIT	Top marginal tax rate set at 32%
2004	E.O. 313 signed	Exempts BOI-registered firms from paying taxes and duties on imported raw materials and capital goods
2005	VAT	Reformed VAT (RVAT) Law expanded the VAT base and raised the VAT rate from 10% to 12%; this reform helped generate an additional 1.5% in revenues
2005	CIT	CIT rate raised to 35%
2006	Administration	MOA between DoF/BIR and BOI
2006	E.O. 528	Extended and amended the effectivity of EO 313
2007	Republic Act No. 9490	The Aurora Special Economic Zone Act of 2007
2008	PIT	Minimum wage earners exempted from PIT
2012	VAT	Sales of residential lots valued below 1,919,500 exempt from VAT
2012	VAT	Sales of houses and lots valued below 3,200,000 exempt from VAT
2012	Excise	Sin taxes indexed
2014	VAT	VAT threshold 1,919,500 gross sales not required to register for VAT
2015	Administration	Tax Incentive Management and Transparency Act passed by Congress
2016	PIT	Personal Income Tax free bonus threshold increased from 30K to 82K

Section 3. Recommendations

Tax reform is most effective when it is founded on a clear understanding of the first principles of the economics of taxation. As a prerequisite to crafting tax policy, this includes keeping in mind the traits of a good tax system of equity (fairness), efficiency, simplicity, flexibility that should be designed to limit tax evasion, and avoidance (as detailed in [Section 1](#)) and identifying the incidence of proposed measures, market failures, and public and merit goods, as well as the circumstances that justify and guide government interventions in markets. This also includes the use of empirical methods and evidence-based estimation and analysis of the potential impacts of proposed changes in tax policy on society, which should be the basis for crafting tax reform.

1. Personal Income Taxes (PIT)

- Taking account of the personal exemption as the equivalent of a zero rate, there are 8 brackets in the marginal rate scale. Consistent with international norms, the existing brackets for PIT should be rationalized, with no more than 3 rates in addition to the personal exemption.
- A program for regular review of the marginal rate structure should be implemented to limit the impact of bracket creep. The period of review depends on inflation levels, but could be undertaken every 3 years.
- Align existing top marginal PIT rate of 32% with the corporate rate so as to limit the impact of tax planning through personal income companies. The other brackets adjusted accordingly. The reduction in marginal rates is to be financed by the base broadening measures in (4) and (5) below, an increase in the tax on petroleum fuels, a tax on diesel fuel and the fiscal dividend from improved administration discussed below. It is important to prepare modeling and costings to ensure that any revised tax free threshold and reductions in marginal rates are affordable.
- As it is not consistent with global standard tax treatment, remove exemptions from fringe benefits tax (FBT) for rank and file employees. This would counter planning that converts the remuneration of rank and file employees from cash salary to benefits in kind. Instead, compensation of rank and file employees should be subject to income taxes. Equity concerns can

be addressed through the progressive income tax which includes the tax-free threshold. This ensures that vertical and horizontal equity is maintained among rank and file employees.

- Full taxation of capital gains on disposal of shares in resident companies. This aligns with the recommendation in the “property taxes” section below for taxation of dividends otherwise there would be an incentive to realize the profits in a company through sale of shares rather than dividends. This will provide greater equity as the current concessionary treatment of dividends and capital gains is likely to mainly benefit high income earners.
- Introduce a simplified tax system for small business and align with changes in the VAT registration threshold recommended in the “value added taxes” section below. Under the simplified system, those taxpayers that are below the VAT registration threshold (micro businesses) may be subject to either a flat amount of tax payable annually or a turnover based tax (say 2% of turnover). Those taxpayers who are registered for VAT but with an annual turnover below PHP15 million are subject to cash accounting (same for VAT) and outright deduction of the cost of capital assets.

2. Corporate Income Taxes (CIT)

- Reduce the CIT rate from 30% to 25% to better align with the CIT rate in neighboring countries and enhance the country’s investment competitiveness. As with personal income tax cuts, it is important to prepare modeling and costings to ensure that any reduction in the corporate tax rate is affordable.
- Greater alignment of the CIT base with financial accounting profit determined under IFRS. This will reduce compliance and administrative costs, and ensure full recognition of capital expenditure by companies.
- Introduce tax-free reorganizations and loss transfers within wholly owned corporate groups.
- In line with best global practice of base-broadening, rationalize tax incentives, improve the process of industry and firm-level selection

for incentives, introduce or intensify the use of economic criteria for granting tax incentives (e.g., reducing redundancy and addressing market failures). Impose greater checks and balances on their provision and administration. Provide DoF, NEDA and DBM with greater roles to play in investment promotion agency decision-making. Broadening their roles in incentives provision is consistent with global best practice.

- Tax law should clarify the distinction between non-profit organizations (subject to a 10% income tax rate) and non-stock, non-profit charitable institutions (exempt from income tax). To ensure that exemptions are properly targeted, the tax treatment of such organizations should be reviewed and the government should consider granting income tax exemptions only to those charitable institutions registered with the Philippine Council on NGO Certification (PCNC), a service organization whose main function is to certify non-profit organizations that meet established minimum criteria for financial management and accountability in the service to underprivileged Filipinos. In particular, introduce taxation of the business or other income that is beyond the core purpose of the non-profit organizations. This will prevent abuse through disguising real business activity through the use of a non-profit organization. Also, it ensures equitable treatment of all those conducting the same business activity. The BIR must enhance audits for this sector which is very much unmonitored and subject to less oversight from authorities. The BIR must expand the scope for regular review of such corporations and impose penalties for deliberate non-compliance.
- Implement performance-based tax incentives based on tax deductions, tax credits and allowances rather than current dependence on income tax exemptions and income tax holidays, which reduce the buoyancy of the tax system and potentially lead to greater complexity and abuse in the tax system.
- Abolish the system of two income tax bases used to calculate taxable income: gross income earned (GIE) for exporters and net income for non-exporters and other regular taxpayers. Instead, all corporate taxpayers should be taxed on basis of taxable income. Exporters could be given a lower preferential rate on net taxable income. Withholding taxes (apart from non-resident withholding taxes) paid on business income should be non-final and creditable against the tax payable on net taxable income. This will eliminate the arbitrages that exist with final withholding on some items of business income through the payer being allowed a deduction for the payment at the corporate rate but the payee being taxed on the payment at the lower withholding tax.
- The current system of using GIE as the exporter tax base is also very generous (the tax rate on GIE is 5%) and is perpetual, since there are no sunset clauses. Hence, if recommendation (7) is not accepted the GIE rate should be raised. Furthermore, tax administrators should improve monitoring of the sector to prevent abuse of conditions for gaining eligibility for exporter tax preferences.
- All forms of preferential treatment should have a definitive sunset period, to allow for review of performance of laws and programs.
- All proposed changes affecting registered export locators currently operating in special economic zones overseen by the Philippine Economic Zone Authority (PEZA), should be subjected to a careful review in consideration of existing agreements between the government and the investors so as not to unfairly prejudice the latter. Alternatively, existing locators could be grandfathered under the new law, so that only new locators coming in after the passage of the new law would be covered by changes.
- Implement international tax reforms recommended in the Final Reports on the Base Erosion and Profit Shifting (BEPS) Actions, particularly in relation to tax arbitrage, limitation on the use of tax havens, thin capitalization, treaty shopping, permanent establishment definition, transfer pricing in relation to intangibles, and transfer pricing record keeping. This will limit the opportunity for MNEs to extract profits from the Philippines with little or no Philippines tax.

3. Value-Added Taxes

- While 12% VAT rate is not high by international standards, it is high by ASEAN standards where VAT rates are generally in the 7% - 10% range and, therefore, the VAT rate should not be increased. Rather, expand the base for the levying of VAT by reducing exemptions as recommended below.
- In line with base-broadening, repeal VAT exemptions for senior citizens and many other special laws (cooperatives, low-cost and socialized housing which legislate VAT tax expenditures not consistent with global standards or best practice). Other modalities are already in place to direct social assistance to these groups. Impact of expanding the VAT base will be offset by PIT cuts.
- Repeal exempt supply treatment for supplies of any intermediate goods and services as this can lead to cascading of tax as well as potentially significant revenue losses.
- Investigate the expansion of the VAT base to include financial services (at least when an explicit fee is charged) and gambling services. As gambling is regarded solely as a recreational activity, gamblers will not be allowed input tax credits and, therefore, the VAT can be collected on a periodic net margin basis. This will go some way to rationalizing the many gross receipts taxes currently imposed in the Philippines.
- Increase the VAT threshold to PHP3 million, as the current threshold is low by international standards. This ensures that micro businesses are not registered for VAT and aligns with the recommendation in the “personal income taxes” section above for the income taxation of micro businesses. The VAT registration threshold should be regularly reviewed (say every three years) to take account of inflation.
- Implement the BEPS Action 1 recommendations for taxation of imported services and digital products, particularly facilitating electronic registration and compliance by leading suppliers of digital products.
- The absence of a credible refund mechanism for VAT has led to nonstandard VAT policy with leakages. In principle, standard VAT zero-rating of exporters allows them to claim input VAT, but lacking such a refund mechanism, the government zero-rates their input suppliers (nonstandard

policy which leads to revenue losses). Although some legal remedies have been implemented in recent years to monetize refund-related claims, the government should continue to address persistent concerns and problems faced by enterprises entitled to claim VAT refunds, such as zero-rated enterprises claiming input VAT. Not doing so erodes the credibility of the legal system and the investment climate.

- Align the imposition of VAT of sale of services from that based on cash receipts to that based on the accrual method. This will be consistent with the general method of recognizing revenues for income tax purposes and also similar to the method for imposing VAT on sale of goods. In the process, the complications arising from the compliance by taxpayers and enforcement of the BIR that are being encountered under the present method will be avoided.

4. Excise Taxes

- Introduce annual indexation of all specific excises for inflation.
- Restore excise taxes on diesel and selected fuel products, such as LPG.
- Increase excise taxes on other fuel products.
- Strengthen tax administration for excise tax collections and publish collections by taxpayer to ensure compliance.
- Institute sophisticated fuel marking programs to control illegal fuel products.
- Enhance efforts to control smuggling of alcohol, tobacco and fuel products. This should include strategic enforcement at ports and in the marketplace together with increased monitoring of raw material imports and declared import prices.
- Impose user fees for motor vehicles with due consideration for desired effects on road congestion, fuel efficiency and air quality.
- Any proposals to extend excise taxes beyond the standard excisable goods must be based on clear evidence of the negative externality that the tax is correcting and absence of highly substitutable products. If the externality is identified, then furthermore, the tax must be imposed in a way that limits distortions in the market place.

5. Property Taxes

- Adopt a unified national tax on property and update and adopt uniform standards for determining zonal values on properties.
- Mandate the regular update at specified intervals of the zonal values to ensure that current values are being used for taxation purposes.
- Levy positive transfer taxes at sustainable levels calibrated to ensure efficiency and equitable tax treatment across modes of transfer.
- To enhance efficiency yet retain equity in the transfer system, reduce the highest marginal tax rates for the estate tax from the current 20% to 6% and the donor's tax from the current 15% to 6%, to equal the capital gains tax that is imposed on transfers of properties between buyers and sellers. The government should keep the progressive nature of these taxes by raising the tax-free threshold and simplifying the tax by reducing the number of brackets. Consistent with the literature, gifts to people considered legally as minors should be taxed less.
- Tax-free thresholds for transfer taxes should be subject to regular review. The process of settling estates of the deceased and taxes on donations should be simplified. However, tax administration must be strengthened to guard against undue arbitrage and abuse (for example against violations of standard inurement and benefit legal principles applicable to donations (see next section below)).
- In time, a deeper analysis of the need to further differentiate tax treatment across bequest and donor motives should be made (balancing the costs of introducing additional complexities into the tax system and the enhanced efficiencies of such differentiation).

Taxes related to transfer of properties are levied at different levels of government. These include estate taxes, donor's taxes, transfer taxes and capital gains taxes, among others. These taxes all benefit from having a reliable tax base from which computations of tax liabilities are made. Hence, a fundamental reform of property taxation involves mandating that zonal values be regularly updated at specified intervals to ensure that current values are being used for taxation purposes and ensure greater buoyancy of property

taxes and especially capital gains taxes on property. From an efficiency standpoint, it is fundamental that taxes related to transfers should not be prohibitive as to discourage actual transfer or to encourage avoidance and evasion.

In recent years, several laws have been introduced in Congress that seek to adopt a uniform method for determining zonal values on properties that is administratively feasible given current technology. In light of the potential for a national tax on property to generate revenues and also be progressive, the government should revisit such laws and finally legislate such a system, paving the way for a national tax on property.

The economic literature providing normative guidance on transfer taxes is sparse, yet provides some guidance on the design of such taxes, some of which runs counter to the unpopularity of such taxes.

The efficiency of taxing bequests depends on the nature (unplanned versus planned) and motive underlying planned bequests (purely altruistic, paternalistic or strategic). However, it is likely that bequests in reality will be motivated by a mix of such factors. Hence, the optimal transfer tax should not be equal to zero. The literature suggests taxing unplanned bequests and purely altruistic planned bequests at higher rates, as doing so will not necessarily affect the pattern of life cycle savings. Inter vivos gifts (made between the living) and in particular, gifts made to children or young donees, should be taxed at lower rates (Cremer, 2007, Cremer and Pestieau, 2009).

With the above guidance in mind, the government should levy positive transfer taxes at sustainable levels that consider the differences between bequest types.

Also, the government should reduce the highest marginal tax rate for the estate tax from the current 20% to 6%, to equal the capital gains tax that is imposed on transfers of properties between buyers and sellers. This would encourage greater frequency of transfers from the deceased to heirs and perhaps also less evasion and avoidance, enhancing the efficiency of the tax system. The government should keep the progressive nature of the estate tax by raising the tax-free threshold and simplify the tax by reducing the number of brackets. Thresholds should be subject to regular review. The process of settling estates of the deceased should be simplified.

6. Taxes on Financial Instruments

- Eliminate the distortions that arise when savings instruments with similar attributes are taxed at differential rates e.g., government securities, mutual funds comprised of the same securities and ordinary bank deposits.
- For dividend income, where company tax is paid on profits of a company then a withholding tax of, say, 10% should be levied on the dividend paid to individuals by the company.

7. Bank Secrecy Provisions

- BIR to have full and free access to bank records for the purpose of administration of tax laws – retrospective and prospective. This will align the Philippines with most other economies.
- Misuse by a BIR officer of access to bank records for administration of tax laws to be a criminal offense.
- Give taxpayers an opportunity to voluntarily disclose income and bank account information without penalty before the BIR secures access to bank records.
- Every interest or dividend payment must be assigned to an account holder's Taxpayer Identification Number (TIN) and reported to the BIR. If no Taxpayer Identification Number (TIN) is assigned, then tax should be deducted at the time of payment of the interest or dividend at the CIT rate or highest marginal PIT rate. Interest and dividend payments to be electronically reported to the BIR.
- The above recommendations to dispense with bank secrecy for administration of tax laws will make a considerable contribution to revenue and is recommended for full implementation. Alternatively, there could be a phased implementation period.
- Every interest or dividend payment must be assigned to an account holder's Taxpayer Identification Number (TIN) and reported to the BIR. If no Taxpayer Identification Number (TIN) is assigned then tax should be deducted at the time of payment of the interest or dividend at the CIT rate or highest marginal PIT rate. Interest and dividend payments to be electronically reported to the BIR.

- The above recommendations to dispense with bank secrecy for administration of tax laws will make a considerable contribution to revenue and is recommended for full implementation. Alternatively, there could be a phased implementation period.

8. Legislation Giving Rise to Tax Expenditures

All subsequent legislation granting tax incentives and/or leading to tax expenditures should be codified (i.e., made part of the tax code), in order to facilitate reference and analysis.

9. Sequencing and Credibility of Tax Reforms

- To maximize the chances of reforms succeeding, every effort must be exerted to encourage top officials, including and especially the President, to buy into the reform process. The effort can also benefit from positive use of media, non-government organizations and building of alliances across agencies of the type cited in section 2.
- Consistent with global best practice, pursue tax rate reductions concurrently with base-broadening measures and not the former followed by the latter, as political pressures often delay or undermine the latter, which weakens or stops the overall reform effort. A phased process of reform with elements of rate reductions and base-broadening in each phase should be designed to reduce and manage sources of delay and opposition.

10. Administration of Tax Laws and the Process of Formulation of Tax Policy

The BIR needs to significantly improve its administration of the tax system and the DoF and its allied institutions need to improve the process of formulating tax policy. The following appendix includes recommendations for improvements along those lines and strengthens/augments tax reforms. They may be implemented without need for legislation.

Addendum: Recommendations for Improvements of Administration of the Tax System

1. Ethics

The BIR should strive for high ethical standards and prevent opportunistic behavior. The BIR should be open and transparent in its tax administration processes, support and educate taxpayers to want to voluntarily comply and effectively deal with tax evasion and avoidance.

Areas where ethical indiscretions should be addressed include the tax audit and assessment processes, the rule making procedures and the inspection of establishments. The enhancements that can be made are clarification of the burden of evidence and proof on assessment issues, instituting an administrative tax dispute resolution system, adopting an effective Whistleblower program in collaboration with private tax advocacy groups, instituting a post tax audit oversight review process, prescribing clearer and more detailed rules and procedures, putting in place an industry benchmarking process to pinpoint levels of tax compliance and for audit selection.

The BIR needs to review the effectiveness of the attrition law to prevent situations where tax auditors prioritize revenue generation (to meet their targets) over ensuring that taxpayers are compliant.

2. Tax Expenditures

- Enhance the Tax Expenditure Statement as published by the Department of Budget Management in its annual Budget of Expenditures and Sources of Financing by including VAT-related tax expenditures. Make it standard practice to require an estimate of the extent of potential tax expenditures and fiscal risk associated with each new law being introduced or being considered, as well as potential costs and benefits of alternative means of financing social benefits.
- A transparent tax system should allow the public to assess whether taxes collected and earmarked for particular causes are properly utilized and accounted for.

3. Tax Incentives

- Implement proper processes for analyzing and reviewing tax incentives and tax expenditures to enhance their targeting and efficiency. This should involve:
 - (i) clear policies for identifying the market failures or industry polices that tax incentives are intended to address; and
 - (ii) implementation of processes for regular review of incentives to determine whether they have been successful in achieving their goals.
- Review current policy on identifying appropriate merit goods, and whether they are best delivered through the tax system.
- To improve screening of taxpayers applying for exemptions, implementing agencies should refine administrative rules to prevent up-front, needless and outright grant of income tax benefits without subjecting taxpayers to more rigorous performance tests.

4. Non-Stock, Non-Profit Organizations and Other Special Laws

- When dealing/auditing non-stock, non-profit corporations and other taxable institutions eligible for exemptions, revenue collection officers are also encouraged not to presume tax exemption of institutions at the outset.
- To prevent abuse, the BIR should implement a regular program for audit of foundations, non-profit organizations (including church-related organizations) and cooperatives, and revoke licenses for violators and non-reporters. Hence, it should incorporate into its annual audit program:
 - (i) a clear definition of public benefit;
 - (ii) avoidance of private inurement;
 - (iii) penalties for excess benefit; and
 - (iv) taxation of unrelated business income.

- In the medium term, the BIR, SEC, BOC and other implementing institutions should enhance their minimum annual reporting and disclosure requirements. While gaps in auditing must be addressed, regular disclosure requirements from taxpayers also need to be improved. The BIR needs to have a better idea of, for example, whether nonprofit corporate taxpayers fulfill their primary mission, so more concrete and timely information has to be culled from taxpayers themselves regarding their activities. This entails requiring all exempt institutions to e-file and considering the enhancement of BIR forms (annual information report and/or ITR – and drafting clearer guidelines for submission of these) and timely submission of minutes of meetings or else risk losing their tax-exempt privileges.
- The government should consider long-run reform of architecture of the sectors benefiting from tax expenditures, such as establishing a commission similar to the UK’s Charity Commission, to regulate nonprofits. But given its issues with all other institutions granting tax expenditures, such as investment-related tax incentives, the DoF should consider a larger institution to oversee all institutions receiving tax benefits. The DoF should amend the cooperatives law to put in place stronger incentives for patronage and genuinely collective decision-making in cooperatives. Meanwhile, the Cooperative Development Authority (CDA) should immediately allow cooperatives to be audited for tax purposes and should improve reporting forms, creating the same level of transparency expected of nonprofits.
- The BIR, BOC, SEC and DoF should establish a working group to establish a viable taxpayer data and information transparency policy. Development of protocols for proper and ethical tax data sharing across agencies, without undermining the anonymity of taxpayers should pave the way for improved and more granular analysis of the tax system.
- Once systems are in place for collecting and processing better taxpayer information, the government should ease taxpayer compliance and improve risk profiling by developing criteria for classifying taxpayers, taking care to identify those taxpayers that are well- (and not well-) behaved. Once taxpayers are better profiled, implementing institutions can adopt the practice seen in other countries of classifying taxpayers by criteria such as asset size and number of donors (or members or patrons) then base compliance and audit rules on these criteria. Implementing institutions, such as the BIR, may also classify by type, for example:
 - Independent or public charities (less risk)
 - Corporate or private foundations (more risk)
 - Political organizations (more risk)
 - Religious organizations (less risk)
 - Private schools, hospitals, NGOs (develop criteria)
 - Trade associations and social clubs (develop criteria)
- Implementing agencies must introduce risk-based and performance-based criteria in claiming tax benefits and charge risk-based (higher/nonzero) user fees for beefing up regulatory capacity at point of registration and renewal of licenses. They should also enforce automatic revocation of exemption and other benefits for failing to satisfy reporting requirements and for engaging in criminal activity and enforce automatic suspension of operations upon suspicion of use in money laundering.
- To tighten tax administration efforts, effective administrative data gathering mechanisms must be established or enhanced to check taxpayer compliance, curb illicit trade and tax evasion, as well as plug tax leakages.

5. Information Technology

- The government should further enhance transparency by:
 - Investing in good information technology (IT) systems and good field information collecting systems in implementing, screening and monitoring agencies.
 - Immediately setting up information sharing protocols among institutions possessing and requiring data on tax expenditures and eliminating inter- and intra-agency frictions in the flow of data regarding taxpayers and tax expenditures.

- The furnishing of a Taxpayer Identification Number (TIN) by all parties transacting with government must be mandated. The use of this universal TIN will be able to capture in the taxable net a significant amount of transactions of taxpayers dealing with government.

6. Designing Safety Nets in Lieu of Granting Special Tax Treatment

- Since efficiency and equity are important criteria of taxation, it follows that the notion of means testing should be incorporated as much as possible in the design of tax laws and administrative procedures. Means testing is a further check and containment against the costs of potential mis-targeting of benefits. For this purpose, future tax laws may wish to consider means-testing mechanisms currently being employed by the Department of Social Welfare and Development for their subsidy programs.
- To protect entitlements and to provide safety nets for poorer seniors and other special groups (e.g., persons with disabilities), the government should consider increasing the scope of pension and health coverage. Such efforts could have positive spillovers as they may facilitate the conversion of informal businesses into formal business and increase business compliance with formal pension and health contributions and ultimately also broaden the tax base.

7. Electronic Transactions

- Legislatively mandate electronic filing (e-filing) of tax returns for all large taxpayers (using the VAT registration threshold as the test of a large taxpayer) and enforce penalties on those who insist on manual filing. This ensures that e-filing has the intended effect of reducing administration costs.
- Implement electronic payments direct into the BIR bank account. Besides reducing compliance and administrative costs, it also reduces opportunities for corruption and lost tax payments that could occur under a manual system.

8. Excise

- Strengthen tax administration for excise tax collections and publish collections by taxpayer to ensure compliance.
- Institute sophisticated fuel marking programs to control illegal fuel products.
- Enhance efforts to control smuggling of alcohol, tobacco and fuel products. This should include strategic enforcement at ports and in the marketplace together with increased monitoring of raw material imports and declared import prices.

9. Tax Amnesties

Do not rely on tax amnesties as these can have the effect of increasing non-compliance as compliant taxpayers will decide to be non-compliant and wait for the next amnesty.

10. Partnerships with Industry and Business Groups and Government Regulators

- Establish partnerships with industry and business groups to encourage “community” or industry based tax compliance and payments.
- Enhance the collaboration and information sharing between the various regulators, including the Bureau of Customs, the local government tax collecting units, the Securities Exchange Commission, the Board of Accountancy, the Bangko Sentral ng Pilipinas, and the various license or permit granting government offices. These government offices are responsible for regulating their constituents who or which are engaged in doing business and hence are expected to be registered with the BIR and reporting the appropriate tax returns.

Section 4. ASEAN Tax Rates

Country	Standard Corporate Income Tax Rate	Top Personal Income Tax Rate	Indirect Tax (i.e. VAT/GST) Standard Rate
Brunei Darussalam	18.5 percent	--	--
Cambodia	20 percent	20 percent	10 percent
Indonesia	25 percent	30 percent	10 percent
Laos	24 percent	24 percent	10 percent
Malaysia	24 percent	26 percent	6 percent
Myanmar	25 percent	25 percent	Commercial Tax rate. On April 1, 2016, Myanmar passed the Union Tax Law to introduce a Special Goods Tax
Philippines	30 percent	32 percent	12 percent
Singapore	17 percent	22 percent	7 percent
Thailand	20 percent	30 percent	10 percent, although a reduced 7 percent rate applies to 30 September 2016
Vietnam	20 percent	35 percent	10 percent

Endnotes

¹Asprey Committee, at para 3.24

²For example, sunscreens may be exempt from consumption tax for medical reasons. This requires the tax administration to police the border between sunscreens and other products. Further, it may encourage taxpayers to engage in tax planning by including sunscreens in other products, such as make-up, creating uncertainty as to whether the product is taxable as make-up or exempt as a sunscreen.

³For example, if bread is exempt or subject to a lower tax rate as a basic foodstuff and confectionary is fully taxable, then is a bread roll with icing on top basic foodstuff or confectionary?

⁴These Executive Orders were: EO 924 (November 1983), EO 928 (December 1983), EO 947 (June 1984)

⁵This paragraph is based on the narrative in Fabella and Chua ().

⁶In the *World Bank Economics of Tobacco Toolkit*, it was suggested that “[s]pecific taxes should be automatically adjusted by reference to the consumer price index (CPI) to keep pace with inflation. It is critical that the adjustment be automatic—by administrative order—and not require a decision of an executive agency or approval of a legislative body. Countries may suspend automatic adjustments in periods of high inflation.” (Ayda Yurekli and Joy de Beyer, *World Bank Economics of Tobacco Toolkit, Toll 4: Design and Administration*, p. 27),

⁷Quimbo, Stella, “Does Taxing Sin Deliver us from Disease: An Initial Assessment of the Health Impact of Sin Taxes in the Philippines.”

⁸BIR Revenue Regulations Nos. 7-2014 and 9-2014.

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