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Philippines: Technical Assistance Report on Road Map for a Pro-Growth and Equitable Tax System

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Fiscal Affairs Department

PHILIPPINES

ROAD MAP FOR A PRO-GROWTH AND EQUITABLE TAX SYSTEM

Kiyoshi Nakayama, Selcuk Caner, and Peter Mullins

November 2011

CONTENTS PAGE

Tables

Appendixes

PREFACE

In response to a request from the Secretary of Finance of the Philippines, Mr. Cesar V. Purisima, for technical assistance in tax policy, a mission from the International Monetary Fund's (IMF) Fiscal Affairs Department (FAD) visited Manila from September 6–19, 2011. The mission comprised Mr. Kiyoshi Nakayama (head), and Mr. Selcuk Caner (both FAD); and Mr. Peter Mullins (FAD panel expert).

The main task of the mission was to provide advice on a road map for a pro-growth and equitable tax system.

The mission met with: at the Department of Finance (DOF): Mr. Cesar V. Purisima (Secretary of Finance), Mr. Gil S. Beltran (Undersecretary), Ms. Teresa S. Habitan (Assistant Secretary), Mr. Dante Sy (Director of the Research and Information Office); Ms. Rachelle M. Diaz (Director IV-Privatization Office), Ms. Elsa P. Agustin (Chief, Fiscal Policy Division), Ms. Rowena S. Sta. Clara (Chief, Statistics Division), Ms. Miriam Tasarra and Ms. Juvy C. Danofrta (both, Research and Information Office) and other staff; at the Bureau of Internal Revenue (BIR), the mission met with: Ms. Kim S. Jacinto-Henares (Commissioner), Ms. Marissa O. Cabreros (Assistant Commissioner, Legal Service), and other staff; at the Bureau of Customs, Mr. Horaicio Suansing (Deputy Commissioner, Intelligence and Enforcement), Mr. Gregorio Chavez (Deputy Commissioner, Assessment and Operations), and other staff; at the Senate, Mr. Rodelio Dascil, Director General, Senate Tax Study and Research Office, and other staff; at the Department of Natural Resources, Ms. Teresa M. Manake, Ms. Ellengrac R. Galiste, and Mr. Edgar C. Madera; at the Department of Energy, Mr. Raymond B. Sena; at the Board of Investments (BOI), the mission met with: Ms. Lucita Reyes (Executive Director), Ms. Erlinda F. Arcellana (Director) and other staff; at the Philippines Economic Zone Authority (PEZA), the mission met with Ms. Marry Harriet O. Abordo (Deputy Director), Mr. Elmer H. San Pascual (Group Manager) and other staff.

The mission also met with representatives of academia, think tanks, civil society organizations, business community, accounting profession, and donors including the Japan International Cooperation Agency, and Asian Development Bank. The team acknowledges the excellent support that it received from Mr. Dennis Botman, the IMF Resident Representative in Manila and his staff.

The mission would like to thank DOF and BIR staff for their collaboration and hospitality, and expresses its gratitude to all participants for taking time to share their thoughts and concerns about tax reform issues in the Philippines.

This report sets forth the mission's conclusions and recommendations. It consists of an Executive Summary and the following seven chapters: (1) Introduction and Progress in Tax Reform; (2) Tax Incentives; (3) Other Corporate Income Tax Issues; (4) Excise Taxes; (5) Personal Income Tax; (6) Mining Taxation; and (7) Road Map for Tax Reform.

ACRONYMS

AEC	ASEAN Economic Community
AMLC	Anti-Money Laundering Council
AMLL	Anti-Money Laundering Law
BIR	Bureau of Internal Revenue
BOC	Bureau of Customs
BOI	Board of Investments
CIT	Corporate Income Tax
CPI	Consumer Price Index
DOF	Department of Finance
DTA	Double Taxation Agreement
DST	Documentary Stamp Tax
EBIT	Earnings Before Interest and Taxes
FAD	Fiscal Affairs Department
FCDU	Foreign Currency Deposit Unit
FDI	Foreign Direct Investment
GIE	Gross Income Earned
GDP	Gross Domestic Product
GRT	Gross Receipts Tax
IBFD	International Bureau of Fiscal Documentation
ITC	Input Tax Credit
IMF	International Monetary Fund
IPP	Investment Priority Plan
MGB	Mining and Geosciences Bureau
NMR	Net Mineral Revenue
MNE	Multinational Enterprise
NIRC	National Internal Revenue Code
OCW	Overseas Contract Workers
OEC	Overseas Employment Certificate
OFW	Overseas Filipino Workers
OSD	Optional Standard Deduction
PEZA	Philippine Economic Zone Authority
POEA	Philippine Overseas Employment Administration
PHP	Philippine Peso
PIT	Personal Income Tax
RRT	Resource Rent Tax
TCC	Tax Credit Certificate
VAT	Value Added Tax

EXECUTIVE SUMMARY

FAD's technical assistance mission on tax policy in February 2010 (the '2010 mission') recommended a comprehensive tax reform, the main lines of which are rationalizing tax incentives, full and automatic indexation of the major excises, and broadening the VAT base.

While the Aquino administration has been trying to increase tax revenue by reforming tax administration, the bills to rationalize tax incentives and reform excises on tobacco and liquor that were prepared by the Department of Finance (DOF) still await discussion at the Congress.

The present mission assessed the authorities' progress in implementing the FAD recommendations including the proposed reform bills on tax incentives and excises. To provide the government with a road map for feasible tax policy reform plans that would achieve an increase in tax revenue by 3.0 percent of GDP by 2016, the present mission considered a wide range of options in addition to those in the recommendations of the 2010 mission and the recent World Bank mission.

The mission's work was based on the following key objectives besides the revenue goal:

- Improving the Philippines' competiveness in doing business under the ASEAN Economic Community (AEC) framework;
- Simplifying the tax system;
- Improving the equity of the tax system; and
- Improving the effectiveness of the tax system.

The mission's assessment and key issues in implementing tax reform plans are as follows: (Recommendations by the 2010 mission on VAT and taxation of the financial sector are still valid and the mission found no new issues to add.)

Table 1. Mission Assessment and Key Issues in Implementing Tax Reform Plans

Area	Assessment and Key Issues
Tax Incentives	The preferred reform option (Option 1) is to remove the income tax holidays and the 5 percent tax on gross income earned (GIE) so as to considerably cut the corporate income tax (CIT) rate to at least 25 percent. The next best reform (Option 2) is a significant rationalization of incentives. The DOF rationalization proposal is a positive step in this direction, and goes some way to address the concerns with the current regime.
	The DOF proposal could be significantly improved by making the following changes: (1) limiting the period for all incentives to no more than 10 years; (2) providing only two rate options—an income tax holiday followed by a 7.5 percent tax on GIE, or simply the tax on GIE; (3) for existing recipients, allowing time-bound incentives to expire, and phasing out those that are not time-bound; (4) removing the VAT zero-rating for suppliers outside the zones to exporters within the zones; (5) reducing the list of Investment Priority Plan activities eligible for incentives; and (6) including a sunset clause, of no more than 5 years, for all incentive laws.
	A serious rationalization of incentives, and addressing tax planning opportunities and non-compliance, would allow a reduction in the CIT rate to at least 25 percent. This could be phased in over time to ensure the reform is at least revenue neutral. A reduction in the CIT rate will benefit all companies, improves efficiency, and will continue to make the Philippines a competitive location in which to invest.
Other corporate income tax issues	There are other reforms to the CIT system that could be made to better align the tax system with international practice. These include: (1) taxing capital gains on the sale of shares and real estate not used in the company's business as ordinary income as is the case for other capital gains; and (2) introducing transfer pricing and thin capitalization rules.
	The tax treatment of cooperatives in the Philippines is very generous compared to international practice. While there is merit in encouraging these cooperatives, the current tax exemptions place commercial businesses run through cooperatives at a competitive advantage relative to other businesses, and may also be leading to unnecessary revenue leakage. Therefore, it is recommended that cooperatives be subject to CIT and VAT, with distributions to members subject to withholding tax. As to small cooperatives, with turnover below the VAT threshold, the 3 percent percentage tax or a *de minimus* rule should be considered in order to reduce the administrative burden.
Excises	Many excise rates need to be increased in order to recover the lost revenue which amounts to 1.8 percent of GDP since 1997. This revenue loss is due to a lack of indexation of the specific taxes on tobacco and alcohol products, use of old prices in classifying such products, and reduction in excise on petroleum products.
	While DOF's proposal is a positive step, and in line with the recommendations of the 2010 mission, the following adjustments are desirable: (1) start the rate adjustments no later than the beginning of 2012; (2) use the Consumer Price Index (CPI) to adjust the excise rates periodically (say, quarterly) instead of an index of cigarette prices since cigarette prices may decline due to industry competition and price strategies employed by the producers even when inflation is up; (3) adjust the specific rates on tobacco products to reach the excise on tobacco products to GDP ratio attained in 1997; (4) complete the adjustment in three years; (5) move to a unified specific rate on tobacco products in the medium-term; and (6) maintain a tax burden (all taxes) on cigarettes no less than 50 percent of the retail price.
	Excise on petroleum products needs to be increased after the sin tax reform bill is approved at the Congress. The specific rate on gasoline should be increased from its current levels and an excise should be levied on diesel.
	Initiate a study on the revenue and economic effects of an excise on SMS and other mobile phone services. The excise on telecommunications should be considered as

	proxying a tax on economic rent obtained from services provided by a few operators. A very low rate applied to a broad range of services can mitigate the effects that may be argued as regressive. The total number of SMS in the Philippines in a year could be estimated as 600 billion in 2010. The revenue raised by an excise of 10 centavos per text would be PHP60 billion.
Personal income tax	It is desirable to index the rate schedule to inflation accumulated since 1997 in order to retain the progressivity of the tax system in the medium term and reduce the number of brackets to make the rate schedule simpler. In the short term, broadening the lowest tax rate band to the income bracket to which a 10 percent rate is currently applicable, would be appropriate to mitigate partly the projected increase in the tax burden on low income taxpayers caused by indexing excises as proposed by the DOF.
	Limit the Optional Standard Deduction (OSD) to those whose sales / receipts are less than the VAT threshold. While the OSD may reduce costs of the self-employed in calculating taxable income, a VAT taxpayer has to calculate input credits based on invoices. Thus, the compliance cost of VAT taxpayers will not change even if he or she opted for the OSD. Alternatively, as the House Bill No. 3992 proposes, the amount of standard deduction should be reduced to 20 percent or less.
	Align the lower interest withholding tax rates on Foreign Currency Deposit Units (FDCUs) and deposits with long maturity with the standard interest withholding tax rate (20 percent)
Mining taxation	The existing fiscal regime on mining operations can be characterized as a regime that levies a high royalty rate (5 percent royalty rate plus 2 percent excise). Also additional national and local government taxes and fees are not conducive to the development of the mining industry as a source of growth. Thus, the regime overlooks the basic design features of a progressive system that can capture resource rents.
	In addition, the calculation of the net mining revenues (NMR) discriminates against capital. Capital charges are not included in the calculation of NMR. Even though the "additional government share" is an attempt to tax resource rent, it does not have the progressivity features of fiscal regimes used by many countries to increase the government's take in excess profits.[1]
	The current mining law does not have "ring-fencing" provisions to separate the mining activities of a mining project from other activities. Lack of "ring-fencing" may lead to loss of government revenue particularly if the fiscal regime is profit-based.
	The mining fiscal regime should be changed to sufficiently capture a portion of the resource rents. An *ad valorem* tax for metals based on market value of production with a progressive mechanism to tax resource rents (excess profits) is often preferred in many countries. In addition, specific royalty rates based on volume or quantity should be levied on high-volume-low-value minerals such as construction or dimension stones. Such a fiscal regime with different royalty rates for metal and non-metal mining secures revenue for the government as soon as production commences (front-end loading). It is considerably easier to administer than most other fiscal instruments, and ensures that companies make a minimum payment for the minerals they extract.
	To design the mining taxation regime that fits the Philippines, further work needs to be done by a specific tax policy mission on mining. The revenue impact of various fiscal regimes should be estimated to determine the best choice of mining fiscal regime for the Philippines.

[1] Excess profits are defined as profits earned above normal profits based on rate of return estimates for an average mine accepted industry-wide.

Table 2. Estimated Revenue Impact (in percent of GDP)

	2012	2013	2014	2015	2016
Tax Incentives Reform					
Option 1	↑	↑	↑	↑	↑
Option 2	↑	↑	↑	↑	↑
CIT					
Rate deduction	Will phase in corresponding to incentive rationalization. Every 1 percentage point reduction in the CIT rate will cost 0.1 percent of GDP.				
Apply CIT rate to capital gains	↑	↑	↑	↑	↑
Transfer pricing	↑	↑	↑	↑	↑
Thin capitalization	↑	↑	↑	↑	↑
Taxation of cooperatives	↑	↑	↑	↑	↑
Excises					
Tobacco (DOF bill)	0.33	0.40	0.46	0.48	0.51
Liquor (DOF bill)	0.34	0.54	0.86	0.95	1.04
Petroleum	↑	↑	↑	↑	0.42
Mobile communications					0.67
VAT					
Repeal exemption post - 2006			0.26	0.26	0.26
Refund mechanism			▼	▼	▼
Increase threshold			▼	▼	▼
Rate increase					
PIT					
Index rate schedule to inflation post 1997					▼
Limit OSD to under VAT threshold	↑	↑	↑	↑	↑
Unified W/H tax of 20 percent on interest			0.1	0.1	0.1
Resource Taxation		↑	↑	↑	↑
Total	0.67	0.94	1.68	1.79	3.0
Increase by BIR reform	0.1	0.2	0.3	0.4	0.5
Tax / GDP	13.1	13.38	14.13	14.25	16.0

Source: DOF and staff calculations

*Figures are based on the GDP in 2010 and show an accumulated revenue increase since 2010.

↑=unquantifiable revenue increase, ▼=unquantifiable revenue decline

I. INTRODUCTION AND PROGRESS IN TAX REFORM

A. Background

1. **Tax revenue has declined over the last decade in the Philippines due to generous and expanding tax incentives, tariff rate reduction, deteriorating tax compliance caused by ineffective and inefficient revenue administration, and a gradual erosion of excise revenue due to non-indexation.** While this changed temporarily in 2006 with the successful implementation of the VAT reform, cyclical factors and fiscal stimulus measures, in addition to deteriorating tax compliance, caused the tax-to-GDP ratio to fall to 12.1 percent in 2010, increasing the fiscal deficit to 3.6 percent of GDP.

2. **FAD's technical assistance mission on tax policy in February 2010 recommended a comprehensive tax reform, the main lines of which are rationalizing tax incentives, full and automatic indexation of the main excises, and broadening the VAT base.** (see Appendix I for the main recommendations) The mission advised the authorities to propose tax reform plans by the end of 2010, during the post-election period.

3. **The focus since the election has not been on introducing new taxes or increasing existing ones, but on enhancing collection by reforming tax administration.** It is understood that tax policy may be revisited in 2012. While the Philippines government aims to increase the tax-to-GDP ratio to 16 percent of GDP, which is 3.4 percent higher than that in 2010, the tax administration reform has not registered an increase in revenue, though some slight progress has been made in recent months. The 2012 budget projected that the tax administration reform would increase revenue by 0.4 percent of GDP.

B. Progress Made in Implementing the 2010 FAD Mission Recommendations

The mission found progress in the following areas.

Tax incentives

4. **The bill prepared by the DOF is currently awaiting discussion at the Senate.[2]** The bill rationalizes the tax incentives mainly by providing a taxpayer with three rate options:

(1) 6 year income tax holiday followed by 5 percent tax on GIE for 19 years;
(2) 5 percent tax on GIE for 25 years; and
(3) 15 percent CIT for 25 years.

[2] As of September 2011.

5. **This proposal is partly in line with the recommendations by the 2010 mission** and a positive step to reform the current incentive regime that provides tax holidays ranging from three to eight years followed by a 5 percent tax on GIE for an indefinite period. Details of this proposal and the counter proposal by the Board of Investments (BOI), which was approved at the House of Representatives, and the mission's view are discussed in Chapter II.

Excises

6. **The bill prepared by the DOF to simplify and increase the excise tax on tobacco and alcohol was presented to the Legislative Executive Development Advisory Council[3] (LEDAC) in August.** The bill has been included as one of the priority bills of the Aquino Administration. The bill proposes to shift the current multi-tiered rate schedule to a unitary rate and index the tax rate to inflation. These proposed changes broadly follow the recommendations of the 2010 mission.

7. **Ten excise reform bills other than the DOF bill have been filed to the current Congress session.** Most of the bills do not include the indexation to inflation. The World Trade Organization (WTO)'s ruling on Philippine taxes on imported liquor may affect discussion of excise bills in Congress[4]. Details of the DOF's proposal and the mission's view are discussed in Chapter IV.

VAT

8. **Revenue Regulation No. 14-2011 that prohibits the tradability of Tax Credit Certificates (TCCs) was issued on July 29, 2011.** The mission supports this regulation as a first step towards the abolition of TCCs. The 2010 mission suggested that the tradability of TCCs upsets price signaling, and increases the opportunity for rent seeking.[5]

9. **The BIR has started preparation for establishing a proper VAT refund mechanism—to ensure that a taxpayer can get a refund if the amount of input credits exceeds the amount of VAT on taxable sale for each taxable period.[6]** The mission

[3] LEDAC is a consultative and advisory body to the President as the head of the national economic and planning agency for further consultations and advice on certain programs and policies essential to the realization of the goals of the national economy. It comprises the President, the Vice President, the Senate President, the Speaker of the House of Representatives, and 16 other members.

[4] The WTO ruling declared Philippine taxes on liquor imports as discriminatory.

[5] It is possible for a taxpayer to buy a TCC which is expiring in a short time at a price lower than the TTC's face value and offset his/her VAT liability. This would unduly benefit a buyer of a TTC while a seller has to give up a part of a legitimate refund claim.

[6] The funding for refund payments is projected in the 2012 budget.

welcomes this progress. Business representatives the mission met unanimously criticized the current refund system and indicated that it is one of the main reasons for companies to apply for Philippine Economic Zone Authority (PEZA) tax incentives, which exempts VAT on imports and zero-rates supply by domestic companies to free zone companies. A proper VAT refund system is a prerequisite for abolishing tax incentives.

C. Assessment of the World Bank Recommendations

10. **The June 2011 World Bank mission made recommendations that would increase tax revenue by 3 percent of GDP by 2016.** The World Bank mission provides detailed analysis on the distribution impact, which would be a useful basis for further policy discussion. While the main lines of the World Bank recommendations are similar to those of the 2010 mission, the present mission found that their views on some matters differ from ours.

- *PIT rate schedule*: The World Bank recommends that the top PIT rate be reduced from 32 percent to 25 percent to align with the CIT rate. The present mission does not think the recommendation is a viable option given the current fiscal condition and income inequity in the Philippines, though it is desirable to align the top PIT rate with the CIT rate in the longer term.
- *Withholding tax on interest*: The World Bank recommended that a unified 18 percent withholding tax should be applied to interest. This mission agrees that a unified withholding rate should be applied as the current reduced or zero withholding tax on interest income derived from deposits with long maturity or those in foreign currency benefits mainly wealthy households. Given the current foreign currency reserve of the Philippines, that is 10 months of imports, there is no longer a legitimate reason for preferential treatment for deposits in foreign currency. However, the present mission recommends a unified 20 percent rate, which is the current rate on interest from deposits or bonds with a maturity of less than three years.[7]
- *VAT*: The World Bank did not recommend that VAT on capital inputs should be fully deductible. Though re-establishing full deductibility requires careful consideration of the impact on VAT revenue, it would have significant positive implications for the competitiveness of the Philippines economy, as would a proper refund system. The World Bank projected an increase in revenue by 0.26 percent of GDP from eliminating the exemptions introduced since 2006 while establishing a refund system. However, revenue would be the same in the short term if the Philippines adopts all FAD recommendations on the VAT.

Overview of the aide memoire

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[7] According to the World Bank mission, more than 50 percent of savings and investment are deposited in checking and savings accounts, which have very short maturities.

11. **The mission revisited all major taxes, which the 2010 mission reviewed, to find viable options to be included in a road map for a feasible tax policy reform that would increase tax revenue by 3.0 percent of GDP by 2016.** This aide memoire explains the mission's new findings on and analysis of tax incentives, other CIT issues, excises, and PIT, and mining taxation, (of which the mission conducted a preliminary review). As to the VAT and taxation of the financial sector, the mission found the previous recommendations are valid and has nothing to add. Lastly, the aide memoire provides a road map for tax reform.

II. Tax Incentives

A. Overview

12. **The need for the rationalization of tax incentives in the Philippines is widely recognized.** Numerous studies and reports, including those of previous FAD tax policy missions in 2001 and 2010, have found that the existing regime is very generous and unnecessarily complex. [8] Despite this recognition, there has been very little reform of incentives, with a tendency to expand rather than rationalize them. There are, however, a number of bills currently before Congress seeking to rationalize incentives.

13. **The Philippines provides a range of different tax incentives.** These include: income tax holidays for 3 to 8 years; 5 percent tax on GIE (in lieu of national and local taxes)[9]; increased tax deductions; tax credits; and exemptions from VAT, import duties, and other fees and charges. These incentives are provided under a number of laws that are administered by the BOI, PEZA, and a number of other special economic zone authorities.[10] It is estimated that there are around 180 laws that provide tax incentives.

B. Effects and Costs of Tax Incentives

14. **The 2010 report clearly outlined the concerns with tax incentives.** Of particular concern are tax holidays and reduced tax rates, which are among the most ineffective forms of tax incentives. Without repeating the analysis of the 2010 mission, it is worth emphasizing some of the arguments against incentives including: (1) they involve a loss of current and future revenue which usually means that taxes must be higher in other activities which harms economic efficiency and compliance, and causes inequities; (2) tax incentives by their nature

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[8] See Aldaba (2006); Botman, Klemm and Baqir (2008); Chalk (2001); Reside (2006); Reside (2007); and Le Borgne et al (2011).

[9] Gross income earned is gross sales less costs of sales, cost of production and direct cost of services.

[10] Some of the other authorities operating special economic zones include: Cayagan Economic Zone Authority; Clark Development Corporation; Zamboanga City Economic Authority; and Subic Bay Metropolitan Authority.

are inequitable and inefficient as they create different tax treatments between and within sectors leading to distorted resource allocations; (3) incentives create opportunities for tax abuse (e.g., transfer pricing between related parties to ensure profits are made in exempt or low taxed enterprises and deductions in taxable enterprises); (4) tax holidays tend to attract footloose firms which leave as soon as the incentive expires, or alternatively, the incentive does not lead to a change in the intended behavior as it simply benefits those firms which are, or were intending, to undertake the sought behavior; (5) the benefits of tax incentives may be reversed if a foreign investor is from a country which taxes its residents on a worldwide basis (e.g., the U.S.), so that there is effectively a transfer of revenue from the Philippines to the residence country; (6) tax holidays are inefficient in promoting investment in new enterprises that are often unprofitable in the early years and, hence, are unlikely to benefit from the incentive; (7) spending on social infrastructure could be more effective in attracting investments to less developed regions than providing tax holidays; and (8) while taxes are important, they are not the most important factor in investment decisions, with other factors, such as market size, labor costs, infrastructure, and a stable economic and political environment, likely to be more important.

15. **In addition to the common concerns outlined above, the Philippines has its own particular problems with tax incentives.** These include: (1) the provision of incentives by multiple agencies (and multiple laws) which creates unnecessary competition between agencies and zones and is confusing for investors; (2) multiple incentive agencies also mean that a significant number of resources are involved in providing essentially the same services; (3) the monitoring of investors' compliance with incentive conditions appears to be weak; and (4) the limited involvement of the DOF in decisions to grant investment incentives results in an absence of fiscal discipline.

16. **There is insufficient data available to obtain an accurate estimate of the cost of tax incentives in the Philippines.** Based on previous studies, the revenue forgone could be as high as 1 to 2 percent of GDP.[11] The World Bank is currently undertaking a project to estimate the cost of tax expenditures in the Philippines, but its findings are not yet available.

C. How does the Philippines Compare with Other Countries?

17. **One of the key reasons for providing tax incentives in the Philippines is the concern that the country needs to be competitive with other countries in the region in order to attract Foreign Direct Investment (FDI).** Appendix II provides a comparison of the tax incentives offered by countries in the region, as well as the standard CIT rates. It shows that the legislated length of tax holidays are relatively consistent with regional

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[11] For example, Manasan (2002) estimates that the cost of fiscal incentives for the years 1998 to 2000 were from 1.1 to 1.9 percent of GDP, and Reside (2006) estimates that the revenue loss from redundant incentives alone could be 1 percent of GDP.

practice, however, the allowance of a lower tax rate (5 percent of GIE) for an indefinite time period is more generous—the maximum period for incentives in almost all countries in the region is 15 years, with most being less than 10 years. The CIT rate is now one of the highest in the region. The worldwide trend has been for a reduction in CIT rates, with a number of countries in the region reducing their rates in the last two years (this is discussed further in Chapter III).

18. **Despite the generous incentives offered by the Philippines, growth in FDI has remained lower than its neighbors, suggesting that other factors may be more relevant in deciding whether to invest in the country.** For example, in South-East Asia the stock of inward FDI grew by 14.4 percent during the period 2005 to 2010, while for the Philippines it declined by 12.9 percent.[12] Some of the non-tax factors raised with the mission as being deterrents to FDI were lack of adequate infrastructure, power costs, poor legal environment (including land ownership and labor laws), and difficulties in doing business.[13] A concern was raised with the mission that providing incentives may be an attempt to offset the non-tax factors, without adequately addressing the non-tax constraints. However, it was also noted that the Philippines has regional competitive advantages, including the age, quality, and education of its workforce, and the widespread use of the English language.

D. Options for Reforming Tax Incentives

19. **The preferred reform option in the 2010 report was to remove all tax holidays and the 5 percent tax on GIE, while also reducing the CIT rate.** It was considered that this option (with appropriate grandfathering provisions for existing investors) would be best able to address the concerns with the current regime. The reform would result in a system that is simpler, more transparent, equitable and efficient than the current regime, and consistent with international trends. It would also provide a more favorable and sustainable investment climate in the Philippines than the current regime.

20. **However, if the preferred option was not considered feasible then the 2010 report recommended rationalizing tax incentives, with a smaller reduction in the CIT rate.** It proposed limiting tax holidays to a few very specific investments/sectors, with clear criteria and a time period of no more than 5 years, and the removal of the 5 percent tax on GIE. The World Bank tax policy report in 2011 made similar recommendations, except that it

[12] Based on data from the United Nations Conference on Trade and Development (UNCTAD) Statistics database.

[13] In the 2011 "Doing Business" survey by the World Bank, the Philippines ranks 22nd out of 24 countries in the East Asia-Pacific region in terms of ease of doing business.

recommended retaining the tax on GIE but increasing the rate to 7.5 percent.[14] It argued that retaining the tax on GIE allowed companies access to the simplified administration available in the PEZA zones (that is, streamlined administration with limited or no dealings with the BIR, BOC and local governments), while collecting more revenue from these firms. However, the report suggested that the tax on GIE could be removed once the BIR, BOC, and local government administrations have improved to an extent that there is little difference between the levels of service provided within zones and outside zones.

21. **There are currently two main bills for the rationalization of incentives before Congress.** One bill has been drafted by the DOF and the other by the BOI. The DOF is much more ambitious in its reform, making a significant rationalization of incentives. The BOI bill, which has been passed by the House of Representatives, imposes a time limit on all incentives but continues to expand the range of incentives. Table 3 compares the key features of the two bills.

[14] It was assumed that the revenue from an increase in the GIE rate would go to the national government and not be apportioned to local governments (that is, the existing arrangement under which revenue from 2 percent age points of the GIE is distributed to local governments would continue).

Table 3. Comparison of Tax Incentive Reform Bills

Feature	DOF Bill	BOI Bill (House approved)
Income Tax Incentives	Three rate options: (1) 6 year income tax holiday followed by 5 percent tax on GIE for 19 years; (2) 5 percent tax on GIE for 25 years; (3) 15 percent CIT for 25 years. Losses – 5 year carry forward. Accelerated depreciation. Double deduction for training, and research and development expenditure.	A number of options depending on the activity, location and significance of the project: (1) 4 to 15 years income tax holidays; (2) 10 or 15 percent CIT, or 50 percent reduction in CIT rate, for periods of 10 to 19 years (ensuring total incentives do not exceed 25 years); (3) 5 percent tax on GIE for 25 years. Losses – 5 year carry forward. Accelerated depreciation. Double deduction for training, and research and development expenditure.
Indirect Tax Incentives	VAT zero-rating and duty exemptions for firms within the zones. VAT zero-rating for suppliers to exporters within the zones.	VAT zero-rating and duty exemptions for firms within the zones. VAT zero-rating for suppliers to exporters within the zones.
Eligibility	Exporters and projects within the 30 poorest provinces undertaking activities in the Investment Priorities Plan (IPP), and strategic domestic projects (in terms of employment and investment). An exporter must export at least 70 percent of production, and if this is not met the exemption is lost. VAT and duty applies to all domestic sales.	Exporters, domestic firms, and projects within the 30 poorest provinces undertaking activities in the IPP, and strategic domestic projects (in terms of employment and investment). An exporter must export at least 30 percent of production, and if the exports are between 30 and 70 percent the incentive must be apportioned. VAT and duty applies to all domestic sales.
Institutional Arrangements	PEZA is the sole agency for granting incentives. BOI focused on investment promotion. DOF is represented on all boards of investment promotion agencies.	Multiple agencies for both granting incentives and investment promotion with BOI having an oversight role.
Allocation of the tax on GIE	3 percent to the national government. 2 percent to the local government.	2 percent to the national government. 2 percent to the province or city. 1 percent to the municipality or city.
Other	One law covering incentives. DOF to monitor tax expenditure data.	1 percent levy on value of incentive to fund BOI investment promotion.

Source: DOF.

22. **The DOF bill, which the mission prefers to the BOI bill, is a positive step towards reform and contains a number of improvements compared to the existing regime.** Having a single regime for all eligible enterprises will simplify the system and make it more equitable, at least amongst incentive recipients. Removing the access to incentives for most domestically focused enterprises, other than those in specific locations, will reduce the current redundancy of incentives, and also remove the most egregious incentives (such as for

housing developers). The institutional arrangements provide an administratively more efficient regime, and ensure that the DOF has appropriate input into the process. The monitoring of tax expenditures by the DOF and having the incentives in a single law are consistent with the recommendations of the 2010 mission and should make the system simpler and more transparent. In the long term, the DOF should be the sole organization responsible for drafting legislation on tax incentives. The BOI bill is less attractive because it expands the range of incentives and makes the system even more complex than the present regime.[15]

23. **There are, however, a number of further improvements that could be made to the regime proposed by the DOF.** These include:

- The period for providing incentives is still too long and should be reduced. As shown in Appendix II, most countries in the region do not provide incentives beyond 10 years. The main reason for time-limiting incentives is that they are usually offered to attract firms to undertake a particular activity and/or to assist in their establishment. Once that objective is achieved—or at least enough opportunity given to do so-- the incentive should cease.

- Consideration should be given to providing taxpayers with only two rate options: an income tax holiday followed by a tax on GIE; or the tax on GIE. The proposal to offer a lower CIT rate raises the question as to why not simply provide a lower CIT rate for all taxpayers rather than a 15 percent rate for some. Consideration should also be given to increasing the rate of tax on GIE to 7.5 percent, as recommended by the recent World Bank mission.

- The continued VAT zero-rating for suppliers outside the zones to exporters within the zones, as proposed in both the DOF and BOI proposals, is not supported. The zero-rating in these cases is too prone to abuse and difficult to monitor, with leakage to the domestic market. This measure was introduced partly due to the inadequacies of the VAT refund regime. These concerns are being addressed with the reform of the VAT refunds, so that there is less need for the zero-rating.

- In order to align existing firms with the regime offered to new firms, and to reduce the forgone revenue, it is recommended that, if legally possible, the incentives provided to existing investors be grandfathered. This could be achieved by allowing

[15] For example, the BOI bill targets industrial activity as well as regions to qualify for incentives thus distorting investors' choices as well as making it difficult to administer. The bill also gives the BOI an oversight role for tax incentives while keeping the multiple agencies' existing role of granting incentives and promoting investments.

those incentives that are time-bound to expire, and phasing out those incentives that are not time-bound within a reasonable time frame.

- While the narrowing of the activities eligible for incentives is a positive step, effort should be made to ensure the list of activities under the Investment Priorities Plan (IPP) is also reduced. As mentioned in the previous FAD report, governments are generally not good at picking winners. It is better to limit those activities eligible for incentives so that a lower CIT rate can be provided to all corporate taxpayers. Some of the activities on the current IPP list that are unlikely to warrant incentives are mining, telecommunications, and property development.

- The incentive laws should all include a sunset clause, of no more than 5 years, to ensure the incentives are achieving the purpose for which they were introduced.

Which option for the Philippines?

24. **While the preferred reform option is still to remove all tax holidays and the tax on GIE, the proposed DOF bill with the recommended improvements outlined above, may be more politically feasible.** The DOF bill would not remove all concerns with the current incentive regime, but it does go some way to addressing them. It is likely to make the system simpler and easier to understand for investors, while also making it more transparent, equitable and efficient than the current regime. This regime, together with a reduction in the CIT rate, should enhance make the Philippines' attractiveness to investors.

Recommendations

- Reform tax incentives with the preferred option being to remove all tax holidays and the tax on GIE (with appropriate grandfathering provisions for existing investors), with a reduction in the CIT rate to at least 25 percent.(Long Term)
- If the preferred option is not considered feasible, rationalize tax incentives using the DOF bill as a base with the following amendments:(Short Term)
    - Limit the total period for all incentives to no more than 10 years;
    - Provide only two rate options: an income tax holiday followed by a 7.5 percent tax on GIE; or simply a 7.5 percent tax on GIE;
    - Remove the VAT zero-rating for suppliers outside the zones to exporters within the zones;
    - Grandfather existing recipients of incentives, by allowing those incentives that are time-bound to expire, and phasing out those incentives that are not time-bound within a reasonable time frame;
    - Reduce the list of IPP activities eligible for incentives; and

- Include a sunset clause for all incentive laws of no more than 5 years.

III. OTHER CIT ISSUES

A. Tax Rate

25. **While the CIT rate was reduced in 2009, a further decrease may be necessary to remain regionally competitive.** As mentioned previously, the international trend has been for a decrease in CIT rates, with the average rate for the ASEAN region being 25.9 percent, which is consistent with the average CIT rate for the entire Asia region (25.6 percent).[16] Therefore, there is likely to be growing pressure to reduce the CIT rate in the Philippines.

26. **A significant reduction in the rate, to at least 25 percent (phased in over a period of time), would be possible if there were a serious rationalization of incentives.** Such a rate would be competitive within the region, and would ensure that the Philippines rate is consistent with the international trend. However, the fiscal position is unlikely to be able to support a reduction if there is not a significant rationalization of incentives. A one percentage point reduction in the CIT rate would cost tax revenues of about 0.1 percent of GDP, without offsetting revenue raising measures. Therefore, a rate reduction may have to be phased in over a period of time in line with reductions of incentives.

27. **It was suggested that a CIT rate cut may be pro-rich and anti-poor, however there are a number of reasons why this is not the case.** First, as mentioned previously, the Philippines is competing with other countries in attracting investment, and a cut in the CIT rate will likely be one of necessary measures if the Philippines wishes to be competitive. This increased investment should lead to greater employment opportunities, which should benefit all Filipinos, including the poor. Second, even with a rate cut to 25 percent, the effective tax on CIT profits distributed to shareholders is 32.5 percent (that is the CIT rate plus the 10 percent dividend withholding tax), which is still higher than the existing top PIT rate.[17] Third, the cut in the CIT rate is to be accompanied by a rationalization of incentives, with many companies having to pay tax at higher rates, allowing for a more equitable tax system.

Recommendation

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[16] The International Bureau of Fiscal Documentation (IBFD) database. The CIT rates of neighboring countries are Cambodia, 20 percent; China, 25 percent; Indonesia, 25 percent; Thailand, 30 percent; and Vietnam, 25 percent.

[17] The effective rate is calculated as the proposed 25 percent CIT rate plus 10 percent on the after-tax profits available for distribution (i.e., 10 percent of 75).

- Consider a reduction in the CIT rate, to around 25 percent, with the extent of the reduction, and potential phase-in time, dependent on base broadening through rationalization of incentives. (Medium Term).

B. Cooperatives

28. **Cooperatives receive preferential tax treatment in the Philippines.[18]** A cooperative is exempt from all taxes (including income tax, VAT and import duties) if its business transactions are with members only, or it transacts with non-members and its accumulated reserves and undivided net savings (effectively its share capital) are less than PHP10 million.[19] If the cooperative exceeds the PHP10 million threshold it may be taxed on its business with non-members, although there are further exemptions for agricultural cooperatives, certain credit cooperatives, and for cooperatives where each member's contribution to share capital does not exceed PHP15,000.[20]

29. **Distributions to members by cooperatives are also exempt from tax.** The exemption covers patronage refunds (including refunds, credits or rebates), and distributions based on the member's share capital, essentially interest income, which is exempt from withholding taxes.

30. **The tax treatment of cooperatives in the Philippines is very generous, especially compared to international practice.** The international practice on taxing cooperatives and their members varies widely. Many countries treat cooperatives in the same way as other business entities by taxing them at the entity level and applying the same tax rules to distributions as they would to dividends paid by a company. Some countries provide reduced tax rates (or even exemption) for certain cooperatives (for example, agricultural cooperatives). Another example is a power cooperative. The power cooperative retains its earnings without distributing it to members. The consistent feature of the tax treatment of cooperatives in most countries is that their profits are taxed at some point: at the entity level; the member level; or both.

31. **The extent of the exemption in the Philippines is open to abuse, has unintended outcomes, and is difficult to administer.** Government officials as well as members of the private sector expressed concerns about cooperatives being used to avoid tax, and also as a

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[18] As of December 31, 2010, 18,205 cooperatives are registered with the Cooperative Development Authority (CDA) and the total membership of the registered cooperatives amounts to some 7.2 million.

[19] Membership of cooperatives is limited to natural persons and there must be at least 15 members, with no member holding more than 10 percent of the share capital.

[20] The relevant law providing the tax exemptions is the Philippine Cooperative Code of 2008, with implementing rules and regulations in BIR Revenue Memorandum Circular 12-2010.

means to overcome other laws such as labor laws. For example, the mission was advised that some employers were encouraging employees to form cooperatives to provide services to the employer, so that the employer could avoid their legal responsibilities as an employer and also to provide a tax exemption to the employees. It was also suggested to the mission that cooperatives are undertaking significant commercial enterprises, and there is a concern about revenue leakage. It is also difficult for the BIR to effectively monitor cooperatives, including the level of non-member transactions.

32. **The main benefits of cooperatives can still be obtained without the need for a tax exemption.** Cooperatives are established for many different purposes. For example, production cooperatives are often established by groups of small producers to get better access to markets and prices, and take advantages of economies of scale. Consumer cooperatives can obtain greater buying power and hence lower prices for goods and services. These benefits are available irrespective of tax incentives.

33. **Most cooperatives are conducting business activities in the same manner as other commercial enterprises, and therefore should be taxed in a similar manner.** Not taxing them provides the cooperatives with a competitive advantage over business entities that are not cooperatives but are operating in the same market. The taxes that should apply are income tax (at the cooperative level at the CIT rate), VAT, and import duties.

34. **Small cooperatives, say with gross turnover below the VAT threshold, could be subject to either the 3 percent percentage tax on turnover and/or a *de minimis* rule, in order to reduce the administrative burden.** This special treatment would recognize that the members of small cooperatives are unlikely to be earning income above the personal tax exemption, and they would not have to register for VAT had they been a non-cooperative business. Therefore, there is unlikely to be a significant loss of revenue. These small cooperatives are also often being operated for non-profit purposes. It would also reduce the need for the BIR to monitor the small cooperatives.

35. **Payments to members either in the form of interest or patronage refunds would be subject to creditable withholding tax as , say, 5 percent**. If there were concerns about the administrative burden of withholding from small amounts paid to many members, a *de minimis* rule could apply exempting small amounts.

Recommendations

- Tax cooperatives, other than small cooperatives (i.e., with turnover below the VAT threshold), in the same manner as other entities conducting businesses (i.e., income tax at the CIT rate, VAT, and import duties). (Medium Term)

- Small cooperatives could be subject to the 3 percent tax on turnover or gross sales and/or a *de minimis* rule.(Medium Term)

- Apply withholding tax to interest and patronage refunds paid by cooperatives, subject to a *de minimis* rule.(Medium Term)

C. Taxation of Capital Gains

36. **Capital gains earned by corporations are taxed as ordinary income, except if the gain is from the sale of shares in another company, or the sale of real estate not used in the company's business.** For the sale of shares in a non-listed company, the first PHP100,000 of net capital gains (i.e., excess of capital gains over capital losses) are subject to a final 5 percent tax, with any excess taxed at 10 percent. Capital losses are only deductible to the extent of gains in the same year. Net capital gains from the sales of shares in listed companies are not subject to income tax, but are subject to a percentage tax of 0.5 percent of the sale price. Gains on real estate that has not been used in the business of a corporation are subject to a 6 percent final income tax.

37. **The special treatment of capital gains on the sale of shares and real estate is generous and unnecessarily complicates the tax system.** The trend in most countries is to tax these types of capital gains as ordinary income of the company. There is no strong reason to treat them in a special way. Treating real estate gains consistently with other gains will also remove some of the disputes between BIR and taxpayers as to whether a particular asset is used in the business of a corporation.

Recommendation

- Treat capital gains on the sale of shares and all real estate (irrespective of its purpose) as ordinary income of a corporation.(Short Term)

D. International Taxation

Transfer Pricing

38. **The BIR guidelines on transfer pricing are expected to be issued next year.** While Section 50 of the NIRC allows the BIR Commissioner to adjust transfer pricing, the BIR took a prudent approach by not applying the rules until the BIR provides guidelines for taxpayers and BIR staff. The guidelines are modeled after the latest version of the OECD Transfer Pricing Guidelines ('OECD Guidelines'), and provide sufficient guidance on how the basic methods operate.

39. **While the Philippines' relatively high CIT rate may induce a multinational enterprise (MNE) to shift its income from the Philippines to overseas jurisdictions, transactions with related parties which enjoy income tax holidays and other tax incentives could have the most serious transfer pricing risks.** For example, if a company supplying material or parts to a free zone company, and the free zone company are related companies, the corporate group can reduce CIT as a group by under pricing sales to the free

zone company. The current CIT return form does not include information on related parties, so the BIR has difficulties in focusing on such a transaction.

40. **Similar price manipulations may be likely within a single company if a part of the company enjoys tax incentives**. Unless a tax return form or its attachment shows segmented information by a tax incentive measure, it is unlikely that the BIR detects such manipulations.

Recommendation

- Change the CIT return form to enable the BIR to indentify related transactions.(Short Term)

E. Thin Capitalization

41. **Thin capitalization is the practice of excessively funding a branch or subsidiary with interest-bearing loans from related parties rather than with share capital.** The current rule on deductible expenses in the Philippines cannot prevent thin capitalization. [21] To counter this practice, the tax rule needs to deny deductions for interest in defined cases. One common approach is to provide express ratios of loan capital to share capital beyond which interest deductions are denied (debt to equity rules). Another is to limit interest deductions by reference to a proportion of the income of the taxpayer (earnings-stripping rules). What are the appropriate financial ratios is also an issue in each approach (between 1.5:1 and 3:1 being common for debt-equity rules).[22] In setting the appropriate financial ratios, data on funding by Philippine companies should be examined in order to minimize the risk of interfering in legitimate business activities.

42. **The thin capitalization rule may affect the mode of FDI by increasing investment in equity.** As the United Nations Conference on Trade and Development (UNCTAD) report[23] cautioned, it is desirable to reduce dependence on the non-equity-modes (NEMs) of foreign direct investment such as business-process outsourcing (BPO) and contract manufacturing.[24] However, under the current incentive regime, the thin capitalization rule

[21] Section 34 (B) (2) (b) of the NIRC denies deduction of interest on a loan between family member, but does not apply an inter-company loan. Revenue Regulation No. 13-2000 reduces deduction of interest by 38 percent of interest income subject to a final withholding tax, but this rule is meaningless in case that a borrowing company has no interest income.

[22] A different ratio should apply to financial institutions whose business consists in borrowing and lending and which typically operate at much higher debt levels than other businesses.

[23] World Investment Report 2011.

[24] The UNCTAD report indicates that NEM foreign direct investments have “footloose” natures that makes them easy to get but also easy to lose.

may not affect tax revenue and the mode of FDI in the short term as the income tax holiday and 5 percent GIE tax will not be affected by the thin capitalization rule.

Recommendation

- Introduce a thin capitalization rule after examining data on funding by Philippine companies. (Short Term)

F. Exchange of Information

43. **A new law that allows the BIR to exchange information (EOI) under a double taxation agreement (DTA) was enacted last year.**[25] Under the new law, "Exchange of Information on Tax Matters Act of 2009", the BIR Commissioner can access bank accounts in order to provide information requested by a tax treaty partner. Bank secrecy has been strictly protected by the Foreign Currency Deposit Act in which only the Secretary of Finance can make a request to access bank accounts. With the new law, the Philippines now can comply with the "internationally agreed standard on transparency and exchange of information" [26]. However, the BIR still cannot access the bank accounts for its own needs to combat tax evasion and avoidance**.** This contradictory rule that bank secrecy is lifted only for foreign governments' needs should be changed.

44. **The BIR should utilize the Philippines' extensive DTA network**[27] **to tackle tax evasion or avoidance using overseas banks by the Philippine taxpayers.** As all of Philippine's tax treaty partners are members of the Global Forum on Transparency and Exchange of Information (Global Forum), which committed to comply with internationally-agreed tax standards, the BIR can obtain information including bank accounts as far as the BIR can specify a taxpayer.[28]

45. Banks' reports to the Anti-Money Laundering Council (AMLC) under the Anti-Money Laundering Law (AMLL) would provide the BIR with useful leads to detecting tax evasion or avoidance. The AMLL requires banks to report a transaction if the total amount exceeds PHP500,000 in one banking day as well as a suspicious transaction. Currently, the BIR is not allowed to access information held by the AMLC. Given the rapid growth of

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[25] Executive Order 56 to implement the new law was issued on September 6, 2011.

[26] The internationally agreed standard requires a jurisdiction to provide information to a requesting jurisdiction where the information is foresseabaly relevant for the administration or assessment of the taxes of the requesting jurisdiction, regardless of bank secrecy or the existence of a domestic tax interest.

[27] The Philippines concluded 36 DTAs.

[28] As the current Philippines-Switzerland DTA does not have a provision for exchange of information.

cross-border transactions, access to the AMLC's information would assist the BIR effort in mobilizing revenue.

Recommendations

- Allow the BIR access to bank accounts for its own needs (Short Term).
- Allow the BIR access to data held by the AMLC (Short Term).

IV. Excise Taxes

A. Overview

Current Situation

46. **Philippines' excise tax revenues significantly declined as a share of GDP, as well as compared to average levels in the region, due to low rates.** The share of excises declined from 2.6 percent of GDP in 1997 to 0.8 percent of GDP in 2010. The decline in excise tax revenues also adversely affected the VAT because the VAT rate applies to duty- and excise-inclusive prices. Many excise rates need to be increased in order to increase the overall tax to GDP ratio. The decline in excise taxes are because of a lack of indexation of the specific taxes on tobacco and alcoholic products, use of old prices in classifying such products and reduction in excise on petroleum products.

Reversing the Decline in Excise Revenues

47. Excises should be increased within a timeframe of three years in order to bring the share of excise taxes in GDP to their 1997 levels. The adjustment process of excise rates has to start immediately and spread over three years in order to limit any possibility of illegal activity and minimize the adverse effects on consumers. Furthermore, the scope of excises can be extended to the telecommunication services as an additional revenue source. This way taxes on the consumers of tobacco and alcoholic products do not have to be increased significantly and the authorities are given longer to phase in all necessary adjustments. The mission recommends a gradual approach in implementing excise tax adjustment.

Regional Comparison

48. **Comparison of countries in the region shows that the Philippines has one of the lowest excise tax revenues as share of GDP and of total tax revenues (Tables 4 and 5).** Furthermore, excise taxes as a share of GDP have been on a declining trend. One of the main reasons for such low tax yield is the reliance on specific excise tax rates that were set at low levels without sufficient updates for inflation.

Table 4. Regional Comparison of Shares of Taxes

					Taxes on Income, Profits and Capital Gains						Domestic Taxes on Goods & Services				International Trade				
		Total Revenue and Social Security Contributions 2/	Tax Revenue	Other Revenue	Total	Individual	Corp.& Other Business	Unallocable	Payroll & Work Force	Property Taxes	Total	Sales, Turnover & VAT	Excises	Other	Total	Customs & Import Duties	Export Duties	Other	Other Taxes
Bangladesh	2008	10.3	8.3	2.0	2.0	1.3	0.7	0.0	0.0	0.0	3.0	2.9	0.0	0.0	2.8	0.0	2.8	0.0	0.5
Bhutan	2008	22.8	8.5	14.2	4.7	0.5	4.2	0.0	0.0	0.0	3.5	1.5	1.6	0.3	0.3	0.2	0.0	0.0	0.1
Cambodia	2006	9.8	8.2	1.6	1.1	0.2	0.9	0.0	0.0	0.0	4.6	2.9	1.4	0.3	2.5	2.1	0.4	0.0	0.0
China (P.R.)	2007	17.0	9.9	7.1	2.8	0.7	2.1	0.0	0.0	0.7	5.8	4.6	0.9	0.3	0.5	0.5	0.0	0.0	0.0
India	2008	14.5	12.5	2.0	6.5	2.3	4.1	0.0	0.0	0.0	3.9	0.0	2.5	1.4	2.2	2.2	0.0	0.0	0.0
Indonesia 3/	2004	17.4	12.3	5.1	5.2	4.2	1.0	0.0	0.0	0.6	5.9	4.3	1.3	0.3	0.6	0.5	0.0	0.0	0.1
Lao PDR 3/	2009	14.8	13.3	1.5	3.7	0.0	0.0	0.0	0.0	0.1	7.9	2.9	3.0	1.9	1.6	1.5	0.1	0.0	0.0
Malaysia 3/	2003	21.2	16.5	4.7	10.6	2.5	8.1	0.0	0.0	0.1	4.8	2.0	1.2	1.6	1.2	0.9	0.2	0.0	-0.1
Nepal	2008	12.3	10.4	1.9	2.0	0.0	1.6	0.4	0.3	0.4	5.2	3.7	1.4	0.1	2.6	2.5	0.1	0.0	0.1
Pakistan	2007	14.5	9.8	4.6	3.7	3.6	0.0	0.1	0.0	0.1	4.4	3.6	0.8	0.0	1.5	0.0	0.0	0.0	0.0
Philippines 3/	2008	15.8	14.2	1.7	6.5	2.0	3.9	0.6	0.0	0.0	4.1	1.9	0.8	1.4	3.5	3.5	0.0	0.0	1.2
Sri Lanka 3/	2008	14.9	13.3	1.4	2.9	0.5	1.4	0.9	0.0	0.0	6.9	4.6	2.3	0.0	2.2	1.4	0.0	0.0	0.1
Thailand	2008	20.1	16.5	2.7	7.9	2.1	5.8	0.0	0.0	0.0	7.4	3.7	3.4	0.4	1.1	1.1	0.0	0.0	0.0
Vietnam 4/	2004	24.7	21.5	3.3	8.2	0.5	7.7	0.0	0.0	0.5	9.7	5.8	2.0	1.9	3.0	0.0	0.0	0.0	0.0
Unweighted Avg.		16.4	12.5	3.8	4.8	1.5	3.0	0.1	0.0	0.2	5.5	3.2	1.6	0.7	1.8	1.2	0.3	0.0	0.1

Sources: Government Finance Statistics and World Economic Outlook (IMF).

1/ Data for consolidated central government, unless otherwise noted.

2/ Excluding grants.

3/ Budgetary central government data.

4/ General government data.

Table 5. Regional Comparison of Tax Structures, as Share of Total Revenues

					Taxes on Income, Profits and Capital Gains						Domestic Taxes on Goods & Services				International Trade				
		Total Revenue and Social Security Contributions 2/	Tax Revenue	Other Revenue	Total	Individual	Corp.& Other Business	Unallocable	Payroll & Work Force	Property Taxes	Total	Sales, Turnover & VAT	Excises	Other	Total	Customs & Import Duties	Export Duties	Other	Other Taxes
Bangladesh	2008	124.4	100.0	24.3	24.2	15.3	8.9	0.0	0.0	0.0	35.7	35.1	0.6	0.0	34.3	0.0	34.3	0.0	5.7
Bhutan	2008	268.0	100.0	166.7	55.3	5.7	49.5	0.0	0.0	0.0	40.6	18.0	19.1	3.5	3.3	2.8	0.0	0.4	0.8
Cambodia	2006	119.8	100.0	19.8	13.6	2.8	10.7	0.0	0.0	0.0	56.1	35.7	17.1	3.3	30.0	25.2	4.8	0.0	0.3
China (P.R.)	2007	171.3	100.0	71.3	28.6	7.2	21.4	0.0	0.0	7.4	58.5	46.1	9.0	3.4	5.5	5.5	0.0	0.0	0.0
India	2008	116.0	100.0	15.9	51.6	18.7	32.9	0.0	0.0	0.1	31.0	0.2	20.1	10.8	17.3	17.2	0.0	0.1	0.0
Indonesia 3/	2004	141.4	100.0	41.4	42.0	33.8	8.2	0.0	0.0	5.2	47.7	34.9	10.3	2.6	4.5	4.4	0.1	0.0	0.6
Lao PDR 3/	2009	110.9	100.0	10.9	27.7	8.2	0.0	0.0	0.0	1.0	59.0	22.1	22.6	14.3	12.2	11.5	0.8	0.0	0.0
Malaysia 3/	2003	128.2	100.0	28.2	64.2	0.0	49.1	0.1	0.0	0.3	29.0	12.3	7.1	9.6	7.1	5.7	1.4	0.0	-0.7
Nepal	2008	117.8	100.0	17.8	19.5	15.0	15.6	3.9	2.9	3.5	49.4	35.0	13.1	1.3	24.7	24.1	0.5	0.1	0.0
Pakistan	2007	147.1	100.0	47.1	37.8	0.0	0.0	1.2	0.0	0.8	44.6	36.2	8.3	0.0	15.5	0.0	0.0	0.0	1.3
Philippines 3/	2008	111.8	100.0	11.8	46.0	36.6	27.2	4.4	0.0	0.0	29.2	13.4	5.9	10.0	24.8	24.8	0.0	0.0	0.0
Sri Lanka 3/	2008	111.9	100.0	10.7	21.6	14.4	10.9	6.7	0.0	0.0	52.3	34.8	17.2	0.3	16.8	10.9	0.0	5.9	9.3
Thailand	2008	122.3	100.0	16.6	47.7	4.0	35.2	0.0	0.0	0.0	45.1	22.3	20.7	2.2	6.5	6.4	0.0	0.0	0.7
Vietnam 4/	2004	115.3	100.0	15.3	38.3	12.6	36.0	0.0	0.0	2.4	45.2	27.0	9.3	9.0	14.1	0.0	0.0	0.0	0.0
Unweighted Avg.		136.2	100.0	35.6	37.0	2.3	21.8	1.2	0.2	1.5	44.5	26.7	12.9	5.0	15.5	9.9	3.0	0.5	1.3

Sources: Government Finance Statistics and World Economic Outlook (IMF).

1/ Data for consolidated central government, unless otherwise noted.

2/ Excluding grants.

3/ Budgetary central government data.

4/ General government data.

49. **Table 6 compares excise tax rates in selected South East Asian countries.** Cambodia and Vietnam use *ad valorem* rates on tobacco and alcohol. Thailand uses both *ad valorem* and specific rates to tax tobacco and alcohol. The Philippines is the only country in the region that uses specific excise rates. Use of specific excise rates on tobacco products addresses the issue of negative externality of smoking but the four tiers of excise rates make the tax structure like an *ad valorem* excise tax. The advantages and disadvantages of specific versus *ad valorem* excise taxes are discussed in the next section.

Table 6. Comparison of Regional Cigarette and Alcohol Excise Taxes

Product	Philippines 1/	Cambodia 2/	Vietnam 2/	Lao P.R. 2/	Thailand (in % or Baht) 2/	
	(Peso)	(percent)	(percent)	(percent)	(percent)	(Baht)
Cigarettes (pack of 20)	2.72-28.30	10	65	55	75	
Alcoholic Beverages - high alcohol content	14.68-634.89	10	45/50	70	35 to 50 /liter of pure alcohol	35 to 50 or 240B/liter of pure alcohol
Alcoholic Beverages - low alcohol content	22.01-550.24	10	25	60	25 /liter of pure alcohol	25 or 100B/liter of pure alcohol
Beer	10.42-20.57	30	45/50	50	55 /liter of pure alcohol	55% or 100B/liter of pure alcohol

1/ 2011 rates.

2/ 2010 rates.

Source: IMF

B. Specific vs. *Ad Valorem* Tax Rates and the Mixed Use of Both

50. **In competitive markets, the choice between specific and *ad valorem* taxation is irrelevant: any specific tax could be replaced by its percentage equivalent with no effect on consumer and producer prices or on government revenue.** However, in an imperfectly competitive market – a much more common phenomenon – quality levels between similar excisable products, such as cigarettes, differ widely. With imperfect competition, firms' incentives to raise price and to distort quality may be quite different under specific and *ad valorem* taxation. In the case of a monopolist, that perhaps closely resembles the case of Philippines where Phillip Morris accounts for 90 percent of the market, specific taxation increases marginal costs by a fixed amount, whereas *ad valorem* taxation acts as a proportional tax on costs, together with a proportional (lump-sum) tax on monopoly profits.

51. **The choice between specific and *ad valorem* excises affects the revenue collected as well as the price and the quality of the tobacco products.** Specific rates reduce relative price differences between low-priced and high-priced brands, whereas *ad valorem* rates increase absolute price differences. Because when an *ad valorem* tax is levied, tobacco excise is not differentiated according to tobacco content. Especially heavy taxation of tobacco products is justified because of their negative externality which is the tobacco itself. Accordingly, a rational tax structure should be based on tobacco content, not relative values. A specific tax will mitigate the negative externality of smoking while at the same time providing an incentive for producers to improve the quality of their products. As the tobacco content for cigarettes, both filtered and unfiltered, tends to be the same, averaging around one gram per stick, the rate for these two products should be the same.[29] In contrast, the overall tax on these two products will be different on application of the *ad valorem* excise. The rate can be on a per mille basis, to keep administration simple. The amount of tobacco contained in cigars has a high degree of variance, and so a rate based on the tobacco content would be more appropriate than on a mille basis. An appropriate rate for cigars would be aligned to the rate for cigarettes, but expressed in terms of grams.

[29] An argument could be made that the specific tax rate for unfiltered cigarettes should actually be higher than filtered cigarettes, as the health risks and associated costs imposed on the health care system are higher.

52. ***Ad valorem* excises have a multiplier effect.** For example, if a manufacturer facing a tax-exclusive *ad valorem* tax of 40 percent[30] decides to improve the quality of its products and passes the added costs to customers, the price increase will be 40 percent more than the added cost because of the *ad valorem* tax (Table 7). Conversely, if the same manufacturer cuts its costs, the retail price will decrease by more than the reduced costs, because the tax will decrease under an *ad valorem* system. In a specific excise system, the amount of tax would not change.

Table 7. The Impact of an *Ad Valorem* Tax on Retail Prices

		Ex-factory price	*Ad valorem* tax (40%)	Retail price	Price change
Case #1	Initial situation	1.00	0.40	1.40	NA
Case #2	Cost increase = 0.20	1.20	0.48	1.68	0.28
Case #3	Cost decrease = -0.20	0.80	0.32	1.12	- 0.28

Source: Staff calculations.

53. **The multiplier effect provides a strong incentive for price competition, as any competitive advantage will be "multiplied" by the tax system and put the most competitive firm at an even stronger advantage (and vice-versa).** This in turn will provide a strong incentive to cut all costs, including quality and diversity (Keen, 1998), and lead to an industry with few manufacturers producing few low quality brands. The tobacco industry tends to have an oligopolistic structure both at the international and national levels (a few firms control the market), hence manufacturers have the capacity to increase price above their competitive level. By providing the advantage to cost-cutting low-pricing firms, *ad valorem* taxes mitigate this market power by keeping downward pressure on prices.[31]

54. **Specific taxes result in less intense price competition, higher quality, diversity and prices, and a larger number of manufacturers.** Because the tax per cigarette is fixed, manufacturers can reap the benefits of investments in product differentiation with a smaller price increase (improved quality and greater diversity). In addition, specific taxes constitute a de facto minimum price and push the entire price spectrum higher by the same amount (the

[30] A tax-exclusive *ad valorem* rate is the percentage that is applied to the tax base to arrive at the transaction price. A tax-inclusive *ad valorem* rate is the percentage of the final price paid in *ad valorem* excise. Statutory *ad valorem* rates are generally expressed exclusive of the tax. For example, for a transaction price of US$1.40, a tax-exclusive rate of 40 percent would mean that the ex factory price is US$1.00, and the tax US$ 0.40 (i.e., 40 percent of US$1.00). A tax-inclusive rate of 40 percent would mean that 40 percent of the final price is paid in tax, i.e., 0.40 X US$ 1.40 = US$0.56, hence an ex-factory price of US$0.84.

[31] The resulting price competition has the additional benefit of reducing the price differential between duty-paid and illicit/cross-border shopped tobacco, thus reducing the incentive for consumers to buy illicit product.

price of all brands will be increased by the amount of the tax) hence there will be a lower percentage price difference between high and low quality brands, making it easier to switch to higher quality brands (Table 8). Finally, specific excises in an oligopolistic context are also more likely to result in shifting of the tax increase, i.e., passing more than the price increase to consumers (*ad valorem* taxes are also known to have resulted in shifting, although by a lesser extent than specific taxes).

55. **There is no single result as to whether *ad valorem* or specific excises are preferable in order to raise tax revenue.** Choice of taxation depends on industry structure.[32] Limited administrative capacity in many countries may also play a role in the choice of the best tax mix for revenue raising purposes. However, the impact on product quality is a key concern regarding the efficiency of excise tax policy (Delipalla and Keen, 2006). A good tax system should minimize distortion of economic choices, including quality of the product. However, quality can be strongly influenced by the counterbalancing forces of specific and *ad valorem* taxes and therefore deviate from its optimal level (i.e., the quality that would exist as a market outcome in the absence of excises). An optimal tax system should therefore use both taxes in a way that would leave quality unchanged, compared to the hypothetical “no-excise” world. The quality level resulting from an optimal mix of *ad valorem* and specific excises also maximizes tax revenue for a given tax burden. Therefore, by choosing a mix of taxes that generates the right amount of quality and diversity in the market, governments can both raise revenue efficiently and minimize distortions on the optimal quality and diversity of products. Although a mix of *ad valorem* and specific excise rates are preferred form the point of minimizing distortions, improvements to quality and mispricing by vendors may dictate the use of specific excise rates instead of *ad valorem* rates as it seems to be the case for the Philippines.

[32] For example, these might include one or more dominant firms and many small firms with potentially unrecorded activities (e.g., Pakistan, Brazil), a monopoly with cartel features (e.g., China), or a small formal market with a huge fringe of low-quality substitutable products from small scale manufacturers (India).

Table 8. Effect of Specific Excise on the Relative Price of High Quality Brand

	Specific tax = 0		**Specific tax = 0.50**	
	Low quality brand	High quality brand	Low quality brand	High quality brand
Pre-tax price	1	1.25	1	1.25
Specific excise	0	0	0.5	0.5
Final price	1	1.25	1.5	1.75
Percentage price difference	(1.25-1.00) / 1.00 = **25%**		(1.75-1.50) / 1.50 = **16.7%**	

Source: Staff calculations.

C. Earmarking Excise Taxes on Tobacco and Alcohol

56. **Earmarking excise revenues is advocated by some to finance health expenditures, projects that stimulate the production, and consumption of clean energy, or restore the environment, or to pay for the building and maintenance of the road transport system.** Bird and Jun (2007) classify eight types of earmarking by the degree of specificity of the expenditures involved, the strength and nature of the linkage between the earmarked revenues and the expenditure, and whether or not there is an identifiable benefit rationale for the linkage. In its strongest form, earmarked revenues come directly from those who benefit from the expenditures which is consistent with the benefit principle. However, earmarking generates budget inefficiencies because it prevents allocation of budget expenditures to their best use.

57. **Tobacco or alcohol excise revenues could be used to finance health expenditure for the treatment of the ailments which they cause—but this can be problematic.** It would be very difficult to establish a link between medical conditions related to tobacco and alcohol and the financing for their treatment. Earmarking is considered "irrelevant," because the marginal expenditure decision remains firmly in the hands of the budgetary authorities. Earmarking is particularly suspect in the case of tobacco and alcohol excise revenues since it would be difficult to isolate health expenditures on smoking-related diseases and finance them by tobacco duties. Cnossen and Smart (2005) show that tobacco tax revenues exceed the external cost associated with smoking, primarily because smokers tend to die earlier than non-smokers and, hence, may not attract age-related diseases which require expensive treatment. With alcohol the case for earmarking is the same, because moderate drinkers would be asked to pay for the health and other social costs attributable to abusive drinkers. The case for earmarking, even if the benefit rationale is quite strong, remains tenuous at best.

D. Tobacco Excises

58. **Excise revenues from tobacco products declined from 0.6 percent of GDP in 1997 to 0.3 percent in 2010.** The government of the Philippines is in the process of increasing the excise on tobacco products. The tables below show the effect of various excise tax options on tobacco products compared to the burden of current tobacco excises on

consumers. The tax burden estimates are for demonstration purposes. Currently cigarettes are classified according to prices into four tiers.[33] Such an excise tax structure with narrowly-defined price bands with big jumps in excise rates is difficult to administer and provides opportunities for mispricing cigarettes. To avoid abuse and improve the quality of cigarettes consumed, it would be beneficial to eliminate the multiple excise rates. The tax burden (excise and VAT) estimates are made on an average pack of cigarettes with 20 sticks. Table 9 shows the burden of current specific excise tax rate per pack of average brand. The specific excise tax rate on an average pack of cigarettes is PHP8.75.[34] The table demonstrates the burden of current excise taxes as a share of the retail price. The total tax burden of excise and VAT is about 44 percent and the burden of excises is 33.65 percent.

Table 9. Tax Burden of Current Excise Tax on Tobacco

Tobacco	Rates/ Specific Amount	Equivalent rate on retail price	Average Price
Retail Price Including All taxes (P)			26
Taxes			
Specific Tax t_s	8.75		8.75
Ad valorem t_a*P	0.0%	0.00%	0.00
VAT (t_{vat})	12%	10.71%	2.79
Total Tax $\{t_s+[t_a+(1+t_a)*t_{vat}]*P\}$			11.54
Retail Price ex-taxes P_o			14.46
Total Tax Burden			44.37%
Share of Excise Tax			33.65%

Source: DOF and staff calculations.

59. **The DOF proposes to reduce the current 4 tiers of excise rates to two tiers for 2012 and 2013 and switch to a uniform rate thereafter.** Table 10 shows the current retail prices and taxes by price group. According to the DOF's proposal the specific rates will be periodically adjusted by an index of prices.

[33] The rates are 2.72 pesos per pack for hand-packed and cigarettes valued less than 5 pesos; 7.56 pesos for cigarettes priced between 5 to 6.50 pesos; 12.00 pesos for cigarettes priced between 6.50 to 10.00 pesos; and 28.30 pesos for cigarettes priced over 20 pesos.

[34] The average price and excise rates are weighted averages provided by the Philippines authorities.

Table 10. The Current Excise Taxes on Tobacco Products and DOF's Proposal

Cigarette prices by brand	Average Current Retail Price (including VAT & Excise Tax) (a)	Value-Added Tax (b)	Applicable Excise Tax (c)	Average Current Net Retail Price (excluding VAT & Excise Tax) (d)=(a)-[(b)+(c)]	Weight by Consumption	Change in Retail Price
Current Excises						
High-price: Local and Imported	35.29	3.78	13.00	18.51	54.2%	
Medium price	25.56	2.74	7.14	15.68	12.3%	
Low-price 1/	13.35	1.43	2.47	9.45	33.5%	
Weighted average of all brands	26.74	2.87	8.75	15.13	100.0%	
MOF's Proposal						
High-price: Local and Imported	52.40	5.61	30.00	16.79		48.5%
Medium price	51.17	5.48	30.00	15.68		100.2%
Low-price	26.26	2.81	14.00	9.45		96.7%
Weighted average of all brands	43.49	4.66	24.64	14.19		62.6%

Source: DOF and staff calculations.

1/ The lowest two price brackets are combined into one.

60. **Table 11 shows the effect of increasing the specific excise tax rate from the current level of PHP8.75 on an average pack of cigarettes to the fully phased-in excise of PHP24.64 according to the DOF's proposal.** The total tax burden increases from 44 percent to 67 percent. The effect shown in Table 11 is the fully phased-in effect of increasing the excises on tobacco products. The DOF proposal contains a three-year phasing of the new excise rates under which brands with net retail price (net of taxes) over PHP10 will be subject to the PHP30 per pack rate immediately. Brands with a net retail price less than PHP10 will be subject to an excise of PHP14 and PHP22 in the first two years and the PHP30 like high-priced brands after the second year of transition.

Table 11. Tax Burden of PHP24 Specific Excise Tax Rate

Tobacco	Rates/ Specific Amount	Equivalent rate on retail price	Average Price
Retail Price Including All taxes (P)			43.5
Taxes			
Specific Tax t_s	24.64		24.64
Ad valorem t_a*P	0.0%	0.00%	0.00
VAT (t_{vat})	12%	10.71%	4.66
Total Tax $\{t_s+[t_a+(1+t_a)*t_{vat}]*P\}$			29.30
Retail Price ex-taxes P_0			14.20
Total Tax Burden			67.36%
Share of Excise Tax			56.64%

Source: DOF and staff calculations.

61. **DOF should consider alternative phase-in options of the new excise rates in order to avoid brand switching and minimize illegal trade of tobacco products.** The rate increase proposed by DOF is consistent with the excises in the region; however, phasing-in should not trigger contrabanding and counterfeiting of cigarettes. Since two-thirds of cigarettes consumed are high priced cigarettes a sudden large increase in prices may lead to

brand switching and some illegal trading. It is possible to increase the rates by PHP10 each year over three years. Alternatively, DOF may prefer to keep the increases low in the first two years (e.g., PHP7 in 2012, PHP8 in 2013) with a large increase in the third year of phasing in the excise rates reaching the target excise rate of PHP30 by 2014. The fully phased-in increase may increase the excise yield as much as 0.8 percent of GDP. So, DOF should aim to reach the tobacco excise-GDP ratio of 1997 by 2014.[35]

62. **The adjustments to the specific rates after 2014 should be based on the CPI rather than an index of tobacco products as proposed by the DOF.** Basing the indexation on cigarette prices would subject the tax revenues to fluctuations in the cigarette prices due to industry competition as well as price strategies employed by the producers even when inflation rises. The proposal by DOF increases the share of excises from about 33 percent to 56 percent. Future indexation should maintain a specific excise rate such that the share of the excise in the price remains over 50 percent and gradually increases to 70 percent as recommended by the WHO.

Tobacco Taxation and Employment

63. **The effect of increases in tobacco excise taxes on employment is not obvious.** It is difficult to separate the tax effects from the effects of change in population, technology used in growing tobacco, production technologies and international supply of tobacco leaves. Some argue that the tax increases will result in job losses, noting that many are employed in tobacco growing, manufacturing and distribution (WHO, 2010). However, many of the jobs that are counted in estimates of the economic contribution of tobacco are far from dependent on tobacco, but rather involve tobacco in some limited way, often indirectly (e.g. retailers who sell tobacco products, among many other products, or jobs in the heavy equipment sector where farming equipment is produced). Similarly, these estimates include so-called "expenditure induced employment"—jobs that result from spending by those whose incomes are earned in the jobs counted as tobacco related (multiplier effect). In general, only jobs in tobacco farming (which are often part time and for which tobacco is one of several crops), tobacco leaf drying and warehousing (which involves very few jobs), and tobacco product manufacturing can be considered truly dependent on tobacco.

64. **When it is argued that higher taxes on tobacco products lead to employment losses, this argument ignores the fact that shifts in spending away from tobacco products generate new employment in other sectors, with the net impact generally positive.** In addition, a major factor ignored in the arguments on the employment effects of tobacco taxes is the possibility of increase in exports of tobacco products. Tobacco

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[35] Annual increase in excise revenues on tobacco products according to the DOF's plan are estimated using average tax elasticities for tobacco products from countries similar to the Philippines (Table 1). The elasticity estimate used by the DOF is on the high side compared to those cited in WHO (2010).

producers increase sales abroad when faced with declining domestic demand. While the domestic price elasticity of demand for tobacco products is small, the price elasticity of export demand is relatively large[36]. So it seems unlikely that tobacco farmers would be very adversely affected by increases in tobacco excises.

65. **In most countries, employment in tobacco dependent sectors has been falling over time as farming techniques have improved and as tobacco product manufacturers have adopted new, more capital intensive production methods.** Improvements in productivity that lead to reduced imports and higher domestic production may have the potential to more than offset any reduction brought about by tobacco tax increases. In some countries, increased imports of tobacco leaf and/or tobacco products have contributed to reduced domestic employment in tobacco dependent sectors. For most countries, the job losses in tobacco dependent sectors that have resulted from these factors exceed any job losses resulting from higher taxes and other tobacco control efforts. For example, Turkey has changed the type of tobacco leaves it grows in addition to blending home-grown tobacco with imported tobacco leaves. More importantly, any tobacco dependent jobs lost in response to the reduced demand for tobacco products caused by higher tobacco taxes can be expected to be offset by new jobs in other sectors. The money not spent by tobacco users who quit or spend less on tobacco products after a tax increase will not disappear from the economy, but will instead be spent on other goods and services, creating jobs in these sectors. Rising incomes and population growth should offset any negative impact on employment (Jacobs, et al., 2000).

66. **Similarly, government spending of the new tax revenues that result from a tax increase will create jobs in other sectors.** Increases in tobacco taxes or implementation of other tobacco control measures do not lead to net job losses; in many countries, such efforts result in net increases in jobs as spending is shifted to more labor intensive goods and services. This is particularly true for countries where significant shares of tobacco leaf and/or tobacco products are imported, given that much of the money spent on tobacco products will flow out of the country, in contrast to the spending that replaces spending on tobacco in response to tax increases or other tobacco control measures.

67. **In Indonesia, tobacco farming and manufacturing contributes less than one percent of total employment in 2006.** Furthermore, tobacco manufacturing wages are one of the lowest in the manufacturing sector—an average of $876 per year where per capita income is $3,015 per year (2010). Farmers that cultivate tobacco and clove already have very diverse crop holdings and engage in other farm and non-farm enterprises. So, cultivation

[36] Allen and Ballingall (2011) and Dixon and Rimmer (2002) provide estimates of export demand elasticity for a number products. For alcoholic beverages and tobacco elasticity estimates range from -2 to -4.

of alternative crops mitigates the income losses due to decline in demand or competition from imports of tobacco products.

68. **Similarly in Vietnam, employment in tobacco cultivation and manufacturing accounts for a very small share of total employment.** One factor that could affect tobacco employment in Vietnam are the government's policy of promoting exports of tobacco products and encouraging domestic tobacco production (currently about 50 percent of tobacco leaves and materials are imported). Furthermore, industry restructuring undertaken by the government — which has involved the closure of seven factories in recent years — might have already had a stronger impact on tobacco employment than any tax change could have in the near future.

69. **The effects of increases in tobacco taxes elsewhere around the world on domestic tobacco production and employment are negligible.** Even when worldwide tobacco taxes increase they are unlikely to have a significant impact on tobacco dependent employment in most countries. While demand for tobacco products decreased in developed countries it has been on an increasing trend in developing countries (World Bank, 1999). For a few agrarian countries that do depend heavily on tobacco leaf exports (e.g. Malawi), if an immediate reduction in global demand for tobacco products is to occur there may be significant job losses in the short run. However, given the current trend in global demand, higher taxes and other tobacco control measures are not likely to result in a sharp drop in demand in the short run, but rather a slowing of the increase in the near term followed by slowly falling demand in the longer term. This implies that any job losses in these countries will not happen for many years, allowing for a gradual transition from tobacco to other crops.

70. **Countries that are concerned about the impact of tobacco tax increases on domestic employment in tobacco dependent sectors can alleviate these concerns by adopting programs that would ease the transition from tobacco farming and manufacturing to other economic activity.** Crop diversification programs that support farmers and retraining programs for those involved in tobacco product manufacturing could easily be funded by a small portion of the new revenues that result from increases in taxes on tobacco products. In Turkey, for example, the government sponsored "alternative crop program" that was implemented in anticipation of the privatization of the country's cigarette monopoly has proven effective in moving many tobacco farmers to other crops. A study on the effects of complying with the EU excises on tobacco in Turkey showed very little effect on farm employment (Caner and Vasquez, 2008).

71. **Finally, the tobacco industry's structure in the Philippines is a determining factor on the effects of excises on employment and other economic activity.** Philip Morris accounts for more than 96 percent of the sales of tobacco products. It is the largest buyer-supplier of tobacco in the Philippines. The company has the ability to alleviate any decrease in domestic demand by increasing exports thus leaving domestic production unchanged. Furthermore, the company cooperates with customs officials and conducts its

own surveillance to deter any smuggling activity. So, given the circumstances it is very unlikely to expect any decrease in employment or an increase in smuggled tobacco products

Recommendations

- Start the rate adjustments no later than the beginning of 2012. (Short Term)
- Consider alternative scenarios for phasing in the excise increases. (Medium Term)
- Use the Consumer Price Index (CPI) to adjust the excise rates periodically (say, quarterly) instead of an index of cigarette prices since cigarette prices may decline irrespective of movements in the general price level. (Medium Term)
- Adjust the specific rates on tobacco products to reach the excise on tobacco products to GDP ratio attained in 1997. (Medium Term)
- Complete the adjustment in three years. (Medium Term)

E. Excise on Alcohol Beverages

Current situation

72. **Similar to excise on tobacco products, excise revenues on alcoholic beverages declined from 0.6 percent of GDP in 1997 to 0.3 percent of GDP by 2010.** The DOF's proposal will rationalize and increase excises on alcoholic beverages as a reliable source of revenue. DOF's proposal includes changes in excises on fermented liquors, wines, and distilled spirits.

Table 12. The Tax Burden of Excise Taxes on Fermented Liquor and Distilled Spirits: DOF's Proposal

	Rates/ Specific Amount	Equivalent rate on retail price	Fermented		Distilled	
			Low price	High Price	Low price	High Price (Imported)
Retail Price Including All taxes (P)			66.5	104.0	300.0	879.8
Taxes						
Specific Tax ts			25.0	25.0	150.0	150.0
Ad valorem ta*P	0	0	0.0	0.0	0.0	0.0
VAT (tvat)	12.0%	10.7%	7.1	11.1	32.1	94.3
Total Tax {ts+[ta+(1+ta)*tvat]*P}			32.1	36.1	182.1	244.3
Retail Price ex-taxes P0			34.4	67.9	117.8	635.6
Total Tax Burden			85.9%	58.8%	110.7%	44.8%
Share of Excise Tax			37.6%	24.0%	50.0%	17.0%

Source: DOF and staff calculations.

73. **DOF's proposal on alcoholic beverages increases the excises on some products while decreasing them on others**. For example, while the tax burden on fermented liquors and low-priced spirits will increase, it will decrease on high-priced imported spirits.

However, this approach will harmonize excise rates along the alcohol content of the beverages. Furthermore, the new structure does not differentiate between domestic and imported brands with same alcohol content. In addition, the DOF's proposal introduces a unified specific excise rate for wines which are currently differentiated according to price. As in the case of tobacco excises, applying differentiated rates to different price bands would provide an opportunity to misprice the products to avoid higher excise rates. Furthermore, it is administratively difficult to follow all prices and pricing strategies of the producers. The new excises on wine products will be PHP 300 and P 50 per bottle for sparkling wine and still wine respectively. The effects of increases in excises on selected alcoholic products are shown in Table 12.[37]

Recommendations

- Increase excises on all alcohol as proposed by DOF. (Short Term)
- The new excise taxes on alcoholic beverages should be set according to alcohol content, domestic or imported. (Short Term)
- Use the Consumer Price Index (CPI) to adjust the excise rates periodically (say, quarterly) instead of a price index of alcoholic beverages for the same reasons explained under recommendations for tobacco excises. (Medium Term)

F. Petroleum Excises

Current situation

74. **In 1997, excises on petroleum products raised PHP30.8 billion, 1.2 percent of GDP.** In 2010, they raised PHP9.7 billion, 0.1 percent of GDP. Excises on gasoline were PHP17 billion and excise on diesel was PHP 9 billion. Currently, diesel is exempt from excises and gasoline is subject to an excise of 4.35 PHP/liter. The excise on gasoline was reduced to this level, from 4.80 PHP, in 2005.

75. **It is sometimes argued that lower excise taxes on petroleum products help the low-income population, but 74 percent of gasoline consumed is unleaded premium which is hardly the choice of low-income people**. Excises on petroleum have been a significant source of revenue for the government. Reinstating the excise tax on diesel at the old rate of PHP1.63 would increase the excise revenue to GDP ratio by almost 0.1 percentage point. A further increase to PHP3.5/liter on diesel and a PHP5/liter on gasoline would

[37] Revenues from increase in excise on alcoholic beverages are estimated similar to those above for tobacco products, using tax elasticities. Additional revenue projections are provided in Table 1.

increase excise revenues on petroleum products by 0.42 percent of GDP (see Table 2).[38] This would be a very small burden given the current level of diesel prices. Furthermore, a small increase in the excise on gasoline would only be catching up with lost revenues since 1997.

76. **The share of excise in the price of gasoline has declined since 1997.** The increase in excise on petroleum products is not only justified as a way of catching up with excise revenues but because of its effects in reducing CO_2 emissions and local pollution. Higher specific rates would induce consumers to switch to cleaner fuels thus reducing the adverse effects on the environment. The mission repeats the recommendation of increasing the excise on gasoline to PHP 5/liter and excise on diesel to PHP 3.5/liter which was made by the 2010 mission. The government expects to raise planned revenue from excises on tobacco products and alcohol beverages in the next three years. There are further plans and the will to introduce a new excise on diesel and increase the excise on gasoline in the next three years. Ultimately, the excises on petroleum products have to be increased to preserve their revenue yield in real terms.

Recommendations

- The specific rate on gasoline should be increased from its current levels after phasing in excises on tobacco and alcoholic beverages.(Medium Term)
- Start adjusting the excise on gasoline using CPI immediately. (Short Term)
- Reinstate the specific excise tax rate on diesel after phasing in excises on tobacco and alcoholic beverages. (Medium Term)
- Adjust the excise on diesel using CPI after its introduction. (Medium Term)

G. Excise Taxation of Telecommunication Services

Current situation

77. **In the Philippines, there are no additional taxes on mobile telecommunications services other than VAT.** However, given the volume and the increase in the usage, it can be a significant source of revenue with no or very little distortionary effects. In order to increase the tax to GDP ratio, and reduce the extent of increases in excise on products like petroleum, tobacco and alcoholic products, authorities should look into the possibility of taxing mobile phone communications at a very low rate per call.

[38] Revenue gains are estimated for 2010 and projected to 2016.

Issues

78. **Three issues have to be considered in the taxation of mobile telecommunications services: (1) abnormal profits to the operators because of limited spectrum; (2) positive externalities benefiting existing users as the networks expand; and (3) complex pricing schemes by the operating companies that make the tax base difficult to define**. In the case of taxing mobile telecommunications services, the usual arguments for excise taxation are difficult to justify. However, some countries do have specific charges on mobile services on the grounds that the revenues obtained from mobile services can be used to further expand the network, therefore, welfare increasing as in the case of UK. The excise on telecommunications can be considered as a proxy for tax on economic rent obtained from services provided by a few operators, though further study on to what extent the auctioning of licenses in the Philippines captures this rent is necessary.[39]

79. **In addition, widespread use of mobile phones in the informal economy exists, with mobile phones being used as both business inputs and also for personal reasons.** Given the fact that tax can be collected by a few telecom operators at the time service or access is provided, the excise taxation of telecommunications services makes sense for tax authorities. It may be the only way to tax informal activities where a significant portion of economic activity is undocumented and tax evasion is pervasive.

80. **Taxes can be on the hand set or on the service. Many countries impose a tax on one or the other or both.** In the Asia Pacific Region, Bangladesh, Cambodia, Sri Lanka and Pakistan have specific charges on telecommunications in addition to VAT. Thailand repealed the excise on mobile communications arguing that it is no longer a luxury item. One country where a large number of telecom specific excises exist is Turkey: in addition to the Value Added Tax (18 percent), mobile phone users in Turkey have to pay a Special Communication Tax (25 percent) and a Treasury Share Premium (15 percent) on each mobile phone call they make. Furthermore, they pay a Special Communications Tax when they first take out a subscription (US$18), the Wireless License Fee (US$7.5) and the Wireless Usage Fee (US$7.5 per annum).[40] The Special Communication Tax was imposed as a temporary measure after the 1999 earthquake – the government is also considering imposing a US$9 tax on mobile phone users as part of an ‘Environmental Contribution Fund. Collection from special charges on mobile services amount to 0.7 percent of GDP.

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[39] For example, when the National Telecommunications Commission (NTC) selected carriers for 3G mobile phone service, no bidding was conducted because the number of the applicant that satisfied the criteria set by the NTC is within the number of licensees prescribed by the NTC’s Memorandum Circular. As to the annual spectrum user fee for 3G of the Globe Telecom was PHP65 million while its annual service revenue in 2010 was PHP62 billion. (Source: www.ntc.gov.ph, http://site.globe.com.ph)

[40] http://www.gsmworld.com/news/press_2006/press06_25.shtml

81. **The preferred method is taxing the service which is argued to have the lowest price elasticity.** A study that reviews various options, and the revenue and economic effects of an excise on SMS and other mobile phone services would be useful to determine the fiscal benefits of a fast growing industry. A very low rate applied to a broad range of services can mitigate the effects that may be argued as regressive. The total number of SMS in the Philippines in a year is estimated at 600 billion in 2010 (83million (cellular phone subscribers) X 600 (average SMS per month per subscriber) X12). [41] Revenue from excise of 10 centavos per text can be as high as PHP60 billion.

Recommendation

- Initiate a study on the revenue and economic effects of an excise on SMS and other mobile phone services. (Long Term)

V. PERSONAL INCOME TAX

A. Rate Schedule

Current Situation

82. **The PIT rate schedule has not changed since 1997, while the personal allowance was increased to PHP50,000 in 2008.** The number of taxpayers and amount of paid tax by bracket is:

Table 13. Personal Income Tax: Rate Schedule

Taxable Income	Marginal Tax Rate	Taxpayers1/	Withheld tax1/
(in PHP)	(in percent)		(in PHP million)
0–10,000	5	916,405	2,005
10,000–30,000	10	266,716	66
30,000–70,000	15	419,952	226
70,000–140,000	20	597,296	1,507
140,000–250,000	25	730,046	7,548
250,000–500,000	30	519,113	17,790
500,000 or more	32	203,410	48,814
Total		3,652,938	77,954

Source: BIR
1/Complete data is available for those who have only wage income in 2010. The total number of registered compensation income earners is 9,509,212, and withheld tax from wages in 2010 is PHP 135,153 million.

[41] http://www.ntc.gov.ph

Issues

83. **Under the current law, the income entry level at which the maximum PIT rate applies for single individuals is 511 percent of per capita GDP in 2010.** This level is lower than other emerging economies in the region except Malaysia. (Table 14) It is desirable to index the rate schedule to inflation accumulated since 1997 in order to retain the progressivity of the tax system in the medium term once the data, which would enable the simulation of the revenue impact of such a policy change, become available. The rate schedule simply adjusted by accumulated inflation since 1997 is in Table 15. The table shows that the number of taxpayers in brackets to which the top two rates apply will decline from 722,523 to 203,410. It is also desirable to reduce the number of brackets to make the rate schedule simpler. In the short term, broadening the lowest tax rate band to the income bracket to which a 10 percent rate is currently applicable (Table 16), would be appropriate to partly mitigate the projected increase in the tax burden on low income taxpayers caused by broadening the VAT base and indexing excises as recommended by the mission. A decline in PIT revenue by this change would be minimal[42].

Table 14. Comparison of Maximum Rate Entry Income in Selected Countries
(In relation to per capita GDP: in percent)*

	Philippines	China	Indonesia	Malaysia	Thailand
2007	735	6,060	2,947	471	3,743
2011	511	3,556	1,594	341	2,478

Source: IBFD.
*For single individuals.

Table 15. Personal Income Tax: Inflation Adjusted Rate Schedule

Taxable Income	Marginal Tax Rate	Taxpayers1/	Taxpayers in the current schedule 1/
(in PHP)	(in percent)		
0-20,000	5	1,055,599	916,405
20,000-60,000	10	464,431	266,716
60,000-140,000	15	680,339	419,952
140,000-300,000	20	919,055	597,296
300,000-500,000	25	330,104	730,046
500,000-1,000,000	30	147,174	519,113
1,000,000 or more	32	56,236	203,410
Total		3,652,938	3,652,938

Source: BIR and staff calculations
*The accumulated inflation from 1997 to 2011 is 212 percent. To estimate the number of taxpayers and withheld tax by bracket with currently available data, the rate schedule is adjusted by 200 percent and an upper limit of the bracket to which a 20 percent rate applies is changed from PHP280,000 to PHP300,000.
1/ For those who earned only wages in 2010.

[42] While data on all taxpayers whose income is in the bracket PHP10,000 to 30,000 is not available, one half of the withheld tax collected from those who earned wage income only in 2010 and whose income is in the bracket PHP 10,000 to 30,000 is PHP33million (See Table 13).

Table 16. The Proposed Tax Brackets

Current Brackets		Proposed Brackets	
Taxable Income	Marginal Tax Rate	Taxable Income	Marginal Tax Rate
(in PHP)	(in percent)	(in PHP)	(in percent)
0–10,000	5	0–30,000	5
10,000–30,000	10		
30,000–70,000	15	30,000–70,000	15
70,000–140,000	20	70,000–140, 000	20
140,000–250,000	25	140,000–250,000	25
250,000–500,000	30	250,000–500,000	30
500,000 or more	32	500,000 or more	32

Recommendations

- Overhaul the tax rate schedule to reflect inflation since 1997 once data that enable an estimate of the revenue impact become available. (Long Term)

- Abolish the 10 percent tax rate and broaden the lowest tax rate band to the income bracket to which the 10 percent rate is currently applicable.(Short Term)

B. Taxation of Self-Employed

Current situation

84. The average amount of tax paid by the self-employed and professionals ("self-employed") in 2010 is PHP4,360, which is 30.7 percent of the average tax paid by wage earners (Table 17). The implication is that income earned by the self-employed and professionals are on average below the minimum wage.[43]

Table 17. Comparison of Self-Employed and Wage Earners

	2006	2007	2008	2009	2010
Self-employed					
a Number of taxpayers	1,248,994	1,381,421	1,485,346	1,597,847	1,695,347
b PIT paid by a(in mil.PHP)	5,823	5,481	6,319	7,330	7,392
b/a (in PHP)	4,662	3,968	4,254	4,587	4,360
Wage earners*					
a Number of taxpayers	6,671,043	7,816,942	8,591,689	8,873,943	9,509,212
b PIT paid by a(in mil.PHP)	105,887	120,057	126,787	111,813	135,153
b/a (in PHP)	15,873	15,359	14,757	12,600	14,213

Source: BIR
*Wage earners may include those who have both wage income and income as a self-employed individual.

[43] President Aquino's State of the Nation Address (July 25, 2011).

Issues

85. Making payments to the self-employed subject to a withholding tax or an information return could improve the level of tax compliance by the self-employed.[44] Section 57 of the NIRC requires a payer (withholding agent) to withhold creditable tax on payments to the self-employed, such as a lawyer, at 15 percent or 10 percent.[45] However, while the withholding tax applies to a wide range of payments made by a company, when a payer is an individual, the withholding tax only applies to payments made in connection with the payer's trade or business.[46] Thus, information on only a part of income earned by the self-employed is available to the BIR. Reporting of income by the self-employed mainly depends on their voluntary compliance.

86. **The Optional Standard Deduction (OSD) is too generous for the self-employed, especially for those whose gross sales exceed the VAT threshold.** The OSD allows the self-employed to opt for 40 percent deduction based on the gross sales or gross receipts of the self-employed and has no limitations on the gross sales and gross receipts. The self-employed who opt for the OSD can switch back to an ordinary itemized deduction in the following year, or vice versa. While the OSD may reduce costs of the self-employed in calculating taxable income, the self-employed whose allowable deductions are limited and whose sales are large enough to afford to calculate taxable income could benefit from the OSD. Considering that a VAT taxpayer, whose sales threshold is currently PHP1.5 million, has to calculate input credits based on invoices, the compliance costs of VAT taxpayers will not change even if he or she opted for the OSD. Thus, it is difficult to rationalize allowing a VAT taxpayer to opt for the OSD. The OSD could be one of causes for low contribution in the PIT by the self-employed, though necessary data to verify this are not available. Alternatively, as the House Bill No. 3992 proposes, the amount of the standard deduction could be reduced to 20 percent or less. The House Bill also proposes to limit the allowable deductions to those expenses which are easily verifiable and are directly expended on the production of goods or in the provision of services. This proposal could address tax avoidance practices through over-deduction of business expenses by the self-employed and also provide guidance for taxpayers.

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[44] The US Government Accountability Office report No. 08-266, "Tax Administration Costs and Uses of Third-Party Information Returns", November 2007.

[45] 15 percent rate applies if the current year's gross income of a lawyer exceeds PHP720,000. Dual withholding rates based on the current year's income of a recipient needs to be reviewed in order to reduce compliance costs of withholding agents.

[46] Revenue Regulations No. 02-98, section 2.57.3. Expanding this withholding requirement to all individuals who make payments to the self-employed may not be a viable option.

87. **The World Bank mission recommended that the top PIT rate be aligned with the CIT rate to reduce arbitrage opportunities between the PIT and CIT regimes.** Aligning the top PIT rate and CIT rate in theory may be desirable in theory, but the practice is varied by jurisdiction. However, in the short-term, as the majority of individuals whose income is subject to the top tax rate are those with wage income, a risk that taxpayers will arbitrage the difference between the top PIT rate and CIT rate by incorporating his or her business would not be so imminent even if the CIT rate is reduced further.[47] Also the costs of being incorporated are significant, as the Security Exchange Committee (SEC) of the Philippines requires all corporations, whether or not listed in a stock exchange and regardless of the size of sales, to submit financial statements to the SEC annually. This requirement would not be a light burden for a small corporation. Given the level of income inequity in the Philippines,[48] reducing the top PIT rate to 25 percent as the World Bank recommended would compromise progressivity and needs to be considered carefully as a part of a comprehensive tax reform plan.

Recommendations

- Limit the OSD to the self-employed whose sales are less than the VAT threshold.(Short Term)

- Alternatively, reduce the percentage of the OSD to 20 percent or less without the ceiling of sales. (Short Term)

- Limit the allowable deductions to those expenses which are easily verifiable and are directly expended on the production of goods or in the provision of service in the NIRC. (Short Term)

C. Remittance of Citizen Workers Abroad

Current situation

88. **Remittances by Philippine citizens abroad amount to US$21billion in 2010 and comprise more than 10 percent of GDP.** Overseas Contract Workers (OCWs) and

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[47] As an average PIT rate is lower than a top marginal PIT rate, an incentive to incorporate may not be so great as it seems.

[48] The Gini coefficient estimated in 2000 was 0.4814 in the Philippines, according to the National Statistical Coordination Board. Gini coefficiencts for Taiwan, Malaysia, Thailand and Indonesia are 0.32, 0.46, 0.50 and 0.32 respectively (Jomo, 2001).

Overseas Filipino Workers (OFWs) are not taxed in the Philippines on income derived from their overseas employment.[49]

Issues

89. **Exempting remittance by OCWs or OFWs can be justified because their income is already subject to taxation in the jurisdiction of the income source and their hardship and inconvenience being away from their families may need special consideration to a certain extent.** However, the current rule does not set any limit for remittances that are exempt from the PIT. While the workers must be registered with the Philippine Overseas Employment Administration (POEA) with a valid Overseas Employment Certificate (OEC), the current unlimited tax-free treatment may open a way for the wealthy to return their overseas money to the Philippines without being taxed in disguise of OCWs or OFWs. The refluxed money could have been income that should have been but was not taxed in the Philippines.

90. **Considering that the average amount of remittance per worker in 2010 is about US$2,600 per year, a ceiling that is high enough not to affect legitimate remittances by OCWs or OFWs, say US$25,000 per year, should be set.** Taxes paid abroad can be credited against the Philippine tax. With data on cross-border remittances held in AMLC mentioned in Chapter III, this could prevent abuse by the wealthy without affecting remittance of income by OCWs or OFWs.

Recommendations

- Set a ceiling, say, the equivalent of US$D25,000, on tax free remittances by Philippine citizens working abroad. (Long Term)

VI. MINING TAXATION REGIME

A. Overview of the Existing Regime

Current situation

91. **The mining industry's contribution to GDP was 1.4 percent of GDP in 2010.** The share of mining in exports and investment continues to be low despite a wide range of incentives (Table 18). Furthermore, the contribution of mining to government revenues is even lower than its contribution to GDP (Table 19). Low revenues from mining may be due to continued exploration activities by many firms while only few firms are engaged in

[49] Section 23 (c) of the NIRC.

production. Given the current level of production and taxes and royalties paid, mining yields disappointingly little revenue for the government.

Table 18. Contribution of the Mining Industry to the Philippine Economy

	2007	2008	2009	2010
Value added as share of GDP	1.4%	1.2%	1.3%	1.4%
Share of exports	4.4%	4.2%	3.0%	2.9%
Share of mining in total investment	2.7%	1.8%	2.6%	2.3%
Share of mining FDI in total investm	0.6%	0.5%	0.0%	0.7%
Share of FDI in total investment	11.3%	4.6%	7.0%	4.2%
GDP (billion pesos)	6,892.7	7,720.9	8,026.1	9,003.5
Exports billion pesos)	2,981.8	2,849.9	2,587.0	3,133.5
Gross investment (billion pesos)	1,195.0	1,489.2	1,331.7	1,849.4

Source: DOF and staff calculations.

Table 19. Revenues from Mining Industry as Share of GDP

	2007	2008	2009	2010
Total Royalties and fees MGB	0.01%	0.01%	0.00%	0.01%
Royalties - MGB	0.01%	0.01%	0.00%	0.01%
Fees- MGB	0.00%	0.00%	0.00%	0.00%
Excises	0.01%	0.01%	0.01%	0.01%
Total taxes - National government	0.12%	0.08%	0.13%	0.06%
Taxes -Local governments	0.01%	0.01%	0.01%	0.01%
Total taxes	0.13%	0.08%	0.14%	0.07%

Source: DOF and staff calculations.

92. **The fiscal regime on mining in the Philippines consists of a royalty, an excise tax on the same base as the royalty and a number of taxes and fees paid at both national and local levels (Table 20).** The existing fiscal regime on mining operations can be characterized as a regime that levies a high royalty rate (5 percent royalty rate plus 2 percent excise) and additional taxes and fees that is not conducive to the development of the mining industry as a source of growth.[50, 51] In addition to royalties, taxes and fees, mining companies have to contribute to three funds for contingent liabilities for the rehabilitation of mines. Given the seemingly high royalty and excise rates, the current regime does not adequately capture high rents that may occur as evidenced by the low revenue yield. Multitude of taxes and fees may be contributing to the development of the mining industry.

[50] International comparisons suggest that royalty rates range between 1 and 4 percent for metals.

[51] A recent survey of mining companies by Fraser Institute ranks Philippines at 15 out of 80 countries with a potential to improve, pp.21, (2011).

Streamlining the rates and fees both at the national and local level into one or two payments can be expected to increase the development of the mining industry.[52]

93. **The current regime provides some relief for capital goods and imported inputs, and exploration costs are allowed to be recovered up to five years. Imports of capital goods and inputs are exe**mpt from customs duty. Tax credit certificates (TCC) are issued for VAT payments on the imported goods. A deduction from taxable income is provided for community expenses.

94. **A set of incentives are provided in order to attract investment into mining (Table 21).** The incentives listed in the mining act are in the form of accelerated depreciation, property tax exemption of pollution control devices, and up to five year of loss carry forwards. However, the loss carry forward period should be considered short for cost recovery. The mining act provides for a detailed classification of depreciable assets used for exploration purposes which can be consolidated into three broad classes such as structures, machinery and equipment and vehicles. The mining regime also allows the following investment guarantees:

- Repatriation of investment.
- The right to repatriate earnings from investment in the currency of the investment.
- Exchange rate guarantee for the remittance of foreign loan obligations.[53]
- Freedom from expropriation.
- Requisition of investment.

Current approach to capture resource rents

[52] One of the frequently-cited impediments to investment in mining by foreign investors is the restriction on foreign ownership. The constitution limits the ownership of foreigners in any enterprise to 40 percent. Choice of partnership can be determined best by the market participants. Should a foreign investor determine that it is economically the best choice to have a local partner, it would do so. While it is difficult to make a constitutional amendment, some flexibility may be introduced into the mining contracts.

[53] The bearer of the exchange rate risk is not specified in the mining act however, the government is expected to compensate the companies in case of a large currency depreciation.

95. **The fiscal regime does not include the basic features of a progressive system to capture rents.** Although the current fiscal regime includes features that resemble elements of resource rent capture, the method employed is rather unusual. The resource rent is captured as an “additional government share.” First, a “basic government share” is calculated as the sum of all taxes and royalties paid to the national and local governments. Then, the net mineral revenue (NMR) is calculated after deducting from gross sales all operational expenses, interest expenses, development expenses and the royalty to the land owners.[54] So, it is similar to the corporate tax base but without the deduction of other royalties and fees paid. Then the additional government share is calculated as the difference between the 50 percent of the NMR less basic government share. If this amount is positive, the difference is paid to the government as the additional government share. So, at any time the government’s total revenue share is 50 percent of the NMR.

B. Necessary Reforms

Some issues for further consideration:

96. **A separate section on mining taxation should be introduced in the Corporate Tax Chapter of the NIRC.** Because corporate income taxation is often applied to mining with special provisions, it be would help clarify the treatment of components of income and deductions of the mining companies in deriving their liabilities in addition to royalties. For example, dividend withholding taxes, loss carry forwards, deductible expenses and depreciation allowance can be different for mining companies than the tax treatment of regular corporations.

97. ***Management fees*** **paid to related parties are often used to shift income and, therefore, a special tax rule is needed**. To avoid income shifting, transfer price rules applicable to all taxpayers should be enforced for mining companies as well. However, it is often difficult for the tax administration to establish just what services the management fees cover and whether the charges for these services are arm’s length. Given the importance of the mining sector and the need to protect government revenue, management fees, say in excess of 2 percent of revenue, are in many countries disallowed as a business expense (A separate mining section in Chapter IV of the National Internal Revenue Code (NIRC) on tax corporations could include this a special rule).

98. ***Ring-fencing*** **means a limitation on consolidation of income and deductions for tax purposes across different activities, or different projects, undertaken by the same taxpayer.** Some countries ring-fence mining (and petroleum) activities from other activities of the taxpayer; others ring-fence individual license areas or projects. Ring-fencing rules matter because the absence of ring-fencing by project can seriously postpone government tax

[54] Depreciation expense is not included in the deductible expenses used in the calculation of NMR.

revenue: an investor who undertakes a series of projects will be able to deduct exploration or development expenditures from each new project against the income of projects that are already generating taxable income. Ring-fencing is particularly important if the government is to impose a profit-based surcharge or additional profit tax on highly profitable projects. Tax accounts for the CIT and any surcharge should be ring-fenced by mining license.[55] However, failed explorations and mines that require joint operations may be exempted from ring-fencing. In general, expenses at Mine B incurred by a company already producing at Mine A should not be deductible against income from Mine A. It is quite possible that one company may own many mines or operate mines through subsidiaries.

Table 20. Current Structure of the Mining Regime in the Philippines

		Collecting Agency	Taxes and Rates
	National		
1	CIT	BIR	30%
2	Excises	BIR	2%
3	Royalty	MGB	5%
4	Additional Government Share	MGB	(Basic Government share - 0.5*(NMR) 1/
5	Fees	MGB	
6	Customs	BOC	
7	VAT	BIR	12%
8	Waste and Tailings Fee	MGB	Semi annual payment
	Withholding Taxes		
1	Payroll	BIR	
2	Interest Income	BIR	20%
3	Interest Payments to Foreign Loans	BIR	15%
4	Royalties on Technology Transfer	BIR	40% of Royalties
5	Dividend Payments	BIR	15%
6	Profit Remittence to Principal	BIR	15%
7	Royalties to Landowners/Claims of Owners	BIR	20%
	Local Governments		
1	Business Tax	LGU	Maximum 2% of sales
2	Real Property Tax	LGU	(Max. 3%)* (Assessment Ratio*FMV) /2
3	Registration Fee	LGU	Set by LGUs /3
4	Occupation Fee	LGU	(P75 or 100)/hectar, P5 for exploration (30% province 70% municipality)

Source: Authorities

1/NMR = Net Mining Revenue
2/ FMV= Fair Market Value
3/ LGU= Local Government Unit

[55] Currently there are no ring-fencing provisions.

Table 21. Additional Characteristics of the Mining Fiscal Regime in the Philippines

	Incentives	
1	Pollution control devices	Exemption from real property tax
2	Income tax carry forward losses	5 years within first 10 years
3	Income tax accelerated depreciation	Up to 2*normal depreciation if life >10 years, normal if less than10 years
4	Investment guarantees	6 guarantees on repatriation and remittences
	Recovery Period	Maximum 5 years
	Environmental and other funds	
1	Mine rehabilitation fund	Deposited in a trust fund in a government bank (10% of needed funds or 5 million pesos)
2	Waste and Tailings Fund	
3	Final Mine Rehabilitation and Decomissioning Fund (FMRDF)	Annual Amount= Cost of FMRDP * % Required by rules and regulations on FMRDF.

Source: Philippines Financial or Technical Assistance Agreement.

Principles of Natural Resource Taxation

99. **The key design features of a mining fiscal regime should have the following characteristics**:

- Maximize the net present value of tax revenue, subject to providing adequate incentives for exploration and development.
- A system based on profitability capturing more revenues during periods of high profits.
- Providing predictable and stable tax revenues.
- Protect against tax avoidance.
- Encourage exploration and expansion of the tax base
- Low administrative fees and transaction charges.

100. **Neither a flat-rate royalty nor a profit tax (such as the CIT) will tax rents effectively, though they may partially do so**. So, an additional instrument is needed. There are a number of additional fiscal instrument adopted by different countries to capture supernormal profits in the mining and petroleum sectors. Appendices III and IV elaborate on international practice in taxing mining and oil extraction. Some instruments may work better than others in capturing supernormal profits, and some may be quite distorting and should be rejected although they may be used in certain countries. The choice among the various

instruments may depend on simplicity and the government's desire for early revenue, and whether the additional revenue instrument is based on production or alternative profit bases.

101. **If the goal is to capture a share of supernormal profits, the tax base should be some measure of profits and not sales or turnover**. A profit-based instrument is better targeted at capturing a share of supernormal profits. Most systems contain an element of resource rent taxation based on profitability to capture a portion of the rent that otherwise accrues to the mining company. A variable royalty rate depending on the ratio of earnings before interest and taxes (EBIT) to sales value would be preferred. Over the long-term, migration towards the tax surcharge on cash flow method (or profit-based) is recommended.

102. **Before any amendments can be introduced to the current mining taxation regime, it is advisable to do a quantitative assessment of alternative fiscal regimes against the current fiscal regime.** In order to determine the best choice of fiscal regimes for the Philippines, a separate mission with mining taxation expertise is needed. FAD can provide such an advice assessing the alternative mining regime options with its revenue assessment model. To determine the feasibility of any regime, the tax burden, the capture of the resource rent and the progressivity of the fiscal regime have to be evaluated for different types of mining activity such as gold, oil etc. Such an analysis based on mine specific data would secure the fair share of resource rents from mining industry.

International Practice

103. **Alternative tax instruments are used by many countries to capture the resource rent in mining.** The resource rent tax (RRT) is designed such that a portion of the surplus over all necessary capital and current costs of production (including a reasonable return to the capital invested in the project) would be captured by the state.

Some commonly used instrument to capture resource rents are:

- Excess profit tax based on payback ratio or "R-Factor." The rate of the excess profit tax would depend on the R-Factor or Payback Ratio; namely the ratio of the company's cumulative gross receipts to the company's cumulative gross outlays, which will include payments of the profit tax if the calculation is to be made on an after-tax basis. When the ratio is less than one, payback has not been reached; as it grows to a greater multiple of one, the excess profit tax rate increases. The R-Factor differs from the rate of return method in that it does not take explicit account of the time value of money. Whether the ratio increases quickly or slowly does not matter in the calculation, the same excess profit tax rate is still triggered.

- Variable income tax where the system imposes a lower-than-average rate of tax in years of poor relative profitability offset by a higher-than-average rate of tax in years of high relative profitability**.** The variable income tax retains all the other features of the regular income tax, including the special capital recovery rules for investments in the mining sector; it only adjusts the tax rate.

- Tax surcharge on cash flow where the base of the cash flow surcharge would be determined by adding back depreciation and interest to taxable income before the loss carryover, and deducting any capital expenditure in full.

104. **While most countries levy flat-rate *ad valorem* royalties on the major minerals, a common form of a progressive royalty is a sliding scale royalty with rates that vary by the market price of the mineral.** For example, Mongolia imposes a flat rate royalty and a surtax royalty on the major metals, and on raw and/or refined coal. The surtax royalty has five price brackets for the market price of each mineral in U.S. dollars. The surtax rates range from 1 percent for the lowest bracket to 5 percent for the highest bracket.

105. **Three commonly used royalty options can be considered in moving to a mining fiscal regime consistent with international practice and progressive.** (1) a flat rate *ad valorem* or specific royalty on sales at a uniform rate for all metals and high value industrial minerals; (2) a specific royalty for quarrying and construction material; and (3) the variable royalty mechanism of South Africa which seeks to accommodate divergent cost structures of mines with a low minimum rate irrespective of profitability of the operation.

106. **Royalties raise the marginal cost of extracting minerals, as they are based on the volume or value of production without deduction for cost**. A royalty set too high may discourage development of marginal deposits and lead to high-grading and early closure of productive mines, thus discouraging maximization of the value of the deposit. Nevertheless, a regular minimum payment is usually necessary to justify extraction of the resource in the public mind, to assure stability of the fiscal regime, and to broaden the tax base. While most countries apply royalties in order to secure a stream of early revenue from a project, the actual rates vary widely (Appendix III). The rates chosen will reflect the interaction with other taxes imposed on the mining operation (e.g., a high royalty rate may be offset by a low income tax rate), and higher rates may be assessed on valuable minerals.

107. **Royalties are either specific levies (based on weight or volume of minerals extracted) or *ad valorem* levies (based on the value of minerals extracted).** They secure revenue for the government as soon as production commences (front-end loading), are considerably easier to administer than most other fiscal instruments, and ensure that companies make a minimum payment for the minerals they extract.[56] Often an *ad valorem* flat rate, single assessment method for all high-value minerals including metals and gemstones would be preferable. Weight-or volume-based specific royalties could be used for

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[56] For discussion of royalties for minerals, see Otto et. Al., 2006.

low-value bulk commodities (including construction materials such as gravel, sand, and other quarry materials). The specific rate expressed in pesos per ton or unit should however annually be adjusted with CPI to keep the royalty rate constant in real terms. Usually the royalty on non-metallic mineral and construction material including dimension stones consists of a specific rate on volume or weight which is easy to verify.

108. **Alternatively, adopting a variable royalty rate depending on the ratio of EBIT to sales value would introduce progressivity into the royalty scheme enabling the government to capture some of the excess profits in times on high commodity prices.** For example, South Africa (SA) imposes a variable royalty with graduated rates depending on the ratio of EBIT to sales value—and no differentiation per mineral.[57] There is a minimum rate of 0.5 percent and a maximum rate of 5 percent for refined minerals and 7 percent for unrefined minerals. The formula determines the royalty rate which is then applied on gross sales value (excluding costs incurred to transport the final product/mineral between the buyer and seller). The SA royalty law has transfer price rules and a general anti-avoidance provision. As refined minerals have higher value than unrefined minerals, SA differentiates between refined and unrefined minerals. By legislating for a capped maximum rate, the royalty rate graduation is steeper with rising EBIT profitability levels. The EBIT mechanism allows for the deduction of capital costs but disallows all financing costs. It, therefore, achieves neutrality between equity and debt finance, which is a desirable outcome. The variable royalty percentage rates provide automatic royalty liability relief for marginal mines.

Administrative requirements

109. **As with all taxes, the administrative capacity must exist to monitor closely production volumes, sales and their respective fair market values**. The legislative amendments for a royalty need accurate provisions that stipulate the determination of actual sales value. This would require transfer price rules if related party sales occur. If a single royalty rate is used, there is no need to determine the amount of minerals contained in the product sold (e.g., concentrate).

Recommendations

- Request an FAD mission to assess and compare the current mining fiscal regime with alternative regimes to guarantee a better sharing of mining resources using project data. (Short Term)

- Consider introducing mining tax provisions in a separate section in the NIRC Chapter on tax on corporations. (Medium Term)

[57] The SA royalty regime differentiates through formula designs between refined and unrefined minerals.

- Increase the number of years over which losses can be carried over for mine operators (in Chapter on tax on corporations). (Medium Term)
- Use three depreciation categories for exploration, tangible assets, and other development costs.(Medium Term)
- Establish a ring-fence for tax purposes around each mining license.(Medium Term)
- Change restrictions on foreign ownership.(Medium Term)

VII. ROAD MAP FOR TAX REFORM

110. **In considering a road map for a feasible tax reform plan, the mission's work was based on the following key objectives**, besides the revenue goal of achieving an increase in tax revenue by 3 percent of GDP by 2016.

Key objectives

Improving the Philippines' competiveness under the ASEAN Economic Community (AEC) framework

111. **AEC will have a combined population of over 600 million people and a gross domestic product of over US$1trillion when it starts in 2015.** This economic integration would attract more foreign investment to the region and facilitate trade and investment within the region. This would intensify competition in attracting foreign investment. The Philippines is now at the crossroads. It is unlikely that the Philippines can fully utilize the available opportunities of the AEC without changing the current tax system.

112. **MNEs learned lessons in many countries that tax incentives may change in the future even if the current tax incentives such as a 5 percent tax on GIE have no time limit.** In making an investment decision in the long term, a key criterion is the CIT rate though a tax is not a primary factor in making a decision. Unique tax provisions are also impediments in attracting investment. Differences in tax rules may give MNEs an opportunity for exploring tax arbitrage planning; however, it would increase the costs in doing business. Even if reforming unique tax rules to international standards leads to revenue loss in the short term, more investment will bring more economic growth and tax revenue in the long term.

Simplifying the tax system

113. **Complicated and non transparent tax rules would increase business costs, give discretion to tax officials that leads to corruption or tax disputes.** Tax rules provided in

non-tax laws would be even more problematic. A complicated tax system would also benefit the wealthy who can afford to obtain sophisticated tax advice from tax professionals.

Improving the equity of the tax system

114. **The Philippines has the highest income inequity in Southeast Asia**. While the tax system may not be a primary cause of the inequity, tax provisions that unduly benefit the wealthy should be changed (e.g., exemption or reduced tax rate on capital gains from sales of shares or interest on bank deposits with long maturity). Inertia in correcting the inequity in tax system as well as tax administration would undermine the integrity of the whole tax system.

Improving the effectiveness of the tax system

115. **Given the current level of tax administration and taxpayers' morale, it is unlikely that a tax system solely based on a taxpayer's voluntary compliance would work effectively.** It is desirable to provide the BIR with more measures to verify taxpayers' compliance with a minimum incremental increase in burden on taxpayers and third parties (e.g., a withholding tax on payments to self-employed). At least, tax provisions that are prone to abuse should be changed. The effectiveness is also a key in using a tax system as measures to achieve policy objectives.

Political timelines

116. **As a strong political will is indispensable in realizing tax reform, a road map for tax reform needs to be based on political timelines.** Given the political cycle, a time slot from now to the first half of next year would be a window of opportunity for tax reform. In reforming the issues that require prudent consideration (e.g., excise on mobile communications) and supporting data (e.g., restructuring a PIT rate schedule), or the issues that need to be addressed comprehensively, a rough-and-ready approach should be avoided. For these types of reform plans, the latter half of 2016, which would be the first six months of the next President, would be an appropriate time slot.

Table 22. Road Map for Feasible Tax Reform Plans[*, **]

	2011	2012	2013	2014	2015	2016	2017
Tax Incentives							
[Option1]							
Abolish all tax incentives							
New investment							
Existing investment							
Income Tax Holidays (no extension)							
5 percent tax on GIE (need to grandfather for 5 years)							
Lower CIT rate (phase in)							
Increase loss carry over to 5 years							
[Option 2]							
Increase tax on GIE to 7.5 percent							
New investment							
Existing investment							
Lower CIT rate (phase in)							
Other CIT issues							
Transfer pricing							
Thin capitalization							
Apply CIT rate to capital gains							
Tax cooperatives							
Excises							
Tobacco							
Adjust and unify tax rates							
Indexation							

Alcohol							
Adjust and unify tax rates							
Indexation							
Petroleum							
Normalize tax rates at PHP5 per liter							
Tax diesel							
Mobile communications							
VAT							
Repeal exemption post-2006							
Establish a proper refund system							
Increase threshold to PHP 3mil.							
Eliminate zero-rating for foreign currency denominated transactions							
Limit zero-rating to exports only							
Full deductibility of capital inputs							
Increase tax rate							
PIT							
Index rate schedule to inflation post 1997							
Limit OSD to those under VAT threshold							
Ceiling on tax free remittance by overseas workers							
Financial sector taxation							
Unified 20 percent W/H tax on interest							
Unified 5 percent GRT							
Apply the standard CIT rate to FCDU interest income from residents							

*Shaded parts are new recommendations.

** No specific timeline was proposed for mining measures.

Appendix 1. Main Recommendations of the 2010 FAD Mission

In the short term

Corporate income tax

- A reform plan for tax incentives should be announced before the end of 2010, for implementation over the medium term. Two options are possible, with a preference for the first:

Option 1—Low rate/broad base

- Remove all tax holidays and the 5 percent gross income tax—grandfathering existing investors for those incentives which are time-bound, and phasing out those incentives which are not time-bound within a reasonable time frame.

- Reduce the CIT rate to between 20–25 percent. To avoid sharp revenue decline, phasing of the CIT rate reduction should be considered.

- Increase the loss carry forward period to 5 years.

- If incentives are to be granted for investment, then provide accelerated depreciation or investment tax credits—specified in terms of proportionate rates on the amount of investment in the targeted activities or locations—that reward the actual act of investment; and

- In special economic zones, do not provide income tax incentives but restrict incentives to exemptions for import duties and zero-rating VAT on exports—removing the current VAT zero-rating for suppliers to zones—and limit the zones to designated areas which can be closely monitored (this does not limit the provision of other non-tax incentives such as waiver of fees or provision of infrastructure or services).

Option 2—Rationalize existing incentives

- Ensure the incentives are available to for all eligible taxpayers.

- Limit tax holidays to a few very specific investments/sectors, with clear criteria and a duration of no more than 5 years in total (with no extensions).

- Remove the 5 percent gross income tax; apply the standard corporate income tax when tax holidays expire.

- Grandfather existing investors for those incentives which are time-bound, and phase out those incentives which are not time-bound within a reasonable time frame.

- Restrict tax incentives in special economic zones to exemptions for import duties (that is, no income tax exemptions)—removing the current VAT zero-rating for suppliers to zones—and limit the zones to designated areas which are able to be closely monitored.

- Authorize only one agency to grant tax incentives; once granted, the ongoing monitoring of the incentives would be the responsibility of the BIR and BOC.

- Ensure the DOF has a strong role in the granting of incentives, such as by being a member of the board of the approving agency, and ensure that the revenue costs of any new incentives are estimated.

- Legislate that the laws granting incentives be maintained in one law, preferably the National Internal Revenue Code (NIRC); and

- Impose a sunset clause for all incentive laws, of no more than 5 years, to ensure the incentives are achieving the purpose for which they were introduced.

No matter which option is adopted, require the DOF to keep records of the estimated cost and the actual cost of all concessions and publish these figures in the form of a tax expenditure statement.

VAT

- Announce in the next budget that exemptions that target directly individuals (e.g., the recently enacted senior citizens exemption and boy scouts exemption) will be reviewed in three years to determine whether they have achieved their objectives in helping low-income seniors and developing boy scouts, and at what cost.

Excise taxes

- Clarify the application of excise taxes on imported goods by specifying that the customs duty is included in the base of ad-valorem excises.

Tobacco

- Eliminate the practice of price categorization of cigarettes, and set specific rates (per unit or pack) to reach a certain revenue target (starting at the lower end of the most popular cigarettes, and gradually increasing the rates to meet the revenue target in the medium-term). Cigars, chewing and other bulk tobacco could be taxed at different rates based on units (for cigars) and kilograms (for other tobacco products).

- Provide for full and automatic indexation of specific tax rates in the law. Such indexation should not call for Congress approval.

Alcohol products

- Eliminate price categorization and impose a three-rate specific structure based on alcohol content. For example, alcohol products could be grouped into three categories: beer and the like; wine and the like, including sparkling wine; and other alcohol products (which would include distilled alcohol, cocktails and other bottled or non-bottled products).

- Provide for full and automatic indexation of specific tax rates in the law. Such indexation should not call for Congress approval.

Petroleum products

- Normalize tax rates at 5 pesos per liter for all gasoline and oil that are currently taxed.

- Tax kerosene, diesel, gas and LPG, and fuel oil at 3.5 pesos per liter.

Automobiles

- Set the lower tax rate at 5 percent instead of 2 percent.

- Consider imposing the three higher rates on the full value of the automobile rather than on the excess relative to the previous price bracket, and adjust the rates downward to 15, 25, and 50 percent (on the same price structure).

Taxation of the financial sector

Withholding tax on interest

- Align the lower interest withholding tax rates on FCDUs and those dependent on the period to maturity with the standard interest withholding tax rate, but phase the alignment over a number of years.

Personal income tax

- Repeal the minimum wage earner exemption.

In the medium term

VAT

- Eliminate the exemptions for cooperatives. At a minimum, limit it to agricultural cooperatives.

- Eliminate all exemptions for inputs that go into the production of exempt final consumption goods (e.g., fertilizers and animal feed).

- Eliminate the exemption for social housing.

- Terminate the practice of providing VAT exemptions or any other special treatment in other laws. The tax code should be the only law containing tax provisions.

- Review the adequacy of the current threshold in light of the size and sectoral distribution of the VAT population, and the capacities of the BIR. Consider an increase in the threshold to between PHP3 and PHP5 million.

- Eliminate the provisions for zero-rating of transactions paid for in foreign currency (other than direct exports).

- Limit zero-rating to exports only, and eliminate zero-rating for supplies to export-oriented enterprises and free-zone enterprises.

- Consider re-establishing full deductibility of VAT on capital inputs after a careful consideration of its impact on the cost of capital and its impact on VAT revenues.

- Terminate the practice of allowing trade in TCCs (as a first step towards the abolition of TCCs).

- Establish a proper VAT refund mechanism by estimating current outstanding excess VAT credits, and developing a plan to pay such credits. This requires a strong administrative mechanism to prevent the abuse of input tax credit claims—one option could be to limit the credit to large amounts and to taxpayers known by the tax administration and whose tax standing has been in order for at least three years.

Taxation of the financial sector

Gross Receipts Tax (GRT) and Documentary Stamp Tax (DST)

- Replace the different GRT rates applying to bank income with a single rate, of say 5 percent.

- Rationalize the DST rates on insurance products to 2 rates, with a distinction between life insurance and similar products, and property insurance and similar products.

- Remove the DST on recurrent transactions such as bank checks, bonds, drafts and certificates of deposits.

- Remove the DST on original share issues.

Taxation of Foreign Currency Deposit Units (FCDUs)

- Apply the standard CIT rate to FCDU interest income from residents (replacing the current 10 percent rate), and consider increasing the CIT rate on FCDU foreign source income.

Personal income tax

- Overhaul the tax rate schedule to reflect inflation since 1997. Start with the lowest and highest brackets.

- Consider lowering the ceiling for entertainment expenses and broadening the scope of withholding taxes on payments to the self-employed.

- The Philippines should move to either the TEE or EET model of pension taxation.

Revenue impact

- The rationalization of fiscal incentives has the potential to raise around 1 percent of GDP. The present mission's recommended approach is to eliminate fiscal incentives accompanied by a reduction in the CIT rate. Under this approach, a reduction to around 21 percent would be revenue neutral, while a smaller reduction, to say 25 percent, would be revenue positive.

- Excise tax reform would raise revenue of 0.8 percent of GDP.

- The reform of the VAT and PIT would be revenue neutral. However, if there is a need for a revenue increase, VAT rate increase could be considered.

- These revenue estimates are indicative; the present mission strongly suggests that the authorities undertake more analytical work in this area. This will require the DOF, BIR, and BOC to ensure the availability of better statistical information in support for tax policy development.

Appendix 2. Regional Comparison of Investment Tax Incentives

Country	CIT Rate (in percent)	Eligibility for incentives	Tax Holidays	Other income tax incentives	Other tax incentives
Philippines	30	Sector or region, min. 50 percent of production exported, 70 percent foreign ow nership.	3 to 8 years after start of commercial activty	5 percent tax on gross income earned after tax holidays indefinitely.	100 percent additional deduction in infrastructure spending in Less Developed Areas, 50 percent additional deduction of incremental labor cost, tax credit for duties and taxes for inputs of export products, exemptio nfrom VAT and duties on imported supplies, 10 year exemption from w harfage fee, 10 year exemption on taxes and fees on selected imported agricultural products.
Cambodia	20	Pioneer or high-tech, job creation, export, tourism, agro processing, infrastructure, energy, rural development, environment, and SEZs.	Either: 6 to 9 years starting in the first year of sales; or 3 to 6 years from the year in w hich profits are first derived.	40 percent special depreciation if not using tax holiday.	VAT and duty exemption on inputs;
					Exempt from 1 percent turnover tax.
China	25	Public infrastructure, environmental protection, energy and w ater conservation, agriculture, forestry, animal husbandry, fisheries, new /high new technology, and softw are production.	2 to 3 years	50 percent CIT rate reduction for 3 years.	VAT exemption.
				15 percent rate for new /high technology.	
				Accelerated depreciation.	
Indonesia	25	Investment priority sectors, strategic role in economic development, employment creation, location, and partnership w ith cooperatives.	3 to 8 years: standard period of 3 years (5 if outside Java or Bali) w ith an additional year for each of the follow ing criteria: (1) employs more than 2000 w orkers; (2) at least 20 percent shareholding in a cooperative; (3) at least US$200 million investment realization.	10 year loss carry forw ard in economic development zones or in priority sectors (standard carry forw ard is 5 years);	50 percent reduction in land and building taxes;
				Investment tax allow ance of 30 percent reduction in income tax (6 years maximum);	Maximum 5 percent import duty on imports of capital goods and raw materials for 2 years;
				Accelerated depreciation.	Special duty draw back and VAT exemption if export ratio above 65 percent;
					VAT, sales tax, duty, and excise exemption in bonded zones.
Malaysia	25	High technology or resource based industries, R&D, shipping, fund management, hypermarkets, w aste recycling, manufacturing, offshore trading, technical and vocational training, agriculture and agro-based industry, communication, utilities, transportation, hotels, tourism, environmental conservation.	5 to 10 years.	Double deductions for approved training expenditure;	Duty free raw materials and spare parts for exports;
				Industrial capital allow ance up to 100 percent of capital expenditure;	Import duty and sales tax exemption on machinery and equipment not produced domestically;
				Tax exempt dividends out of exempt income;	Sales tax and excise exemptions on locally produced machinery and equipment.
				Accelerated depreciation.	

Country	CIT Rate (in percent)	Eligibility for incentives	Tax Holidays	Other income tax incentives	Other tax incentives
Lao PDR	35 (Domestic companies) 20 (Foreign companies)	Regions: 1 (inaccessible areas); 2 (partly accessible); 3 (accessible areas).	7 years in region 1 5 years in region 2 2 years in region 3.	Reduced CIT rates: 10 percent in region 1; 7.5 percent for 3 years then 15 percent in region 2; 10 percent for 2 years and then 20 percent in region 3. 0 percent if profit reinvested.	Duty and taxes on imports of: tools, spare parts, vehicles used for production, raw materials, semi-processing products for export, and export (70 percent of total production).
Singapore	17	Pioneer (manufacturing and services), finance and treasury center, regional headquarters, IP hub, development and expansion, and international shipping	Up to 15 years.	5 or 10 percent reduced tax for 5-10 years. 30-50 percent investment allowance. Reduced withholding taxes. Accelerated depreciation.	
Thailand	30	Technology, use domestic sources, job creation, basic and support industries; earn foreign exchange; growth outside Bangkok; infrastructure; energy conservation and environment protection.	3 to 8 years: 3 years in Zone I; 3 to 5 years in Zone II; 8 years in Zone III.	50 percent CIT rate reduction in Zone III if capital investment is at least 10 million baht; Exemption of withholding tax.	Exemptions and reduced import duty and VAT on inputs on exports and in certain sectors.
Vietnam	25	Forestation, infrastructure construction, mass transit, export production and trading, offshore fishing, agricultural processing, research and services of science and technology, plant variety production, and animal breeding.	1 to 8 years: 1 year - Industrial zone (IZ) providing services; 2 years – IZ production firms and exporting more than 50 percent of products, and EPZ providing services; 4 years – Infrastructure projects in all zones, EPZ production firms and OEZ; 8 years – High-tech zones.	Reduced CIT after tax holiday: 10 percent for 2 years - IZ providing services; 7.5 percent for 3 years – IZ production firms and exporting, and EPZ providing services; 5 percent for 4 years – Infrastructure projects in all zones, EPZ production firms; 5 percent for 9 years - OEZ. Instead of tax holiday (depending on sector/area): 10 percent for 15 years or 20 percent for 10 years. Reduction in withholding tax to 3 percent (usually 7 percent)	VAT and import duty exemptions: Commodities imported for export processing; Machinery, devices and means of transportation of foreign contractors for ODA projects or exports; Import for export or vice-versa for exhibition; Goods imported to form fixed assets; Raw materials, parts, accessories and materials for exportation.

Source: Mission compilation based on Botman, Klemm and Baqir (2008)

Appendix 3. Fiscal Regime for Gold Mining in Selected Gold Producing Countries

Country	Regime	Royalty rate	Royalty base	Corporate Income Tax	Depreciation rule	VAT	Import duties	Export Tax	Loss carry forward	Additional profit tax	Dividend Withholding Tax	Interest Withholding Tax	State Participation (% of taxpayer equity)
Australia	Royalty + CIT	WA: 2.5% [gold]	WA: net revenues [gold]	29% 4/	100% straight line over effective asset life (15-20 years for most mining development) 2/	10% [none for exported minerals]	…	…	Indefinite	None	0%	10%	no participation
Botswana	Royalty + Mineral Tax	5% [gold]	Gross market value	Formula-based. Min[25%, 70-1500/profitability ratio] 1/	100%	none for exported minerals	Exempt	…	Indefinite	None	7.5%	15%	
China	Royalty + CIT	4% [gold] plus specific royalty per tonne mined	Net revenue (assumed)	25% [local taxes also apply]	10 years straight line	Exmpt	Exempt	Exempt	5 years	None	10%	10%	no participation
Ghana	Royalty + CIT	3-6% sliding scale based on operational ratio 2/ [in effect, 3%]	Net revenue	25%	80% year of investment, 5% uplift second year, 50% DB after.	Exempt	…	…	5 years [in effect, indefinite]	None	8%	8%	10% free carry
Indonesia	Royalty + CIT	3% [gold]	Gross revenue	25%	100% [exploration] 6.25% straight-line [assets with usual life of 16 years] 20% [intangible assests]	Exmpt	Exempt	Exempt	5 years	None	20%	20%	no participation
Liberia	Royalty + CIT	3% [gold]	FOB Liberia; London pm gold fixing	30%	5 years straight line [tangible fixed and intangible property]	Exempt	Exempt pre-production; max around 4% thereafter	…	7 years	20% surtax when pre-tax IRR > 22.5%; deductible for income tax	5%	10%	0% [assumed]
Mozambique	Royalty + CIT	10% [gold]	Gross revenue	32%	10 years straight line	Exempt first five years 3/	Exempt first five years 3/	Exempt	5 years	None	20%	20%	0% [assumed]
Mongolia	Progressive Royalty +CIT	5% [gold] plus price-based progressive royalty	Gross revenue	25%	100% [exploration costs] 10 years straight line [development costs]	Exempt	5%	None	8 years	None	20% [in practice reduced to zero under DTA's]	20%	34% carried interest
Papua New Guinea	Royalty + CIT	2%	Gross revenue	30% [resident companies] 40% [non-resident companies]	25% declining balance pool [exploration and development costs]; 200% uplift exploration expenditure	…	…	…	Indefinite	None	10% [residents] 0% [non-residents]	0%	0% [assumed]
Sierra Leone	Royalty + CIT	4% [gold]	Net revenue	37.5%	40% straight line first year; 20% declining balance remaining years	…	Exempt	…	Indefinite	None	10%	15%	Varies by contract. Assumed none in FARI model.
South Africa	Royalty + CIT	max 7% [unrefined gold]. Formula-based: 0.5% + EBIT/(gross sales x 9)	Gross revenue	Formula-based 43- (215/x)%, where "x" is the ratio of taxable income from gold mining to income from gold mining	Variable 100% [mining equipment, capex]	14%; certain mining rights are zero-rated	None	None	Indefinite [assumed]	None	0%	0%	0% [assumed]
Tanzania	Royalty + CIT	4% [gold]	Gross revenue	30%	100%	Exempt	Variable	…	Indefinite	None	10%	0%	5% free carry
Zimbabwe	Royalty + CIT	3%[gold]	Net revenues	15%	100%	15%; exports zero-rated	Variable	…	Indefinite	None	20%	10%	0% [assumed]

Source: FAD, Summary Minnig Regimes.

Notes

1/ Profitability ratio is defined as taxable income/ gross income.

2/ Operational ratio defined as (net revenue minus operating costs, interest, and capital allowance) / net revenue.

3/ For simplicity, modeled as exempt throughout the lifetime of the project since most costs are incurred in the first years.

4/ Rate effective 2013. Current CIT rate is 30%.

Appendix 4. Oil Extraction Fiscal Terms in Selected Countries1/

Country	Regime	Signature/ Production Bonus	Royalty rate		Cost recovery limit	Profit sharing	(% profit oil to government)	Corporate Income Tax	Depreciation rule		Loss carry forward	Supplementary Profit Tax	Dividend Withholding Tax	Interest Withholding Tax	State Equity Participation
Angola	PSA	Nil	Nil		50%	Sliding scale, IRR-based. 30%-90%		50%	Straight-line, 5 years		Unlimited	Nil	10%	10%	15%
Australia	Tax / Royalty	Nil	Nil		100% 2/	N/A		30%	Straight-line,	20/5 years (development/ replacement costs)	Unlimited	IRR-based, 40%	Nil	Nil	Nil
Cameroon	PSC	PB	Nil		60%	R-factor based;	20% - 60%	40%	Straight-line, 5 years		Unlimited	Nil	16.50%	16.50%	25%
Equatorial Guinea	PSC	PB	Sliding-scale, production –based;	13%-16%	70%	Sliding-scale, production-based;	10%-60%	35%	Straight-line, 5 years		5 years	Nil	Nil	Nil	15%
Ghana	PSC	Nil	10%		100%	Sliding scale, IRR-based.	12-28%	35%	Straight-line, 5 years		Unlimited	Nil	Nil	Nil	10% carried plus 10% paid
Gabon	PSC	PB, SB	Sliding-scale, production –based;	5%-11%	70%	Sliding-scale, production-based;	50%-63%	35%	Straight-line, 5 years		3 years		20%	20%	18%
Mozambique	PSA	PB	10%		65%	R-factor based;	10% - 50%	32%	Straight-line, 4 years		5 years	Nil	20%	20%	10%
Namibia	Tax / Royalty	Nil	5%		100% 2/	N/A		35%	Straight-line, 3 years		Unlimited	IRR-based, 15%-50%	10%	Nil	Nil
Timor Leste	PSA	Nil	5%		100%	Fixed;	40%	30%	Straight-line, 10 years		Unlimited	IRR-based, 22.5%	Nil	Nil	20%

Source: FAD's Fiscal Analysis of Resource Industries (FARI) database.
1/ The fiscal terms in the comparator countries may vary contract by contract. The terms above are those used in the model simulations.
2/ In royalty and tax systems, the investor receives 100 percent of revenues remaining after royalties for recovery of costs. This is analogous to a 100 percent cost recovery limit under PSC systems.

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