

Gearing Tax Policy and Tax Administration for the Year 2000

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Tax revenue growth in the Philippines has been stymied by structural, organizational and behavioral problems, for example, incoherent and complicated tax structure, inefficient tax collection, graft and corruption, poor tax compliance, and others. To support the attainment of an economically developed Philippines in the year 2000, the author proposes putting in place a broad but simple and efficient tax system that features the following reforms: simplification of tax structure, systematization of operational procedures, and cleansing of the administrative machinery to imbue it with a high level of competence, integrity and morale.

One of the root causes of many economic problems of the country is the inability of government to raise adequate revenues. This has resulted to recurrent budgetary deficits and the failure of government to provide adequate services to its constituents. From the 70s to 1992, expenditures outpaced revenues. From 1975 to 1992, expenditures grew at 18.98 percent annually while revenues lagged behind with an average growth rate of 15.17 percent. The pattern was worse in 1986-1992 with expenditures growing at 29.12 percent while revenues lagged behind with an average growth rate of 17.96 percent.

The inability of revenues to keep pace with the growing requirements of government is evident from its relatively low tax effort or the ratio of tax collection to GNP (Gross National Product). From a 12 percent ratio in 1975, tax effort decelerated starting 1976 to a low of 9.5 percent in 1984. The introduction of the 1986 tax reform package resuscitated the revenue performance of government and signalled the introduction of structural reforms in the tax system. The tax effort since then has inched upwards reaching the 15.2 percent level in 1992. Although efforts of government to improve tax collection had boosted the revenue performance, it should also be mentioned that exigency measures, such as the imposition of an oil and an import levy, had pushed the tax effort ratio. Should the proceeds from the oil levy were netted out from the tax effort in 1992, it would only be 13.8 percent. This is even lower than the 14 percent tax effort in 1990. It cannot be said therefore that the tax performance of government has greatly improved.

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The tax effort of the country does not also match those of similarly situated countries in Asia and which have managed to make a great leap forward. In 1990, the tax to GNP ratio in Thailand is 18.8 percent; Malaysia, 16.4 percent (1989); Korea, 16.4 percent and Indonesia, 15.9 percent (1989). The 1990 figure for the Philippines is only 14.0 percent.

The factors which have inhibited the growth of revenues are fairly straightforward:

(1) *The potential of the income tax as a revenue-raiser has been stymied by the erosion of the tax base.* This has been brought about by the increase in the number of firms which have been exempt from taxation through tax incentive laws and the problems of tax avoidance and evasion. The amount of foregone revenues from exemption laws was estimated at ₱27.4 billion in 1992 (Department of Finance Staff Estimates). The pioneer study on tax evasion which we did in 1987 estimated individual income tax evasion at 62 percent. More recent studies suggest that the evasion rate in 1991 (Yoingco 1987) had gone up to 66.0 percent (Manasan 1993).

(2) *The income tax has also been made unproductive through abuses in deductions.* Deductions eat a substantial chunk of the tax base, i.e., as much as 93 percent of gross incomes of individual taxpayers, and 90 percent of corporate gross incomes, leaving very little income for government to tax (Yoingco 1985).

(3) *The regressiveness of the tax system also impacts negatively on the revenue mobilization efforts of government.* Indirect taxes which contributed about 57 percent to total tax revenues of government in 1990 are borne heavily by the poor. The poorest families bear the same tax burden as the highest income families. Despite the great variance in their incomes, they paid 11.83 percent of their household income as indirect taxes in 1990 (Yoingco, Guevara and Gracia 1992). Such inequity is indicative of the failure of government to effectively tax the consumption expenditures of the affluent.

(4) *The income tax which is supposed to account for the progressivity of the tax system is also inequitable* (Yoingco, Guevara and Gracia 1992). Taxpayers who are similarly situated bear different tax burdens with the wage earners on the losing end. Their effective tax rate (i.e., tax paid relative to taxable income) is 5.45 percent of their incomes relative to a minimal 0.74 percent for the self-employed.

(5) *The VAT (Value-Added Tax) which is a major revenue raiser for government also suffers from problems in structure and collection.* Although it raised ₱32.4 billion in 1992, its potential revenue was estimated at ₱63.8 billion (Department of Finance Staff Estimate). This places actual VAT collection at only 50 percent of the potential tax base.

(6) *The tax system has also become a maze of exemptions, and varied rates and bases, that it has become incoherent and complicated to nurture efficient tax administration and compliance.* Distortions in resource allocation and pricing have also been effected by our tax system with the problems and abuses in cigarette taxation as the best examples.

(7) *Like an often repeated refrain from an old song, tax administration is inefficient and the problems of graft and corruption have yet to be adequately addressed.* Our 1987 study revealed strong apathy of the taxpayers towards tax examiners. Respondents strongly felt that "there is a lot of dishonesty, corruption and bribery in the BIR." They also opined that "many tax functionaries enrich themselves in office" (Yoingco 1987). Although we have not had any opportunity to update the study, I have a very strong suspicion that prevailing attitudes are relatively on the same plane. The public's perception that tax enforcement is far from optimal has forestalled efforts of government to even introduce structural tax reforms. The solution to all these problems are all within our reach. Our experiences in the past proved that we can significantly reform the tax structure, improve tax compliance, and straighten out tax administration. The introduction of the 1986 tax reform package as well as the radical revamp of the BIR in the 70s stand as solid proofs that *we can if we only will. This is our tragedy and our strength.*

It is said that the Philippines is once again at the threshold of a "take-off." But a *sine-qua-non* for breaking away from the problems of poverty is a robust revenue system. This is premised on our putting in place a broad, simple and efficient tax system. How do we gear up the tax system to support the vision of an economically developed Philippines in the year 2000? Allow me to translate my long years of experience on Philippine and international taxation into a framework of needed reforms in tax policy and tax administration.

Tax Policy Reforms

The expanded use of modified gross income taxation (MGIT) should be vigorously pursued. This is to translate into reality our vision of a simple, efficient, and productive income tax system.

The use of modified gross income tax scheme was initiated on compensation income and wage earners in 1982. The reform proved successful not only from the revenue consideration. It also simplified compliance and tax administration. The MGIT approach was continued in 1992 with the adoption of the Simplified Net Income Tax (SNITS) for the professionals and the self-employed. Under the SNITS, indirect costs such as advertising, representation, bad debts, training, and charitable contributions, among others, can no longer be claimed as deductible expenses from income tax purposes. The MGIT approach should now extend to

corporations through the disallowance of many of their indirect costs. Deductions represent a subsidy to corporations and we should question why expenditures on entertainment, advertisements, representation, and fringe benefits should continuously be subsidized.

A comprehensive tax base gives government the opportunity to move towards a scenario of flat and few tax rates. High tax rates breed problems of evasion and discourage productivity and work efforts. The shift away from steep progressive tax rates is almost a global phenomenon. Income tax reforms all over the world are all in the direction of reducing the number and steepness of tax rate schedules.

Value-added taxation should be greatly enhanced through the broadening of the base and improvement in its administration. The VAT structure in its present form excludes many activities and provides for many exemptions. Many services such as those provided in hotels and restaurants remain outside the VAT. As a result, the VAT has become inefficient, unproductive and inequitable. Expenditures of the affluent such as those on travel, entertainment and personal services are outside the VAT. Thus, the VAT burden is regressive at the bottom and top end of the income scale. The broadening of the VAT base can make the VAT one of the major revenue-raisers of government and would address the inequity in the distribution of its tax burden.

Tax incentives should be phased out in favor of a subsidy scheme. Subsidies to deserving sectors are more transparent and promote accountability. The costs of subsidies are visible which help government evaluate their efficient utilization. This is in contrast to a system of tax incentives where the costs of preferential tax treatment are hidden and promoted firms are not held accountable for their tax privileges. More importantly, the distribution of the tax burden will always be inequitable if major sectors continue to remain outside the tax ambit. This implies that the costs of financing government will always bear heavily on salaried and honest taxpayers.

We should learn from our experiences on excise taxation where taxpayers unscrupulously used the weaknesses of the *ad valorem* taxation towards their advantage. Since *ad valorem* rates are based on value, they provide incentives to taxpayers to continuously underdeclare tax bases and use marketing arms to siphon revenues away from government coffers. The simplicity of specific taxation and ease in its administration have caused many governments to shift away from the use of *ad valorem* tax rates. Specific rates are also useful in using tax policy to pursue social objectives such as curbing smoking and protecting the environment. By basing the tax on the number of consumed commodities, e.g. cigarette sticks and bottles of alcohol, the tax can be an effective tool for discouraging consumption of goods which society considers as socially harmful.

Our ultimate objective is to evolve a simple tax structure which is composed of a few but productive revenue taxes which will sustain the financing requirements of development. This is in sharp contrast to our present structure which is composed of several taxes with different rates and bases which are incomprehensible and incoherent.

Reforms in Tax Administration

The heart of the tax system is tax administration. Tax policies no matter how well crafted will be ineffective in the hands of inefficient and dishonest tax enforcers.

Year in and year out, the battlecry of government is always the improvement of tax administration. Everybody recognizes its importance, but nothing of substantial impact has yet been done. Programs have been sporadic and commitments have not been sustained. We also have to see results of programs instituted by different Commissioners such as the "Comprehensive Medium-term Tax Administration Program" in 1989; the "Five-Point Program in Tax Administration" in 1991 and more recently, the "Tax Administration Strategic Plan." All these plans give us hope that there would be a top to bottom reorganization of the bureau in contrast to a mere reshuffling of personnel. Projects like "tax mapping" and "door-to-door" operations sound impressive; but the proof of the pudding is in the eating.

What factors inhibit government from substantially improving tax administration? Could it be the failure to translate goals into small and workable tasks? Could it be the lack of a developmental value-system? The following observations may provide some answers:

(1) There are no mechanisms whereby the BIR can systematically identify and analyze problem areas in tax administration. BIR does not have a handle on how much potential revenue can be collected from major revenue sources such as the income tax and the VAT. Thus, there are no benchmarks or appropriate standards which BIR can use in tracking its performance.

(2) Attempts to analyze trends in collection to spotcheck irregularities have been sporadic. A classic example are the abuses in cigarette taxation which were carried out under the very noses of BIR examiners for years. From 1986 to 1993, the consistent decline in production costs reported by cigarette manufacturers were taken as correct instead of being used as indicators of tax avoidance.

(3) Systematic systems and procedures to permit efficiency in tax collection are not in place. There is no comprehensive tax roll especially for the VAT. There are no systems for recording tax payments and crosschecking tax payments

with other sources of information such as those generated by the Department of Trade and Industry (DTI), Social Security System (SSS), Government Service and Insurance System (GSIS), Securities and Exchange Commission (SEC), and assessment offices in local governments. There are also no systems to monitor payment of delinquent accounts. My own experience suggests that BIR sends notices of delinquencies to all taxpayers following an iterative process and giving them the burden of proving that their taxes have been paid.

(4) The most recent data (1990) suggest that in terms of amount, the BIR collected only 4.2 percent of their outstanding accounts. These collectibles represent about 10.2 percent of total BIR collection (World Bank 1992). Such poor performance is reflective of weak enforcement efforts and the absence of a sustained and vigorous campaign to fully collect taxes that are due the government.

These trends must be reversed and corrected if the tax system is to support the economy's take-off. The efforts to be exerted in order to improve tax administration must parallel if not exceed the endeavors in introducing structural tax reforms.

(1) *Highest priority should be given to the inculcation and development of a high level of integrity and honesty among the BIR officials and employees. A genuine and courageous effort must be waged to purge those who enriched themselves in office. The experience of former BIR Commissioner Plana can serve as a model to inspire and push forward such initiative. He implemented a three-pronged program to fight corruption at the BIR in 1975 (Klitgaard 1985):*

- (a) *Implementation of a new system of performance evaluation. This was based on the amount of assessments an examiner had made, how many of his assessments were upheld and the amounts which were actually collected. The new system broke the "internal market" for promotions and job transfers and the systematized sharing of bribes at the bureau. More importantly, it provided incentives for non-corrupt and efficient tax collection.*
- (b) *Collection of information about corruption. An environment was created in the BIR where employees recognized that their corrupt activities would be detected and punished. Commissioner Plana used several new sources of information. A new group of young CPAs was teamed with a few "clean" senior officials to review tax cases to detect signs of extortion and *areglo*.¹ The Commissioner went to the extent of using intelligence officers to gather direct and indirect evidences about corruption. These included lifestyles of bureau employees, their expenditure patterns, gambling activities, luxurious houses, accumulation of properties, membership in exclusive clubs, and*

maintaining *queridas* (mistresses). "Plana's intelligence network was met with disdain and scorn by the BIR employees, but it worked" (Yoingco and Guevara 1994).

- (c) *Quick punishment of corrupt high-level officials.* In less than a year after Commissioner Plana assumed office, 34 BIR officials were dismissed, 15 were required to resign, and 39 were reorganized out. Criminal cases were also filed in court. Those who were dismissed included deputy commissioners, regional directors and revenue district officers. All these processes were done with full publicity which effectively raised the penalties for corruption.

In addition, a number of anti-corruption measures were introduced in the BIR.

- (a) *Professionalization of the staff through setting higher professional standards.* Job requirements were tightened up and written examinations for personnel were instituted. Recruitment policies were focused on hiring graduates with high honors. A tough anti-nepotism policy was also observed.
- (b) *Identification of potentially corrupt taxpayers.* A selective quality audit program was instituted at the bureau to identify taxpayers who were likely to have understated their incomes or overstated their deductions.
- (c) *Tightening controls over the regions.* Much of the corruption happened in the regions. Commissioner Plana tried to institute tighter controls even informally. He had a day each month for regional directors to monitor performance. Regional directors had to answer questions such as: Why did revenue drop last month? I heard that this examiner was gallivanting around, what is going on?
- (d) *Rotation of agents.* Field workers were periodically moved in an effort to avoid potentially corrupt personal relationships with taxpayers. In a single move, for example, 198 tax inspectors and fieldmen working under the Specific Tax Division (i.e., those monitoring tax collection on cigarettes, beer and oil products) were reshuffled.
- (e) *Changing attitudes towards corruption.* Reorientation seminars and value-formation workshops were organized to inculcate the value of public service among the BIR employees. These were complemented by a total effort along the line of moral reform such as the organization of athletic clubs, glee clubs, and daily masses at the BIR building.

(f) *Personal Example.* Commissioner Plana set a personal example for honesty and incorruptibility. The successful experience of fighting corruption at the BIR can always be improved and replicated.

(2) *For once, the BIR with the full support of the Executive Branch should go all the way in prosecuting and convicting tax evaders.* There can be no better opportunity than today when public awareness of the ill-effects of tax cheating is at its highest.

(3) *A functional data base should be established.* This means developing a comprehensive tax roll of all individuals and corporate taxpayers. This can be facilitated with the assistance of local governments particularly the barangays. Records of concerned government offices such as the SEC on financial statements of corporations, GSIS and SSS for employment data, Philippine Overseas Employment Administration (POEA) for data on overseas contract workers, and the Department of Public Works and Highways (DPWH) for a record of number and amount of construction projects, should be built into the data base. The information would greatly assist BIR in monitoring tax payments and would also bring many firms in the "underground economy" into the tax ambit.

(4) *Rules and regulations on tax laws that are passed must be promptly issued by the BIR.* Past records suggest that it takes BIR up to one year to formulate implementing rules and guidelines. Such a lackadaisical behavior means loss of revenues for government. It also puts into waste the fervor of both the Legislative and Executive Branches in formulating tax reforms.

(5) *Standards should be set to guide the BIR in the conduct of tax audit and investigation.* The lack of standards not only introduces discretion into the system but dissipates administrative efforts which could have been focused on cases which would yield high revenues. Success experiences of other countries can provide useful lessons such as the establishment of industry ratios (i.e., gross profit ratio, tax amount due to gross sales ratio, rate of turnover) as done in Korea. Deviations from normal industry ratios signal potential cases needing tax audit and investigation. The Indonesian government, on the other hand, implements a "Taxpayer Compliance Measurement Program" where taxpayers claiming losses and refunds are identified for tax audit, including those who do not comply with bookkeeping regulations.

(6) *The image of the BIR should be transformed from what it is today into a "service center."* All over the world, the conventional image of a tax office as a collecting agency is almost out. Taxpayers are now referred to as "clients" and "customers" and the main function of tax offices is to "manage clients' debts." Tax investigations are now considered as opportunities to assist the taxpayers in understanding tax laws. Tax information and counselling offices which are staffed by courteous personnel are set up in almost all tax offices. They have also

installed a telephone system which can respond to taxpayers' queries in the soonest time possible. In New Zealand's Revenue Department, for example, a telephone call is answered within two rings. The customer can then select from a wide range of service options or is able to dial direct to any extension. In Singapore, taxpayers can request for tax forms and inquire about their tax accounts through the telephone. In Korea, answers to 312 most frequently asked questions on taxation are provided by computers through the telephone (Yoingco and Guevara 1994). Although we should not expect BIR to reach such a high level of sophistication, there are steps within its means to enhance tax compliance. It does not take much resources to establish a "customers' center" in every district office where taxpayers can seek counsel and information. At present, BIR offices do not give any sense of friendliness or warmth to taxpayers. There is also no system for handling telephone queries promptly and courteously. The transformation of the BIR into a service agency is an immediate possibility needing only realignment and training of personnel.

(7) *Past efforts to computerize operations at the BIR have failed. As BIR enters its five-year tax computerization project, it must hold on to it with a "do or die" attitude.* It must also keep in mind that computerization does not simply mean the procurement of modern hardware equipment. It means the installation of simple and efficient systems and procedures using computers. The BIR has to establish a taxpayers' master file and organize systems in its various operations such as taxpayers' registration, organization of tax returns, processing of returns and payment, tracking of collectibles, income and expenditure matching, collection recoveries, verification of tax credits and refunds, and generation of information for policy purposes. Such systems are organized inefficiently and should be rationalized and streamlined. The fact that the BIR will be assisted by people who established a successful computerized system in New Zealand gives us some degree of comfort. Any outside expertise however can only be successful if it is complemented by a transformed breed of BIR personnel.

In summary, structural, organizational and behavioral reforms have to be instituted to gear up the tax system for the year 2000. These reforms require the simplification of the tax structure, the systematization of operational procedures, and the cleansing of the administrative machinery to imbue it with a high level of competence, integrity and morale.

Endnote

¹A term commonly used in the Philippines denoting "an easy way out" or extra-legal arrangements regarding violation of laws, ordinances, rules, etc. Usually, money is used by the parties involved.

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