Tax Reforms and Collective Action

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tax justice network

President Aquino's Development Policies

Non-governmental organizations (NGOs)—the progressive advocates, especially—pride themselves as visionaries. And so, they are most concerned about the vision of the Noynoy Aquino (P-Noy) administration.

Congressman Walden Bello of the the left-wing *Akbayan*, which is an ally of the P-Noy administration, criticized P-Noy's state of the nation address (SONA) for being "trapped in the 1990s free market and globalization mentality that advocated privatization and removal of subsidies." The radical national democrats under the aegis of *Bayan*—incidentally, the arch-rival of *Akbayan*—have been hostile to P-Noy even before he was proclaimed President. The *Bayan* forces have caricatured the President "P-Noy American," which is but a catchy term for "US-Aquino" regime. And they echo the line of Bello, their nemesis, regarding the SONA: "What's new?"

Former President Fidel Ramos might have spoken for the whole spectrum of the Left: that P-Noy needs a "road map for the future."

Even supporters of P-Noy were surprised, even dismayed, that the SONA omitted unqualified support for key reforms, especially the legislation of Freedom of Information.

The economists—whether of the orthodox or heterodox variety—question "public-private partnerships" (PPPs) as the solution to the fiscal problem. This is not to say that PPPs are bad. Rather, they cannot be the centerpiece of fiscal reforms, which first and foremost must address the problem of very low tax collection.

The debate will continue. And the progressive or reform-oriented NGOs will be at the forefront of stimulating the discussion about P-Noy's development program and vision.

It is nice to know that the Freedom from Debt Coalition (FDC) and the Coalition of Development NGOs (CODE-NGO), despite their conflicting positions on some critical issues, have banded together to review the development strategy under the P-Noy administration. For the conference that will process NGO inputs for the government's medium-term development plan, FDC and CODE-NGO have devoted the opening session to an analysis of the administration's development policies.

I disagree with those who say that P-Noy does not have a road map. He is quite clear about what he wants to do, and this revolves around his campaign promise *Kung walang corrupt, walang mahirap*. We can set aside criticisms regarding the slogan's reasoning, but its message is direct and apparent: P-Noy is going to fight corruption and bad governance towards combating poverty, The debate therefore should focus not on the lack of the so-called road map but on the content of the strategy and plan to fulfill this campaign promise.

Yet, some of the critics belittle the problem of corruption, arguing that a focus on anti-corruption does not translate into growth and progress. And they can argue that countries like China and Vietnam with corrupt governments have enjoyed sustained high growth and have substantially reduced poverty.

But we should emphasize the point that in the Philippines, corruption and bad governance have become the major obstacles to sustaining growth, stimulating investments, and generating jobs.

In analyzing national economic and development policies, I benefit from the growth diagnostics approach pioneered by Dani Rodrik. This is no different from what the Left favors—doing "concrete analysis of concrete conditions" to come out with appropriate, timely solutions and thus overcome society's principal problems. Through growth diagnostics, we are able to identify the few binding constraints that obstruct growth and development. By targeting the binding constraints, we resolve the principal problems at one period and once addressed, move to tackle another set of problems. In this manner, we avoid being overstretched and wasting resources, including political capital.

The Philippine growth diagnostics studies, as done by different individuals and organizations, yield the same outcome. The binding constraints include a) corruption, bad governance, or elite capture and b) worsening fiscal situation, mainly because of low tax effort.

In this context, the P-Noy administration has correctly identified the main challenges at this critical moment.

His pronouncements on fighting corruption, ensuring accountability, and promoting accountability are powerful and unequivocal. His actions and proposed reforms—the appointment of a tough and unimpeachable Justice Secretary, the commitment to prosecute corrupt government officials, the resolve to end extra-judicial killings, the creation of a Truth Commission, will not only serve justice but will also help rebuild the Philippines' damaged institutions.

It is however disappointing, that given his strong stance on good governance, he has not certified urgent the legislation of the bill on Freedom of Information—a very critical component of a reform agenda for transparency.

P-Noy is also fully aware of the gravity of another binding constraint—the fiscal problem. In his SONA, he illustrates the link of corruption, the waste of resources resulting in the aggravation of the fiscal deficit, and the adverse effects on the poor. He particularly centered on the Gloria Arroyo administration corrupt activities that affected the delivery of services to the poor (rice, water, transportation, power, disaster relief).

The fiscal problem is perhaps P-Noy's toughest challenge. He promised not to impose new taxes, and this limits his room for maneuver to solve the fiscal constraint, which is essentially a problem of low revenue collection. This is the context in which P-Noy welcomes PPPs (public-private partnerships). Yet, PPPs will not result in higher tax effort.

Improving tax efficiency (like catching tax evaders) and rationalizing fiscal incentives are most welcome. They will increase tax effort (tax collection as a percentage of Gross Domestic Product or GDP), currently at around 13 percent, by a few percentage points. Unfortunately, these actions are not enough to boost the tax effort to a secure level, say, 17 percent of GDP. One measure that should be immediately taken, without breaking P-Noy's campaign promise of new taxes, is the indexation to inflation of the specific taxes on alcohol and tobacco. Adjusting the tax to inflation is not a new tax.

The NGOs can take up a crucial challenge: Take the lead in having a fiscal covenant with the P-Noy administration. The NGOs should demand fiscal efficiency, accountability and transparency. They should demand higher spending for education, health and infrastructure, which will benefit the poor. As part of the covenant, they should be open to introducing progressive taxes to finance development. P-Noy will also benefit from this type of NGO intervention. He gains political space and additional political capital to resolve the fiscal constraint.

Political Capital

Political capital is precious, and it must be used well.

The Philippine Daily Inquirer (14 August 2010) reports that the P-Noy administration is "ready to sacrifice political capital" in implementing the imposition of the value-added tax (VAT) on road tolls. It is not just about the application of the VAT on the increased tolls of the South Luzon expressway (SLEx) but on the tolls of other expressways as well.

The news item quoted presidential spokesperson Edwin Lacierda: "In the short term, we'd rather be unpopular because in the long term we know that the [value-added tax] that will be collected will be used for the social services that we have promised."

We commend Mr. Lacierda for expressing brave, honest words.

Applying the VAT on expressway tolls remains a legal controversy, as those opposed to it invoke an old law that exempts such expressways from the VAT. But the Bureau of Internal Revenue (BIR) has issued a ruling on the basis of the law, passed in 2005, that expands the coverage of VAT.

The expanded VAT includes the "sale or exchange of services," for entities whose gross sales or receipts have exceeded PHP1.5 million in the past twelve months. All kinds of services for a fee, remuneration or consideration are subject to VAT. Some transactions are VAT-exempt, but expressway tolls are not on the list of exempted transactions. In fact, the law says that sale or exchange of services subject to VAT includes "franchise grantees of electric utilities telephone and telegraph, radio and/or television broadcasting and all other franchise grantees" (italics supplied).

In other words, the government has a strong legal basis to implement the collection of VAT on expressway tolls. The problem was that the Gloria Arroyo administration did not implement the law, just one of the many violations it committed to exploit populism and prevent the further slide of an illegitimate, unpopular regime.

During the Arroyo administration, the BIR issued revenue memorandum circulars (RMCs) that ordered the VAT collection on expressway tolls. RMC No. 52-2005, dated 28 September 2005, was specifically devoted to the VAT liability of the "Tollway Industry." On several occasions, the BIR demanded that the Toll Regulatory Board (TRB), which was then headed by the Transportation and Communications Secretary Leandro Mendoza, implement the VAT collection. Mr. Mendoza, a known agent of Mrs. Arroyo and a politicized TRB, ignored the BIR. This is but one example of the numerous revene-eroding measures that Mrs. Arroyo allowed during her term. Worse, this was done in contempt of the law.

And so, it is correct for the P-Noy administration to exert its political will in pushing for the immediate collection of the VAT on expressway tolls.

Political capital, of which the P-Noy administration has a lot, must be used judiciously. Political capital is scarce and variable. Even a popular president can lose political capital in an instant.

We can learn from the experience of US President Barack Obama—unfortunately, a negative lesson. Mr. Obama had tremendous political goodwill when he was installed as US President. He did use the popular support and huge political capital he had to carry out critical reforms on universal health care, public spending, financial regulation, and US relations with the international community. But here's the rub: the huge political capital he amassed was dissipated, but the reforms he undertook in some areas like the economy and finance were incomplete, tepid, or compromised. Now, Obama's satisfaction rating has declined, and his party faces the risk of losing the mid-term elections, all the more making difficult to consolidate the reforms he promised.

We hope the P-Noy administration will take note of this lesson. The message we wish to convey is this: Even as P-Noy uses political capital and risks losing public opinion to push for the VAT collection on expressway tolls, he should seize the opportunity to convince the people to support his efforts to substantially increase revenues that will finance development.

We should not lose sight of the bigger problem. That is, the country is suffering from a low tax effort (amount of taxes as a percentage of GDP), which if not addressed would translate into a fiscal crisis. In 2009, tax effort fell below 13 percent. The VAT collected from the road tolls will of course contribute to the over-all effort to increase tax effort to a secure level, say 17 percent of GDP. But that will be insufficient.

The P-Noy administration is serious about improving tax efficiency, as shown by its highly visible campaign to go after tax evaders. The substantial gains from tax efficiency will emerge in the medium term, and the expected boost in terms of tax effort is equivalent to less than 1.5 percent of GDP. The P-Noy administration is also committed to the rationalization of fiscal incentives, which translates into an increase of one percent in tax effort.

All told, the tax collected from expressway tolls, the tax administration reforms, and the rationalization of fiscal incentives will still fall short of the tax level that is necessary to avert a fiscal crisis. These taxes are needed to finance infrastructure, health, and education and other essential services, which have deteriorated through the years because of under-spending.

It is urgent for the P-Noy administration to put in place other tax policy reforms. What matters is the passage of all reform elements. An incomplete reform agenda will not serve the administration's medium-term development plan.

What then can be done? The reform of the excise tax on sin products can yield substantial revenues; approximately PHP20 billion can be collected in the first year of its implementation. A progressive, pro-environment petroleum tax can increase tax effort that is equivalent to 0.8 percent of GDP.

In short, as P-Noy is ready to expend political capital in relation to the VAT on expressway tolls, he should take advantage of this opportunity to rally the public behind the reform of the excise taxes on alcohol, tobacco, and gasoline. Only then can he maximize the gains from the use of scarce political capital.

The Tax Challenge

One of the critical binding constraints that the incoming Noynoy Aquino administration will face is the low tax effort. Tax effort, described as the amount of taxes collected as a percentage of Gross Domestic Product, has been dismally low during the Gloria Macapagal-Arroyo regime. In 2009, the tax effort was just 12.65 percent, far from the desirable 17 percent that was reached before the economy plummeted in the wake of the 1997 financial crisis.

What is ironic is that the tax effort has stagnated and even declined despite the fact that the Macapagal-Arroyo administration increased the excise taxes on sin products and jacked up the rate of the value-added tax (VAT) from 10 percent to 12 percent.

The increase in said taxes, among other things, was a forced move on the part of the Macapagal-Arroyo administration to avert a looming fiscal crisis after the highly controversial elections in 2004. The fiscal crisis was manifested in declining tax effort, increasing debt and debt-service ratios, and a yawning public sector deficit. It was triggered by overspending, unsustainable populist measures, huge losses incurred by government corporations, and non-implementation of tax reforms—all intended to favor political allies and vested interests as well as placate or woo voters.

However, the gains from the increase in the excise taxes on sin products, the VAT, and the increase in power tariff diminished as complacency set in. In particular, key reforms like inflation indexing of the specific tax on sin products, the rationalization of fiscal incentives, and the simplification of the net income taxation for the professionals and self-employed have stalled. Moreover, Macapagal-Arroyo and her Congress allowed the passage of revenue-eroding measures.

A compounding factor is the recent announcement to remove the three percent tariff on imported oil products. At this point, any action that takes away revenues hurts the economy.

On tax administration, the momentum for reforms petered out after the principled resignation of Guillermo Parayno, a competent and credible reformer. Worse, the creation of redundant bodies, namely, the Presidential Adviser on Revenue Enhancement (PARE) and the Presidential Anti-Smuggling Group (PASG) undercut the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC). PARE and PASG merely heightened uncertainty among businessmen and opened new sources of corruption.

All told, without any decisive intervention, another fiscal crisis is bound to happen. The fiscal problem has actually become a binding constraint, hindering spending for essential services like infrastructure, education and health as well as threatening macroeconomic stability.

But the advent of a new, credible, and reformist Aquino administration is the first necessary step to prevent the crisis from erupting. President Noynoy Aquino enjoys much goodwill and political capital that he can put to good use to advance hard reforms.

The President-elect has said that he will focus on the efficiency of tax administration to increase revenues. We can indeed expect a revenue boost, precisely because he has the moral ascendancy and the people's trust to enjoin taxpayers to cooperate.

Part of the tax administration reforms is the abolition of redundant revenue-collecting bodies. This will receive wide public support. The new administration can also benefit from the BIR's modest efficiency gains in recent months.

Supplementing the tax administration reforms is support for the tax policy proposals sponsored mainly by the Department of Finance. The package consists of the following: a) the indexation of sin products to inflation, b) the rationalization of fiscal incentives, and c) the simplified net income taxation for the professionals and self-employed. Sadly, these measures received unenthusiastic support from Mrs. Arroyo.

Some might argue that the President-elect made a promise not to impose new taxes. But the president-elect also qualified that statement. In the event that the tax administration reforms would be insufficient to meet revenue goals, he would be open to introducing new measures. But more importantly, to paraphrase the World Bank's Country Director Bert Hofman, an adjustment of the specific taxes to inflation is not really a new tax.

For the medium term, we should welcome green taxes. Green taxes or pollution taxes will be our contribution to the global effort to address climate change. Green taxes offer a triple dividend—a healthy fiscal balance to ensure macroeconomic stability, revenues for development spending, and a cleaner environment.

We are optimistic that fiscal reforms will prosper under the incoming administration, given that our people will recover their trust in government. A leadership not tainted with corruption—a decent and honest leadership—is the key to the success not only of the fiscal agenda but of the over-all reform program to reduce poverty, create jobs, and sustain growth.

Tax Reforms

Tax reforms are most difficult to do. For one thing, the constituency for tax reforms, especially those relating to new taxes or increasing tax rates, is hard to find. For another thing, precisely because the constituency is narrow, legislators avoid being supporters, much less being champions, of tax reforms.

We have seen, for example, how Ralph Recto, who sponsored the law that increased the valued-added tax (VAT) from 10 percent to 12 percent, was trounced in the 2007 Senate elections. He has regained his position by joining the Noynoy Aquino bandwagon and by doing a complete turn-around—packaging himself as a populist by calling for measures (say, reduced oil prices) that make the whole population, especially the rich, happy, even if such measures aggravate the government's fiscal problems.

And in the 2010 elections, Mar Roxas was painted as a firm supporter of the increase in the VAT rate. On the other hand, rival Jojo Binay projected himself as the creator of a socialist Makati, which he intends to replicate all over the country. This is Binay's Makati that offers cash gifts, free movies, free groceries to senior citizens, even to those residing in Dasmariñas and Forbes Park, that has a state-of-the art hospital and modern clinics that are accessible to all, that provides not only free education but also free uniforms, textbooks, and school supplies to children.

But it is also a Makati that owes the national government PHP1.2 billion in unpaid taxes. That the Makati City local government has agreed to settle with the Bureau of Internal Revenue (BIR), I surmise, is Binay's action to at least avoid a collision with incoming President Aquino. The President-elect faces face an acid test in increasing revenue effort, without losing political support.

The point is, tax reforms, as a public interest concern, are hard to attain. Compare tax reforms to freedom of information (FOI). The FOI advocacy has a natural broad constituency—the powerful media, the articulate non-governmental organizations (NGO), the influential business chambers, the opinionated Church, etc. And FOI is a popular issue that politicians will quickly embrace. Only the scumbags—the handful few at Malacañang and the subalterns in the House of Representatives—will scuttle FOI, and they have done so.

Unfortunately for tax reform advocacy, the favorable conditions enjoyed by the FOI campaign are absent. Public opinion, which the media will carry, is allergic to new taxes. The majority of NGOs also resist taxation, especially if it is seen that such taxation is regressive. And business will be divided, for we expect vested interests to fight taxes that will adversely affect them.

Tax reform advocacy is the classic case of a collective action problem. Tax reforms benefit everyone—they are good for macroeconomic stability; the revenues can be used to finance growth and poverty reduction. Higher and stable revenues spur both private and public investments, which in turn create quality jobs. Despite these benefits, the ordinary citizen will not go out of his way to campaign for tax reforms. He may arrive at the calculation that the costs of being politically active—the transaction as well as opportunity costs—will be greater than the perceived benefits. Said benefits are abstract, if not indirect, and they may not even materialize.

In the meantime, this citizen, a potential recruit for the tax reform advocacy, will be awed, nay, threatened and probably discouraged by the huge resources, the sleek organization, the political connections, and the intense lobbying of vested interests.

So, in relation to tax reforms, what can be done to address the collective action problem and thus advance the public interest?

The sequencing of reforms is important. Government must first regain the trust of the people—that it will fight corruption, that it will not be captive to particularistic interests, that it will deliver the public services effectively and efficiently—before the hard taxation reforms can be introduced. At least, we are off to a good start under the Aquino administration. Noynoy Aquino won the elections decisively and thus has tremendous political capital to make good his promise: kung walang corrupt, walang mahirap. Let us not quarrel about the slogan's logic. I interpret it as (Gloria Arroyo's) shameless, immoderate corruption being a binding constraint on investments and poverty reduction.

The next concrete step is to appoint men and women of integrity and independence who will lead the Department of Finance, the Bureau of Internal Revenue, and the Bureau of Customs. Choosing the right people is not going to be a problem because the Noynoy Aquino team has a deep bench.

The tax reforms to be introduced must likewise be anchored on fairness and equity. This is of course a question of principle at the same time that it serves the strategy of getting a mass base for the advocacy. The principle of progressive, equitable taxation should not be diluted. I see a tendency among some leading policy professionals to apply progressiveness of fiscal policy only at the spending side. There is likewise a preference among some technocrats to shift from income taxation to consumption taxation as the main source of revenues. This is an idea that will entail huge political costs and therefore infeasible at this period.

On the other hand, we also have to inform and educate the public, especially those who are capable of undertaking collective action, about the basics and nuances of taxation. For example, a mistaken idea is that indirect taxation is regressive and thus anti-poor. A tax on petroleum is an indirect tax, but it is a good tax. It addresses negative externalities like traffic and pollution. Furthermore, those who pay the petroleum tax are mainly those who have the ability to do so—those who own Benzes, Hondas, and Kias, and they all belong to the high-income bracket in Philippine society.

But what about the effects of a petroleum tax on the poor? The poor can be insulated through well-targeted subsidies—for example, subsidies for public transportation and economic activities of the small fisherfolk and farmers.

Another indirect tax that is beneficial to the whole society is the excise tax on alcohol and tobacco. Such tax is admittedly regressive, but we want our citizens, especially the poor, to live healthy lives. It is a modest proposal to increase the specific taxes on sin products, since such merely adjusts the tax to inflation.

Citizens' ownership of the reforms, especially the more controversial ones, is critical. It is the task of public officials to reach out to civil society, including possible adversaries. Not only will this facilitate healthy debate; it can also lead to new forces, new alliances. I recall for example the initiative of then Finance Undersecretary Nene Guevara in the mid-1990s to talk to the officials of the Freedom from Debt Coalition (FDC) towards getting support for the Comprehensive Tax Reforms Package (CTRP). Before this, she and the FDC had several encounters with regard to the VAT and the oil levy.

But Guevara's entering the FDC den, a lion's den, led to warming up the relationship. And through persistent, friendly dialogue, a convergence was found. Eventually, an organization like Action for Economic Reforms, which we founded, became one of the mainstays in the passage of CTRP. It was the belief that we were meaningfully involved in the reform process that led us to be part of the CTRP coalition.

Now, we can involve more NGOs that will help strengthen national ownership of tax reforms. Some of these organizations are involved in causes that one way or another relate to taxation issues. People's organizations in mining communities as well as environmental groups will be much interested in the advocacy to withdraw the fiscal incentives for extractive industries. A newly formed group called Bantay Kita is a watchdog group that monitors the revenues that extractive industries must pay. Publish what you pay is one of its operative slogans. We find a convergence between the stance of these NGOs and the DOF position. After all, incentives to extractive industries are redundant.

In the area of public health, tobacco control groups like Health Justice (an organization that bridges health and law) actively campaign for the increase in the tobacco tax as a means to reduce smoking prevalence.

Organizations that advocate better public spending to achieve human development goals are natural allies in the campaign for tax reforms. These groups, like the Alternative Budget Initiative, rightly demand increased spending for health, education, nutrition, and essential economic services. Yet, they are aware of the fiscal constraints that government faces. Hence, they will be willing to support reforms that will increase revenues that will finance their pro-poor proposals.

All told, we do have favorable conditions to pursue collective action for tax reforms. Let's seize the moment.

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