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Tax Reform Options to Generate Revenues while Reducing Inequality

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This working paper is a draft in progress that is posted online to stimulate discussion and critical comment. The purpose is to mine reader's additional ideas and contributions for completion of a final document.

The views expressed herein are those of the authors and do not necessarily reflect the views of Ateneo de Manila University.

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Executive Summary

The Philippine government's Comprehensive Tax Reform Program Package 1 (CTRP-1) has sparked considerable discussion on its effects on households at different income levels. This paper focuses on the impact on income inequality of the CTRP-1, discerning gaps that continue to exist in the formulation of the tax reform package. Not only do we find that the overall gains of poorer deciles are less certain, once leakage issues in the delivery of targeted transfers are considered; due to higher increases in disposable income from the reform package that accrue to higher deciles, post-tax income inequality increases significantly.

Following from the analysis, we present options for policymakers on how to enhance the reform package's response to inequality while preserving as much of its efficiency objectives. Lowering the PIT exemption threshold from PHP250,000 to PHP150,000 (as proposed by Senate Bill 1592) appears to regain some of the erosion of the Gini index that occurs with the House version of the bill; we determine, moreover, that effectively transferring PHP7,800 per household per annum, whether through cash transfers or earmarked programs, will serve to lower the Gini index by one full point from pre-tax levels. This outcome can be better guaranteed by increasing the earmarked share of petroleum excise taxes for social spending from 40% to 65%. Should the mobilization of additional resources prove necessary, three revenue-raising option are proposed: bank transactions taxes on demand deposits, a national land windfall tax or betterment levy, and increased sin taxes on tobacco products.

Key words: tax reform, income inequality, earmarking, public finance

JEL Classification: H20, H21, E62

1. Introduction

The Philippine government's Comprehensive Tax Reform Program (CTRP) Package 1— also known as the TRAIN (Tax Reform for Acceleration and Inclusion) bill and from hereon referred to as CTRP-1— has sparked considerable discussion on its effects on households at different income levels. On one hand, there is an urgent need to amend structural flaws in the Philippines' present tax system— characterized by high income and corporate tax rates (among the highest in Asia), bracket creep in the personal income tax burden of the middle class due to non-indexed tax rates, and extensive exemptions and leakages in indirect taxes such as the value added tax (VAT). Closely intertwined with these is the challenge of amassing sufficient levels of funding for the current administration's ambitious development programs, while shifting consumer behavior in ways that could contribute to the public health and sustainability. As officials of the Department of the Finance (DOF) have maintained, the passage of a reform package is instrumental for raising the Philippines' revenue effort in support of the Philippine government's "*Build, Build, Build"* program and 10-point socioeconomic agenda[1].

The government has established clear competitiveness and efficiency-oriented objectives for reforming the tax system. But several concerns have also surfaced concerning the adverse impacts of the tax reform package— its effects on poorer households, its implications on the distribution of the tax burden, and the viability of the proposed transfer mechanism for compensating lower-income groups. Most recently, a discussion paper by the Philippine Institute for Development Studies has argued that the overall impact of the Lower-House version of the CTRP-1 (House Bill 5636), is regressive before targeted transfers are considered, and that the proposed size of such transfers (i.e. PHP 2,400 annually) is still below the levels required for the poorest 40% of households to cope with the reform's adverse impacts by a margin of 78% to 137%[2]. Other commentators have likewise issued criticisms of the House version of the tax reform package, focusing particularly on its claimed "*anti-poor"* character and the practical difficulties of administering transfers to the bottom half of all Filipino households[3].

This paper attempts to reconcile concerns over reducing inequality, with possible design options for the CTRP-1. It undertakes an assessment of CTRP-1— both the House version of the tax reform package, and salient features of the latest Senate version (Senate Bill 1592)— and presents options for policymakers on how to enhance the reform package's response to inequality while preserving as much of the efficiency objectives[4]. In particular, we propose several measures for progressively raising revenues and for earmarking their spending in ways to enhance the distributional impacts of the tax reform package. While

[1] Mary Grace Padin, "No TRAIN, no Build, Build, Build— DOF" *Philippine Star*, 17 August 2017, http://www.philstar.com/business/2017/08/17/1729798/no-train-no-build-build-build-dof (Accessed September 17, 2017)

[2] Rosario Manasan, "An Assessment of the 2017 Tax Reform for Acceleration and Inclusion," PIDS Discussion Paper Series No. 2017-27, *Philippine Institute for Development Studies*, https://pidswebs.pids.gov.ph/CDN/PUBLICATIONS/pidsdps1727_rev.pdf (Accessed September 17, 2017), 24, 26.

[3] Solita Collas-Monsod, "Saving TRAIN (2)," *Philippine Daily Inquirer,* 17 June 2017, http://opinion.inquirer.net/104844/saving-train-2 (Accessed September 17, 2017)

[4] To a greater degree than previous assessments, we focus our attention on the income distribution effects of the tax reform, as measured by the Gini index of income inequality. As defined by the World Bank, the Gini index of income inequality measures the extent to which the distribution of income among individuals or households within an economy deviates from a perfectly equal distribution (World Bank 2017). A Gini index of zero (0) means that the distribution of income is perfectly equal (i.e. all individuals have the same income), while higher Gini index means greater inequality in the distribution of income.

In 2011, the Philippines recorded the highest Gini coefficient among South East Asian Nations with 44 percent. Thailand is the second highest with 42.5 percent. Indonesia followed with 39.4 percent. Vietnam fared better at 37.8 percent (Ho 2011).

earmarking of revenues is, in principle, not ideal in public finance, we highlight this as a promising medium-term option that could make the tax package more political feasible, while also improving both the efficiency and equity impact of the initial reform.

2. Examining the Impact of CTRP-1 on Inequality

Main Message: *Notwithstanding the administration's overall efforts to promote more inclusive growth, the CTRP-1 does not score high on reducing inequality. Without transfers, the Gini index for income rises from a pre-tax level of around 49.1 to a post-tax level of 50.7. Even with transfers and assuming minimal leakages, the post-tax Gini index remains at 50.0.*

As formulated in HB5636, the CTRP-1 contains provisions for five major tax policy reforms, spanning measures for (a) personal income taxes (PIT), (b) petroleum excise taxes (PET), (c) broadening the base of value-added taxes (VAT), (d) automobile excise taxes (AET), and (f) sugar and sweetened beverage (SSB) excise taxes[5]. Among these, arguably the reform of personal income taxes is the most anticipated measure, particularly by the middle class affected by bracket creep (i.e. the movement of average taxable income to higher tax brackets due to non-indexation of tax rates to inflation). Essentially, this will involve an adjustment in income tax brackets, and a lowering of tax rates for all taxpayers except for those located in the top income tax tier. HB5636, the House-approved proposal, exempts individuals with annual incomes of not over Php250,000— which includes 82.4% of the population[6]. Because segments of the population earning compensation income at and below minimum wage levels were already exempted from personal income taxes, these adjustments essentially focus their benefits on the majority of the middle class. In turn, the remaining indirect tax measures of CTRP-1 are expected both to compensate for the foregone revenues from the PIT adjustments and to expand government tax take more generally.

[5] Reforms also related to the rationalizing estate taxes and donor's taxes, and the adoption of various administrative measures ranging from fuel marking and limited adjustments to bank secrecy laws, though the measures expected to have the most widespread impacts are the five ones mentioned above.
[6] Computed from the 2015 Family Income and Expenditure Survey (FIES) data.

Table 1. Impact of TRAIN on Average (Mean) Filipino Income Taxpayers

2015 Mean Annual Income (PHP)	**188,731**
Common Occupations (2017 Salaries)	Call Center Agent, Pre-School Teacher,
2017 Projected Annual Household Total Income (PHP)	207,403
Basic pay per day	663
Monthly income	17284
Net Tax Due (Current)	24573
Net Tax Due (Proposed)	0
Gain from PIT Reform	24573
Loss from PET Reform	2510
Loss from VAT Base Expansion	780
Loss from AET Reform	4143
Loss from SSB Tax Reform	639
Loss from Inflationary Effects	980
Net Gain from TRAIN	15521

Source: Authors' computations, based on the 2015 Family Income and Expenditure Survey.

When examined through national averages, the overall impacts on Filipino households appear highly beneficial. For typical households with a single taxpaying individual, there is a significant net gain per annum, as shown by the figures in Table 1. To illustrate, an individual who earned PHP188,731 per annum in 2015 (PHP207,403 in 2017 according to wage growth trends)— which is equivalent to annual gross income earnings of a Call Center Agent or Pre-School Teacher according to Payscale.com data— pays as much as PHP24,573 worth of tax under the present income tax system. Yet with the PHP250,000 PIT exemption threshold set by the approved HB5636, the agent or teacher will get to keep the entire sum of PIT obligations he/she currently pays under the status quo. Even when the anticipated losses from the reduction from VAT exemptions and the different excise taxes are factored in— namely, PHP780 per annum for the VAT base expansion and PHP8272 for the PET, AET, the SSBT and the projected inflationary effects of the tax package— the increase in disposable income for the mean household continues to stand at a sizeable PHP15,521 annually[7].

Such aggregated figures, however, fail to convey the effects of the reforms across income groups, and their general distributive impacts. For this purpose, we estimated the effects of adopting the proposed tax measure included in the CTRP package 1 (as formulated in HB5636) by applying them to the entire sample of Filipino households surveyed for the 2015 Family Income and Expenditure Survey (FIES), both when grouped

[7] Estimated impacts for this paragraph computed from the 2015 FIES data.

as deciles and individually. Our analysis is informed by features of both the DOF's and Manasan's methodologies in estimating the impacts of the adoption of the CTRP-1, as contained in HB5636, though we focus particularly on the possible impact of the tax reform package on inequality[8].

[8]*Caveat:* with regards to PIT changes, this analysis of the House version of the CTRP-1 focuses only on the implications of reforms on compensation income earners (CIE), and not on self-employed earners and/or professionals (SEP's). Apart from the higher level of complexity involved, this was due to two reasons. First was the overall lower salience of SEP as opposed to CIE taxes. Indeed, according to the sample BIR database used for DOF's computations, SEP personal income taxes accounted for only 6.8% of all PIT taxpayers and 15.6% of all PIT tax collections in 2014. The remainder of the PIT balance in both these areas was accounted for by CIE taxpayers and revenue collections. Secondly, due to the use of a withholding tax system on CIE, tax compliance is significantly higher for CIE's than for SEP's.

There is reason to believe that our focus on changes on CIE income taxes will make our resulting analysis of the inequality-reducing impacts of the CTRP-1 more conservative. In her assessment of HB5636, Manasan (2017) argued that the bill's introduction of a new scheme for SEP taxation will "*introduce severe horizontal inequality in the PIT system with small-/medium-scale enterprises with lower profit margins likely to get less favorable tax treatment under these bills than many professionals who tend to enjoy higher profit margins."* Based on 2015 Payscale.com data on average salaries, many of these professionals (e.g. doctors, lawyers, accountants) would easily be located in D9 or D10.

Moreover, when both CIE and SEP estimates are considered together in Manasan's analysis, it is found that the total PIT liability for D1-D5 will increase (due to increased SEP tax rates), while that of D6-10 will decline (due to lower CIE tax rates) (Manasan 2017, p. 8). On this basis, it may be inferred it is likely that the Gini index would rise even further, post-tax, had it also been included in our analysis.

Table 2. Distribution of Benefits, Losses and Changes in Take-Home Pay from TRAIN, by Decile , and Impacts on Gini Index (D – Decile)

DOF Amended	D1	D2	D3	D4	D5	D6	D 7	D8	D9	D10
Package 1: PIT and consumption										
2015 Mean Annual Income per decile	21610	48332	68499	88464	109744	136270	171874	228033	323408	691244
2017 Projected Annual Household Total Income (PHP)	25043	55989	81026	103701	112967	157448	192390	250784	356489	721993
Basic pay per day	80	179	259	331	361	503	615	801	1139	2307
Net Tax Due (Current – Compensation Income Only)	0	0	0	0	1489	6328	17746	31194	57679	131295
Net Tax Due (Proposed – Compensation Income Only)	0	0	0	0	0	0	0	900	12206	60541
Personal Income Tax Gain	0	0	0	0	1489	6328	17746	30294	45473	70755
Indirect tax policy impacts										
Diesel, Kerosene, and Transportation*	286	611	892	1160	1712	1918	2364	3130	4452	8819
VAT base expansion*	108	230	324	404	576	629	750	976	1353	2366
Automobile excise	0	0	0	0	0	0	0	3420	6120	16200
Sugar and sweetened beverage tax	291	338	403	467	531	616	730	839	955	1175
Inflationary Effect**	298	456	555	639	744	847	992	1183	1468	2620
Change in take home pay (in pesos)	-983	-1635	-2174	-2670	-2074	2318	12910	20746	31125	39575
Transfers	2400	2400	2400	2400	2400					
After transfers – No Leakages	1417	765	226	-270	326	2318	12910	20746	31125	39575
After Transfers – with Leakages (Est. 29% based on 4P's)	721	69	-470	-966	-370	2318	12910	20746	31125	39575
Before-Tax Gini Index of Income (All Pop.)	**49.1**									
After-Tax Gini Index of Income (All Pop.)	**50.7**									
After-Transfer Gini Index of Income (All Pop.)	**50.0**									

Source: Ateneo Policy Center Computations, using 2015 Family Income and Expenditure Survey data.
*Computed using ratios provided in Manasan (2017)
** Estimated DOF Estimates for HB5636

Our analysis confirms lingering concerns over the implications of CTRP-1 on inequality. As shown by Table 2, the averages presented in Table 1 are only representative of the situation of taxpayers in Decile 7 (D7). Yet the impacts of the CTRP Package 1 are quite different for the bottom 50% of households— with lower-income households all experiencing adverse effects from the reform package. Though perfect delivery of targeted transfers of PHP2,400 per household annually (as provided in HB5636) could be sufficient to neutralize the adverse effects of hikes in indirect taxes for most of the bottom deciles, D4 still experiences a net loss of PHP270 from the reform, while the final gain in disposable income for those of D5 (PHP326) and D3 (PHP226) remains largely insignificant relative to their annual incomes. This is mainly because households in such deciles they do not benefit from PIT relief, even while facing a higher indirect tax burden, most especially from the PET hike. So long as flawless executive of the transfers takes place, a transfer of at least PHP2,700 per household per year would be necessary to at least ensure that none of the bottom five deciles would emerge as net losers from the adoption of the CTRP-1.

However, transfers will likely face inefficiencies in implementation. If we go by historical leakage rates of around 29% in the Pantawid Pamilya program as a rough leakage indicator for the CTRP-1 transfers[9], then it becomes much less likely that even the remaining deciles will consistently receive adequate levels of compensation. Once such leakages are considered, households from D3 to D5 could expect to receive a net loss on average, while any final gain in disposable income in D2 would be significantly eroded[10]. Only D1 appears to gain decisively among the bottom five deciles from the reform package,

Based on our decile analysis in Table 2, we make the following additional observations:

- **The impacts of the PET pose the biggest tax burdens to the poor, and inflationary effects should also be considered.** For each of the lower five deciles, the PET hike imposes the heaviest impacts on disposable incomes, while that of the AET is the lowest by virtue of vehicle ownership being uncommon among households of these deciles. With regards to the PET, the greatest impact for the lower deciles occurs through its potential impacts on transport-related expenses;

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[9] Ranier Allan Ronda, "Over 1.5M 4Ps family beneficiaries now non-poor," *Philippine Star*, 6 April 2016, http://www.philstar.com/headlines/2016/04/06/1569961/over-1.5-m-4ps-family-beneficiaries-now-non-poor (Accessed September 17, 2017)

[10] While it is true that the spending of the resulting revenues from the adoption of the CTRP-1 will also have important inequality-reduction repercussions, it is difficult to make a more precise assessment the likely impacts of such spending on the post-tax and post-transfer Gini indices, given the uncertainties that continue to characterize the social and economic spending programs of the government, as well as the range of implementation issues that cannot be taken for granted (e.g. government underspending).

in addition, consumption of kerosene products also tends to be concentrated among the lowest 50% of households.

The SSB tax is also a significant contributor to the indirect tax burden of the poorest three deciles, even outstripping the extra burden of the PET increase and the removal of VAT exemptions for D1. However, even more consequential than the SSB are the anticipated general inflationary effects of adopting the package of indirect tax measures— all the figures for which in Table 2 are based on DOF estimates. For all bottom five deciles, the adverse impacts of increased inflation of other products (e.g. food products) slightly outstrip the immediate losses posed by the VAT base expansion.

- **The post-PIT reform benefits for compensation earners are concentrated among the top 50 % (D6-D10).** This is primarily since the bulk of compensation taxpayers under the current tax regime fall under these same deciles. For income taxpayers located in a small upper segment of D5 until part of D8, the gain will occur by being exempted from income tax payments altogether, whereas for much of D9 and D10 it will come through a lowering of the PIT rate for majority of households. Despite this, gains from the PIT reform are skewed upwards, with the absolute increase in take-home pay increasing markedly with higher deciles until D10. As a share of their annual income, in fact, D8 and D9 experience the biggest *relative* increases in disposable income, representing a significant level of their already existing income. While the top decile (D10) experiences a significant net gain, the relative scale of average increases is diminished by retained, if not higher, tax rates on the two highest tax brackets, and the higher level of annual income to begin with.

- **Pre-Tax Gini Index is high.** Using 2015 FIES data, the before-tax Gini index of income computed across households surveyed stood at 49.1. Incidentally, it is not surprising that this is significantly higher than the Gini index of 46 calculated by the Philippines Statistics Authority (PSA) with the same dataset, since the latter estimate was based on household expenditure patterns, not income. This is because over time, households tend to smooth out consumption depending on estimated long-term average income, which may even out the results of expenditure-based measures for inequality.

- **Post-Tax Gini Index is even higher.** However, with the adoption of the measures of CTRP-1, the after tax Gini index rises to 50.7— more than a 1.5-point increase over the pre-tax index. This seems due mostly to the skew of PIT benefits to the top 50% of the sample (D6-D10). By comparison there is no compensation income tax relief for any households among the bottom 40%, given that most of the individuals are consistently already earning below minimum wage.

Without transfers, the bottom 50% of households suffers adverse impacts from the reform, though the additional burdens are most pronounced among from D3 to D5 While three excise taxes contribute to these losses, it is the SSB tax and the VAT base expansion which appear to be more regressively distributed on the whole, with the bottom 60% shouldering 51% and 29% of the additional burden of the SSB tax and the VAT base expansion, respectively. The more progressive of the indirect taxes, by comparison, are the AET and PET taxes. The tax burden of the AET hike are completely shouldered by the highest three deciles, for example.

- **CTRP-1 transfers as presently designed, are not enough to even preserve the present Gini index.** Even if transfers were to be executed perfectly, with no targeting errors or leakages, the present levels of proposed transfers PHP2,400 per household per annum would only marginally lower the estimated after-transfer Gini index of 50.0. This is mainly because prospective receipts from targeted cash transfers are still negligible when placed besides the gains from the PIT restructuring, which is borne out by comparing the average change in post-transfer disposable income for the top 50% (~PHP21,335 gain), with that of the bottom 50% (~PHP493 gain). While a well-executed delivery of transfers should be able to mitigate the adverse effects of the reform on the bottom deciles, the central issue here is that the poor benefit far less from the adoption of the reform package as compared to the middle and even the non-minimum wage-earning working class. This underscores the importance of calibrating of the design of the CTRP-1 in order to guarantee that the resulting increases in disposable income will be equitably distributed.

3. Calibrating CTRP-1 to Address Inequality

Main Message: *Several options exist so that CTRP-1 responds to inequality, while maintaining the core reform features of the package. In order to examine what adjustments in the design of the tax reform may improve its impact on inequality, we compare the repercussions of major proposed changes in the latest Senate version of the CTRP-1 (SB 1592) on the Gini index of income inequality, relative to the House-approved version of the package.*

While the removal of the top PIT tax bracket in SB 1592 marginally worsens the Gini, its lowering of the PIT exemption level to an annual compensation level of PHP150,000.00 or below nonetheless results in a significant reduction of the Gini, which is further bolstered by its increase of the targeted transfer to PHP3,600 annually.

However, to make the CTRP-1 either not worsen the Gini or begin improving upon it will still require significant increases in effective transfers to the bottom 50% of households (i.e. PHP7,800 per household annually to improve the post-transfer Gini to 48.1). It is unclear whether and to what extent these transfers can be increased and effectively delivered.

Hence, apart from augmenting the level of transfers we examined another option, which consists of raising the level of earmarked CTRP-1 funds from 40% to 65% of the PET incremental revenues for social spending and human capital investments, while refining earmarked funds from the SSB levy to more explicitly support programs meant to strengthen access to healthcare services and public health systems. Two issues are related to this. On one hand, while the reduction in the 1st year PET rate proposed by SB1592 holds little impact on the Gini, its repercussions on the additional tax burden on the lower deciles and on revenues available for earmarked spending should be carefully balanced. On the other hand, though retaining sufficient funds for transport infrastructure spending is critical, extremely high levels of inequality in household spending for health and education suggest that these should be just as prioritized. One way to move forward here would be to make the earmarking temporary, until the full effects of pro-poor investments are able to take full effect. A targeted focus on pro-poor (e.g. poor sectors such as agriculture and fisheries, or poor regions) infrastructure investments could also further skew this transition towards more equitable outcomes in a shorter period.

Raising the PIT Exemption Threshold and Level of Targeted Transfers. According to Republic Act 9504, income earners at and below minimum wage levels are presently exempted from paying income tax. However, as already mentioned, in HB5636, this threshold for PIT exemption has been set at annual compensation earnings of PHP250,000 or below per year. This represents a significant increase in the threshold for those who presently pay zero income tax on compensation earnings, which amounted to a maximum of approximately PHP153,700 in NCR, based on specifications by the Department of Labor and Employment for 313 working days in a year (for those not working during weekends)[11].

[11] DOLE NWPC, "Summary of Wage Orders and Implementing Rules," *Department of Labor and Employment National Wages and Productivity Commission*, 31 August 2017, http://www.nwpc.dole.gov.ph/pages/statistics/latest_wo.html (Accessed September 17, 2017)

Table 3. Gini Indices per PIT Exemption level

	PIT Exemption Level (as per Senate Proposals)				
	HB5636 (250k)	**SB1592 (250k)**	**SB1592 (200k)**	**SB1592 (175K)**	**SB1592 (150K)**
Pre Tax	49.1	49.1	49.1	49.1	49.1
Post Tax	50.7	50.7	50.56	50.38	50.29
Post Transfers (PHP3,600 for SB1592)	50.03	49.69	49.55	49.37	49.28

Source: Ateneo Policy Center, based on 2015 FIES Data.

Table 4. Estimated Pre-Tax Gini-Preserving and Gini-Improving Level of Transfers, per PIT Exemption Level

	PIT Exemption Level (as per Senate Proposals)				
	HB5636 (250k)	**SB1592 (250k)**	**SB1592 (200k)**	**SB1592 (175K)**	**SB1592 (150K)**
Inequality-neutral Transfers (Gini Index of 49.1)	5,600	5,600	5,200	4,500	4,200
Inequality-reducing Transfers (Gini Index of 48.1)	9,300	9,300	8,800	8,100	7,800

Source: Ateneo Policy Center, based on 2015 FIES Data.

Table 5. First-year projected impacts of PET scheme, SB1592 vs. HB5636 Rate*

PET Tax Scheme	SB1952 PET Proposals	HB5636 PET Proposals
Pre-Tax Gini Index	**49.1**	**49.1**
Post-Tax Gini Index	**50.29**	**50.32**
Additional Burden for Bottom Five Deciles (% of Household Income)	**D1 – 0.61%** **D2 – 0.605%** **D3 – 0.62%** **D4 – 0.64%** **D5 – 0.68%**	**D1 – 1.14%** **D2 – 1.09%** **D3 – 1.10%** **D4 – 1.12%** **D5 – 1.51%**
Projected Revenues (PHP billions)	**40.0**	**74.4**

Source: Ateneo Policy Center Computations, and Department of Finance data

* - To maximize comparability, assuming that all other features of the package are as stipulated in SB1592.

Setting the PIT exemption rate at the PHP250,000 level raises questions, both from revenue and inequality-reduction standpoints. Though it has been clear that a higher exemption threshold will diminish potential revenue collections, the case for reducing inequality has been more complicated. For example, what is the impact of the setting the threshold of the PIT reform at the PHP250k level, if it appears, as shown in Table 2, that the greatest relative increases in disposable income from the CTRP Package 1 accrue to D9 and D8? How would alternatives in setting the PIT threshold— such as lowering the PIT tax rate applying to households with less than PHP250,000 in annual income earnings (thus allowing them tax relief), but still keeping them within the PIT tax net— affect the distribution of post-tax incomes?

In this regard, the latest version of the CTRP-1 Senate bill (SB 1592), adopted by the Senate Ways and Means Committee, has proposed lowering the PIT income threshold to cover compensation earners with annual gross earnings of over PHP150,000. This would effectively result in the creation of a new PIT tax bracket of earners between PHP150,000 and PHP250,000, whose annual earnings in excess of PHP150,000 are to be taxed at a 15% rate. At the same time, SB1592 also proposes the removal of the top tax bracket in HB5636, in which individuals with taxable compensation income of more than PHP5-million annually would be levied at an annual rate of PHP1.45-million plus 35% of the excess over PHP5-million. While this latter development may appear to be a move towards greater inequality, other analysts have commented that the small number of salary compensation earners compared to self-employed professionals at this level of annual income may have rendered the existence of this top tax bracket has been more of cosmetic feature rather than real contributor to progressivity in the PIT system[12]. Finally, relative to HB5636, SB 1592 also raises the amount of targeted transfers from PHP2,400 to PHP3,600 per household annually.

In line with this, Tables 3 and 5 presents the effects of adopting these changes on the PIT tax schedule on the post-tax and post-transfers Gini index, though we also provide alternative thresholds for the PIT exemption levels (PHP200k and PHP175k) to illustrate how the Gini indices shift with decreasing exemption thresholds. Likewise, at each exemption threshold for SB 1592, we estimate the post-transfer impact of increasing targeted transfer levels to PHP3,600 per household annually, as well as the amount of transfers needed both to equalize or enhance the post-transfer Gini indices. From this, we discern the following trends:

- **While the elimination of the top tax bracket negligibly worsens the Gini index, lowering the threshold to the PHP150k level appears to progressively improve the post-tax and post-transfer Gini.** As shown by Table 3, by removing the top tax rate of 35% for earners with more than PHP5-million in annual compensation earnings, the post-tax Gini index increases from 51.00 under HB5636 by a slight

[12] Communication with Dr. Rosario Manasan of the Philippine Institute of Development Studies, 26 September 2017.

0.01 points. By contrast, there is a clear improvement in both the post-tax and the post-transfer Gini index as the PIT threshold is set lower, with a PHP150k exemption under SB1592 resulting in a post-tax and post-transfer Gini of 50.56 and 49.57 respectively (including the PHP3,600 transfer). If set at such a level, households at D6 and D5 would remain covered by the PIT, thus slightly lessening the gains of most households which stand to gain from being completely exempted from PIT reform.

If the marginal gains of incrementally lowering the PIT threshold are considered, it is worth noting that setting the exemption level at PHP175k furnishes the single biggest improvement in the post-tax and post-transfer Gini. Whereas lowering the threshold from PHP250k to PHP175 lowers the post-tax/transfer Gini by 0.34/0.35 (with the greater part of it occurring from PHP200k to PHP175k), the additional gains against inequality, by decreasing it still further to PHP150k are more muted at only 0.1/0.1. It appears likely that this is because setting the PIT exemption level at PHP175k would effectively cover up to D7 and D8, which continue to be among the big relative gainers from the PIT reform.

Though it is true that setting the PIT exemption threshold at lower levels may somewhat reduce the level of benefits that households from D8 up to D6 may stand to gain from the CTRP-1 (while still promising them significant tax relief due to the lower applying PIT tax rate), it is important to balance this with two considerations. On one hand, covering more households in the PIT tax net can serve to diminish the potential revenue loss from exempting majority of wage income earners under HB5636, thereby enabling more prospective revenues from the indirect tax measures to be channeled to spending areas that can benefit both middle and lower-income deciles. Indeed, according to recent estimates the DOF and the proponents of SB 1592, for instance, restructuring the PIT schedule from that proposed under HB5636 to under SB 1592, could stem the revenue loss from income taxes by around PHP31-billion in its first year[13].

Secondly, exempting majority of income earners from the PIT tax net could also have a deleterious impact on the cultivation of a culture of tax compliance among earners with more than PHP250,000 in gross annual taxable income. As has been documented by historical tax and governance studies, the existence of large-scale exemptions in direct taxes, whether among high-income (i.e. elite taxpayers) or low-income (i.e. informal sector workers and self-employed) individuals can encourage aspiring free-riding behavior by remaining taxpayers[14]. In both these

[13] Communication with the Office of Senator Juan Edgardo Angara, 9 September 2017.
[14] Margaret Levi, *Of Rule and Revenue* (Berkeley: University of California Press, 1988), 52-54.

regards, setting the PIT exemption cut-off at either 175k or 150k may promise to still offer households in the upper-middle deciles significant tax relief, but at a more equitable level relative to the overall distribution of incomes among households.

- **Changing the scheme of the PET tax has little effect on reducing inequality, but raises possible tradeoffs between revenues and the burden on lower-middle deciles.** Another salient difference between HB5636 and SB1592 lies in the phased scheduling of the PET, for which the former endorsed a 3-2-1 schedule and the latter a 1.75-2-2.25 arrangement[15]. Yet as shown by Table 5, the adoption of either of these schemes (like the removal of the top PIT tax bracket) is only likely, at most, to have a negligible impact upon the Gini (i.e. a lowering of the post-tax Gini index by 0.03 by moving from a 3-2-1 to 1.75-2-2.25 schedule). Instead, much more striking is an apparent trade-off between the potential revenues from increasing the rate of the PET in its first year by a higher amount, and the additional burden to low income taxpayers. Indeed, decreasing the proposed 2018 PET rate leads a massive decline in projected revenues of 46.2% (from PHP74.4- to PHP40-billion)— but it also significantly lowers the additional burden from the PET hike faced by households in the lower five deciles, expressed as a share of their household income. The change is especially noteworthy for households in D4 and D5, with the decrease more than halving their PET burden under a 3-2-1 scheme. This appears to be a result of a significant growth in consumption of fuel as income increases.

The pitfalls associated with both schemes suggest the need to explore a range of other, middle-ground options. On one hand, the 3-2-1 scheme appears to be an especially heavy burden to the lower-middle deciles— being one of the biggest factors why D3 to D5 are vulnerable to negative income shocks from the tax reform in Table 2. On the other hand, the fact that the PET has been identified in HB5636 as the main source of earmarked funds for targeted transfers and other social protection measures associated with the CTRP-1 (e.g. the *Pantawid Pasada* program), also means that lowering the PET hike could also serve weaken measures meant to ameliorate the adverse impacts of the measure on the poor as well as the overall distribution of income. In the light of such constraints, policymakers would be well-advised to consider a range of options that mitigate either of such challenges— such as 2.25-2-1.75 or 2-2-2 PET hike schedules, or a 3-2-1 schedule that staggers the PHP3 increase in the first year into PHP1 increments every four

[15] 3-2-1: Involving incremental increases in oil excise tax rates by PHP3 in 2018, PHP2 in 2019, and PHP1 in 2020.

1.75-2-2.25: Involving incremental increases in oil excise tax rates by PHP1.75 in 2018, PHP2 in 2019, and PHP2.25 in 2020.

months. Such alternatives may provide a more reasonable balance between lightening the burden of the PET hikes on the lower-middle deciles, and retaining sufficient revenues to fund the transfer mechanism and other programs earmarked for spending by the CTRP-1.

- **At the PHP150k exemption level, the degree of targeted transfers required to ensure that the CTRP-1 does not worsen the Gini index is at around PHP4,200 annually.** Over and beyond their immediate impact on the post-transfer Gini index, another key distinguishing factor between the different exemption thresholds are their repercussions on the degree of transfers needed to make the CTRP-1 not worsen the Gini index after transfers are delivered. As shown by Table 6, while achieving this at the PHP250k threshold would require around PHP5,600-worth of transfers annually per household, the number declines to PHP4,500 if the PIT exemption level is set at PHP175k. At the PHP150k level, the level of required transfers is even lower at PHP4,200— only an additional PHP600 (PHP50 monthly) over the PHP3,600 targeted transfers presently proposed under SB 1592. This progressive decrease in the necessary level of transfers is tied to the fact that lowering PIT exemption level also already reduces the post-tax Gini index by a significant decree.

  A similar pattern also applies with regards to the level of transfers needed to begin make the CTRP-1 significantly *inequality-reducing* (i.e. lower the post-transfer Gini by 1 point from pre-tax levels), though the volume of transfers required are more substantial. With a PHP175k exemption cut-off, it is estimated that an annual transfer of PHP8,100 per household will succeed in reducing the post-transfer Gini to 48.1, whereas for the PHP150k level it is PHP7,800 . These are again major improvements from the required level under the PHP250k exemption (i.e. PHP9,300 per household annually). Major questions remain, however, on the practical and political feasibility of administering transfers of such volume to the bottom 50% of households.

Earmarking TRAIN revenues for equitable and pro-poor spending. An alternative to raising targeted transfers even beyond PHP3,600 is that of expanding the degree of earmarked resources in the tax reform package for spending that will especially benefit households in the middle and lower-income deciles. Indeed, DOF officials have maintained that the CTRP Package 1 is necessary to fund the Duterte government's 10-point socioeconomic agenda, which also includes spending for human capital development, and social protection programs[16]. To this end, under HB5636, allocations for social spending have been guaranteed in Sec. 37, which earmarks 40% of the incremental revenues from the PET for a period of four years towards a "*social benefits program,*" which will enable households from the bottom five deciles to claim benefits such as cash transfers, discounts on medicines and public transport fares, food and housing subsidies, among other measures. Beyond this, the House version of CTRP-1 dedicates all incremental revenues collected from the VAT on socialized housing for government housing subsidies, while 85% of the SSB tax is earmarked for a "*Health Promotion Fund*" supporting spending in areas non-communicable disease prevention programs; school-based programs and facilities for sports, potable water, health awareness, and nutrition; and the provision of potable water supply in all public spaces, among others[17].

This earmarking, while not ideal in principle from the point of view of public finance policy, could nevertheless represent a middle ground to help improve both the efficiency and equity implications of the tax package. Given still considerable underspending by government up to the medium-term— with the Department of Transportation estimated to have only spent only 18% of its PHP55-billion budget for this year as of June 2017[18]—, the argument that the government's infrastructure program will severely lack for funds if the tax package is not passed (or if it is passed and much of it earmarked), appears to be less compelling. A middle ground position here would probably involve earmarking towards social (read: pro-poor) spending during a fixed period, after which the revenues could then be reverted back to the general fund of the Philippine government.

Table 6. DOF vs. Manasan TRAIN Indirect Tax Revenue Estimates for 2018, with Social Spending Earmarking Implications (PHP Billions)

Tax Type	2018 DOF Estimate*	Earmarked Revenues	2018 Manasan Estimate	Earmarked Revenues
VAT Reform	**89.3**	**	**31.3**	**
PET Reform	**74.4**	**29.8**	**60.1**	**24.0**
AET Reform	**24.0**	**-**	**20.0**	**-**
SSB Tax Reform	**47.0**	**40.0**	**47.0***	**40.0***
Total	**234.7**	**69.8**	**158.2**	**64.0**

Source: Ateneo Policy Center computations for earmarks, using Department of Finance (2017),and Manasan (2017) estimates.

[16] Department of Finance, "DOF to hold Tax Awareness Forum this week," *Department of Finance, Republic of the Philippines*, 19 June 2017, http://www.dof.gov.ph/taxreform/index.php/2017/06/19/dof-to-hold-tax-reform-awareness-forum/ (Accessed September 17, 2017)

[17] The other 15% of the SBB revenues are to be dedicated to alternative livelihood purposes among sugar farmers.

[18] Paolo Romero, "Underspending still plagues government," *Philippine Star*, 18 September 2017, http://www.philstar.com/headlines/2017/09/18/1740278/underspending-still-plagues-government (Accessed September 17, 2017)

* - DOF high estimates
** - Earmarked revenues for VAT imposition on socialized housing not computed due to aggregated presentation of estimates.
*** - Same as DOF level as Manasan was not able to arrive at an independent estimate for the SSB Tax.

Table 7. Gini index of Household spending, vs. Utilization Rate

Household Spending Area	Gini Index	2015 NGA Utilization Rate
Health	80.6	>80% (DOH)
Transport	59	>20% (DOE); <60% (DOTC)
Food	30.2	<80% (DSWD)
Education	75.6	>80% (DepED)
Housing	50	N/A

Source: Ateneo Policy Center Computations, using 2015 FIES data; NGA Utilization data from Monsod (2016).

But actual earmarked revenues will likely be insufficient. DOF has projected that the House-approved TRAIN bill will raise PHP133.8-billion in net revenues, once losses from the PIT reform (and foregone revenues from changes in estate and donor's taxes) are deducted from gains from indirect tax hikes and other tax administration measures[19]. Under proposed earmarking schemes, as shown by Table 8, this means that dedicated social benefit funds resulting from the measure will possibly fall between PHP69.8-billlion (by DOF estimates) and PHP64.0-billion (by Manasan's more conservative estimates of the CTRP-1's indirect tax take).[20] Of course, if the lower PET tax schedule proposed by SB1952 is adopted, then the figure will be lower (though lowering the PET exemption threshold may moderate this loss). Yet even at the level projected by the DOF for the House version of the tax reform, the total committed funds still fall considerably below the level needed to make the prospective benefits and losses from the adoption of the CTRP-1 even more equitable than the before-tax situation. If earmarked spending areas in the reform package are viewed as prioritizing programs for supporting household spending by lower-income households in human capital investments and social protection measures (e.g. universal healthcare services, scholarship and

[19]Ben de Vera, "First tax package seen generating P1.16T in net revenues in next 5 years," *Philippine Daily Inquirer*, 7 June 2017, http://business.inquirer.net/230885/first-tax-package-seen-generating-p1-16t-net-revenues-next-5-years (Accessed September 17, 2017)
[20] Not including prospective revenues from the lifting of VAT exemption on housing-related expenditures, which has not been broken down in available studies and estimates.

education voucher programs, feeding programs, transport subsidies, etc.), we estimate that present levels of earmarked funds will prove insufficient to enhance the post-tax Gini index by at least a margin of 21.9%[21].

Raising the level of earmarked revenues from CTRP-1 for social and transport spending provides a most promising option for retaining the essential features of the House-version of bill, while firmly addressing concerns over the reform package's repercussions on reducing inequality and its impacts on the poor. Indeed, when even the delivery of targeted transfers has already been demonstrated to suffer from leakage problems, other mechanisms of delivery of targeted human capital investments and spending supports to lower-income households should also be considered. On by how such earmarking should be increased, and how they should be designed, we offer the remarks below:

- **To better address inequality, earmarked revenues can be increased to around 65% of the incremental revenues of the PET component of the CTRP package 1, alongside a stronger emphasis in the SSB tax earmarking for better access to improved health systems.** On the basis that at least PHP7,800 in effective transfers per household would be needed to enhance the post-tax Gini index, or PHP78-billion nationally[22], a gap of around PHP14.0-billion would still exist when the required funds for such equalization are compared to projected earmarked revenues as per Manasan's estimates (i.e. PHP64.0-billion). As can also be observed from Table 6, however, this can be remedied by increasing the share of the PET revenues earmarked for social spending to 65% (~PHP39.1-B) from its current 40% level (~PHP24.0B). Were additional revenues beyond this level to be earmarked and spent effectively for human development-related investments, it is reasonable to expect that the adoption of the CTRP-1 could become decisively inequality-reducing and a major enabler of effective poverty alleviation programs of the Philippine government[23].

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[21] Arrived at by comparing the difference between likely earmarked resources from the PET and SSB tax under Manasan's revenue projections, and a rough estimate of the revenues necessary to execute a PHP7,800 to PHP8,100 per household transfer (which can also take the form of subsidies, discounts and spending supports), corresponding to the setting the PIT exemption threshold at either PHP150k or PHP175k respectively.

[22] This is presuming the PIT exemption threshold is set at a PHP150,000 annual cutoff, as shown in Table 4. Higher PIT thresholds also result in higher levels of needed transfers.

[23] It is important to note than our estimate of this increase in earmarked resources from the PET revenues is based on the assumption that revenues from the SSB tax allocated to "*Health Promotion Fund"* purposes can also significantly contribute to the kinds of equity-enhancing social spending patterns that will be discussed in the remainder of this section. Yet this role for the use of SSB revenues, however, can be further strengthened if the use of earmarked funds from such levies are more explicitly aligned in future drafts of the tax bill towards facilitating universal access to

- **While it is important to maintain flexibility in the range of earmarked programs, existing levels of inequality in health, education and transport spending among Filipino households suggest that these should be given priority.** Though HB5636 allocated 40% of PET incremental revenues to various spending areas classified under the proposed "*social benefits"* program, the share of funds allocated to the different subcomponents of the said program (e.g. targeted transfers, PUV and medicine subsidies), have not been determined in detail. One view here is that this strikes a reasonable balance between guaranteeing the availability of revenues for mitigating possible adverse impacts of the reform on the lower deciles, while leaving earmarked funds sufficiently flexible to be used in the most effective ways available. On the other hand it is also possible that this "flexibility" will not be used in inequality-reducing investments. Earmarks, at least in the short term, could prove useful in ensuring that inequality will also be addressed by the tax reform.

Yet two major factors make prioritization of support to household spending on health and education particularly compelling. When inequality in key areas of household spending on basic needs are considered, health and education, in particular stand as areas where there is extremely high inequality among Filipino households. Indeed, health spending had the highest Gini index of inequality of all those earmarking areas examined (80.6), followed closely by education (75.6) and transportation (59). This is not to say that other areas of household expenditure, such as food and housing, are less important areas of public spending, but simply to emphasize that these other areas appear to be especially prominent facets of inequality in regular expenditures by households.

Secondly, as discussed in research by Monsod (2016), the capacity of government agencies to absorb dramatic increases in budgetary appropriations and to execute intended programs has been highly uneven. In this regard, however, both DOH and DepED have been noteworthy in being among those government agencies able to ensure expanded funds allocated to them are put to effective use, as suggested by their high ratings relative to their peers in the Department of Budget and Management's Utilization Index. It is also clear that the effectiveness with which different agencies will deliver results from increased appropriations should be a key consideration in the formulation of committed spending programs.

healthcare services and the improvement of public health systems regularly needed by households from lower-income deciles. As formulated in HB5636, no earmarked funds are expressly oriented towards universal healthcare-related spending; though SB1592 has expanded earmarked areas to include, among others, expansion of the universal primary care benefit package of Philhealth.

On both these counts, earmarking for health and education public expenditures and investments stands out as particularly promising areas for further earmarking.

3. Proposals for Equitable Taxation

Main message: *Given the need for raising the level of transfers and earmarked spending, and ensuring that the CTRP-1 fulfills the principles of fairness and equitable taxation, we propose measures that can significantly expand the potential revenue collections of the tax reform in an inclusive manner. Specifically, we find that bank transactions taxes on demand deposit/checking accounts (~PHP28.17-billion annually) national land windfall levies (~PHP54.80 billion for Metro Manila alone), and further raising sin taxes on tobacco products (at least PHP23-billion), harbor potential for substantial yet ultimately pro-poor revenue-raising.*

Bank Transactions Tax on Demand Deposit/Checking Accounts. The idea of taxing bank account transactions, such as bank account withdrawals or deposits, is not new, either abroad or in the Philippines[24]. In the Philippines, the possibility of adopting bank debit taxes has been explored in 2006 research, by the Congressional Planning and Budget Office (CPBO) of the House of Representatives[25], and the National Tax Research Center (NTRC)[26]. As discussed by both organizations, a potential version of the tax could involve a 0.2% levy on withdrawals from checking, savings and term accounts, which would be automatically be put into effect for a period of 6 months should the government deficit exceed 3.5% of GDP[27]. Using 2003-2006 data from the Philippine Clearinghouse Corporation, the CPBO study also generated estimates on the potential debit tax yield with regards to checking account transactions. With the total value of cleared checks in 2006 pegged at PHP 14.2-trillion, a 0.2% tax rate, the study's authors estimated, could yield an expected PHP28.40 in additional tax revenues for that year alone.

[24] Most famously, Brazil's CPMF (Portuguese*: Contribuicao Provisoria sobre Movimentacao ou Transmissao de Valores e de Creditos e Direitos de Natureza Financiera*) tax from 1997 to 2008 applied a uniform *ad valorem* tax rate between 0.2% and 0.38% on weekly bank account withdrawals, in order to finance various kinds of social spending— most famously its *Bolsa Familia* or Conditional Cash Transfer program. At the time the tax was discontinued in 2007, annual revenue from the tax amounted to 1.4% of Brazil's GDP or US$20-billion (ILO 2016).

[25] Rodolfo Vicerra and Jaime Singson, "Proposal for a Debit Tax: Automatic Response to Fiscal Emergencies," CPBO Policy Advisory No. 2006-01, Congressional Planning and Budget Department, http://www.oocities.org/cpbo_hor/policy/debttax.pdf (Accessed September 17, 2017)

[26] Monica Rempillo, "The Proposed Debit Tax," *NTRC Tax Research Journal*, XVIII: 2 (2006), http://www.ntrc.gov.ph/images/journal/2006/j20060304-The%20Proposed%20Debit%20Tax.pdf (Accessed September 17, 2017)

[27] It should likewise be noted that both organizations recommend a number of exemptions, both to reduce inequality and to continue to encourage financial and capital market development. These exemptions include: (a) withdrawals from the same account amounting to PHP5,000 and below in a given day; (b) long term loans; (c) transfers between accounts of the same person in the same financial institution; (d) transactions with the Central Bank; (e) inter-bank clearing and inter-bank transfers to ATM operations; (f) stock market and government bonds transactions; and (g) foreign exchange market transactions.

Table 8. Potential Bank Debit Tax Yield, Checking Account Transactions only.

Year	2013	2014	2015	2016	2017 (Projected)
Total Value of Cleared Checks (PHP Billions)	32,910	33,340	32,730	33,560	35,210
CPMO method estimates (PHP Billions)	65.82	66.68	65.46	67.12	70.42
Elasticity-adjusted estimates* (PHP Billions)	26.33	26.67	26.184	26.85	28.17

Source: Ateneo Policy Center estimates, using Philippine Clearinghouse Corporation data

*Elasticity value assumed to be -0.6

Table 9. Distribution of Size and Deposits across Philippine Demand Deposit Accounts, December 2016

Size of Demand Deposit Account		As of December 2016	
		No. of Accounts	Share of Total Deposits
P5,000 and below		38.6%	0.1%
P5,000.01 - P10,000		12.3%	0.1%
P10,000.01 - P15,000		6.7%	0.1%
P15,000.01 - P40,000		12.4%	0.5%
P40,000.01 - P60,000		4.5%	0.4%
P60,000.01 - P80,000		2.7%	0.3%
P80,000.01 - P100,000		2.0%	0.3%
P100,000.01 - P150,000		3.5%	0.7%
P150,000.01 - P200,000		2.1%	0.6%
P200,000.01 - P250,000		1.6%	0.6%
P250,000.01 - P300,000		1.2%	0.6%

P300,000.01 - P400,000		1.8%	1.1%
P400,000.01 - P500,000		1.3%	1.0%
P500,000.01 - P750,000		2.2%	2.2%
P750,000.01 - P1,000,000		1.3%	1.9%
P1,000,000.01 - P1,500,000		1.6%	3.3%
P1,500,000.01 - P2,000,000		0.9%	2.6%
Over P2,000,000		3.5%	83.5%
TOTAL		3,954,774	100%

Source: Ateneo Policy Center Estimates, using Bangko Sentral ng Pilipinas data

- **Revenues from a Bank Transactions Tax could reach around PHP28.17-billion.** Applying this same methodology, but also providing for potential elasticity adjustments, it is found that the measure could yield between PHP28.17-billion in additional revenues, if included as a new tax measure in the CTRP package 1. Table 8 demonstrates that if unadjusted for the assumed elasticity of demand deposit account transactions, a 0.2% tax on checking account transactions could net up to PHP70.42-billion annually. This figure declines to a more modest, but still significant PHP28.17-billion if elasticity concerns are included [28] .

- **Especially with exemptions for small transactions, evidence suggests that the tax burden will be progressive.** While it is difficult to estimate the impact on the post-tax Gini index given that both individuals and business entities avail of checking accounts, existing statistics from surveys conducted by the Bangko Sentral ng Pilipinas have suggested that only around 14% of Filipino households have a deposit account in a banking institution[29]. Yet even among those with bank accounts, the size of checking account transactions appear to be heavily skewed towards higher-income entities. According to 2016 BSP data on Demand Deposit Accounts (i.e. Checking Accounts) in the Philippines (see Table 6), while the number of checking accounts with more than PHP2-million worth of deposits was

[28] Based on a preliminary scan of literature, no concrete estimates of the price elasticity of checking account transactions was found. However, it is important to emphasize an observation of the 2006 NTRC study that most of the burden of a tax on bank transactions, particularly on checking accounts, would be heavy users of the banking system, such as corporations, for whom using such accounts is a business requirement (NTRC 2006, p. 10). Given the pervasiveness and necessity of such checking account transactions for business purposes, it appears reasonable to expect that the price elasticity of such transactions is inelastic in the short-term.

[29] Bangko Sentral ng Pilipinas, *National Baseline Survey on Financial Inclusion,* Manila: Philippines, 2015. 7.

only 3.5% of the total nationwide (3.954-million), it accounted for a disproportionate 83.5% of all such deposit accounts.

It is worth noting that the biggest 10.80% of all checking accounts (holding demand deposits of PHP400,000.01 upwards) held 94.50% of all deposit liabilities for checking accounts across the country. What is clear is that the base for such a transactions tax is likely to be primarily comprised by individuals and business entities at the high end of the Philippine income ladder. This can be further ensured by well-targeted exemptions to checking transactions below a certain threshold (e.g. PHP5000 in a given day).

- **A temporary transactions tax could contribute significantly to raising additional funds for targeted transfers**. Certainly, major limitations of bank transaction taxes, as noted in various Latin American experiences, may include their longer-term disintermediation effects and the implications of such effects on collected revenues. A major trend in such instances has been for strong short-term revenue productivity, though tax performance in this area has usually tended to decline over time, with the notable exception of Brazil, as a result of widespread adjustments in the use of taxed transactions[30].

  Yet such experiences need not weaken the case for a bank transactions tax, if levied with clear limits. On one hand, it is important to keep the tax rate low in order to minimize its distortionary and disintermediation effects— which the proposal (along with NTRC and CBPO) fulfills by limiting the rate to only 0.2% of daily transactions above PHP5,000. Secondly, in the same spirit of the NTRC and the CBPO proposal, it would be prudent to make such a tax only temporary, and be made to fulfill only temporary spending requirements. In relation to TRAIN, this makes the transactions tax particularly appealing as a temporary funding source for targeted transfers, which are planned to be implemented only for a duration of three years. Indeed, as a temporary measure to generate funding for the existing gaps in the transfer mechanism of the CTRP-1, a bank transactions tax would make intuitive sense, given its major role in financing Brazil's Bolsa Familia program in the 2000's (see footnote 13)[31].

[30] Isaias Coelho et al., "Bank Debit Taxes in Latin America: An Analysis of Recent Trends," IMF Working Paper 01/67, *International Monetary Fund,* https://www.imf.org/external/pubs/ft/wp/2001/wp0167.pdf (Accessed September 17, 2017), 11.

[31] ILO Social Protection Department, "Financing Social Protection through financial transactions taxes," *International Labor Organization,* August 2016, http://www.social-protection.org/gimi/gess/RessourcePDF.action?ressource.ressourceId=53855 (Accessed September 17, 2017)

National Land Windfall Tax or Betterment Levy. Another attractive option in the face of the Duterte administration's "*Build, Build, Build"* program is that of raising revenues from the appreciated property values from public infrastructure investments through a national land windfall tax or betterment levy. Indeed, during negotiations for the 2016 United Nations Conference on Housing and Sustainable Development, such "*land value capture*" mechanisms have been officially recognized as "*one of the most powerful but underutilized sources"* of financing urban infrastructural development[32]. In Colombian cities, for instance, the use of betterment levies as a cost-recovery mechanism for public investments has often been able to generate over 25% of local revenues for municipal governments[33]. This same promise of substantial revenue generation has recently led Thailand's government to consider adopting a nationwide land windfall tax, by taxing the appreciated value of properties located within a 2.5-km radius from rail and port projects, and with 5-km from expressways and airports, at a 5% maximum flat rate[34].

The Philippines already possesses a legal framework for imposing such windfall taxes— though only at a local government level. According to the Section 240 of the Local Government Code, provinces, cities and municipalities can impose a "*special levy"* on lands within their territorial jurisdiction benefitting from LGU-funded public works projects and/or improvements, which is not to exceed 60% of the actual cost of the said project or improvement. Yet two major problems persist in relation to the imposition of this special levy. Firstly, the collection of such special levies has been miniscule, with 2011 level collections across LGU's nationwide amounting to little more than PHP80-million[35]. Secondly, the terms under which the special levy was designed do not appear to accommodate infrastructural investments which are funded by other sources than LGU's. In the light of the national infrastructure program of the Duterte administration, this represents a major gap that can yet be filled.

Table 9. Estimated Potential Land Windfall Revenues from National Capital Region

	Conservative Scenario	Moderate Scenario
Average Rate of Appreciation and Sources	• 2.1% (BSP RREPI	• 5.77% (Serra, Dowall and da Motta (2015), and Smolka

[32] Global Taskforce of Local and Regional Governments for Post-2015 Development Agenda Towards Habitat III, "Financing Urban and Local Development: the Missing Link in Sustainable Development Finance," 9.
[33] Lawrence Walters, "Land Value Capture in Policy and Practice," Journal of Property Tax Assessment and Administration 10:2 (2013).
[34] Wicit Chantanusornsiri, "Windfall tax to be vetted," *Bangkok Post,* 29 July 2017, http://property.bangkokpost.com/news/1296087/windfall-tax-to-be-vetted (Accessed September 17, 2017)
[35]Milwida Guevara, "Real Property Taxation in the Philippines," *Land Taxation in Practice: Selected Case Studies,* Richard Bird and Enid Slack (eds.), World Bank, 2003. 5.

	from Q3 2016 to Q1 2017)	(2013) for average land price increments for additional infrastructure investments in three Brazilia, Curitiba, and Recife in Brazil)
Est. Potential Revenues for Cities in Metro Manila from Windfall Tax	PHP 54.8-billion	PHP 56.8-billion

Source: Ateneo Policy Estimates, using BLGF data and projections based on various sources

- **Revenues from a Thailand-style National Land Windfall Tax could reach PHP54.8-billion for NCR alone.** While estimating the prospective tax take of such a nationwide betterment levy is difficult due to the site-specificity of infrastructural investments, preliminary analysis of the possible revenues suggests that they are substantial. As shown by Table 7, were the ceiling land windfall tax rate of Thailand to be applied to Metro Manila's cities following potential average rates of property appreciation under conservative (2.1%) and moderate (5.77%) scenarios, it is estimated that a national betterment levy could net between PHP54.8-billion and PHP56.8-billion in additional revenues for NCR alone[36].

While these figures must be treated with caution— given that it does not disaggregate property appreciation trends, and that property valuation mechanisms in the Philippines are known to suffer from a lack of uniform and up-to-date systems and methodologies[37]—, it is still worth noting that they compare favorably with recorded betterment levy collection levels in Bogotá, the capital city of Colombia and one of the premier examples of a middle-income country city using

[36] These figures were arrived at by using Bureau of Local Government Finance data on Special Education Fund collections from 2009 to 2015 to generate a rough estimate of the Total Assessed Value of real properties within the 16 cities comprising Metro Manila for 2017 based on past trends.

The resulting estimates were then subjected to the two scenarios, the first of which (i.e. the conservative scenario) was based on the increase in the BSP's Residential Real Estate Price Index from Q3 2016 to Q1 2017 (during which infrastructure plans were announced), and the second involving the estimated average increase in residential prices in the three Brazilian cities of Brasilia, Curitiba, and Recife with additional infrastructural investments. Following this, 5% of the appreciated assessed value was calculated according to the basic mechanism of the proposed windfall tax in Thailand.

[37] Department of Finance, Republic of the Philippines, "Property Tax Reforms in the Philippines," Fourth IMF-Japan High-Level Tax Conference, 2-4 April 2013, Tokyo, Japan, https://www.imf.org/external/np/seminars/eng/2013/asiatax/pdfs/philippines.pdf (Accessed September 17, 2017)

land-value capture mechanisms. In 2011, Bogotá's betterment levies generated around $US1-billion (~PHP51-billion) in revenues for investment in public works[38].

- **Apart from sustaining infrastructure financing, a windfall tax can redistribute spillover benefits from public investments.** By taxing land and property owners— who are generally concentrated among higher income-earners—, a windfall tax could be an effective instrument for more equitably distributing spillover benefits from infrastructural investments for sustained pro-poor public spending, rather than allowing it to be absorbed as rent by landowners and land speculators. Indeed, in recent years, there has been increased discussion at a global level on land windfall taxes as a potential anti-gentrification measure. Essentially, it has been argued that such taxes can contribute to averting gentrification dynamics, if used to redirect property value increases from public works improvements away from landowners, land speculators and buy-to-let investors, and back to residents in the form of additional public investments (e.g. in public housing, improved infrastructure, etc.)[39]. On these counts, a national betterment levy would coincide with both the inequality-reduction and revenues aims of the CTRP-1, by opening up significant resources for public investment and while also allowing a more equitable distribution of the benefits resulting from them.

Raising Sin Taxes on Tobacco Products. Whether measured with regards to health or revenue indicators, the reform of excise taxes on tobacco undertaken during the last administration has delivered exceptional, pro-poor gains. From an estimated rate of 29% nationwide in 2012, for instance, national smoking prevalence declined to only 23.3% by 2015, according to National Nutrition and Health Survey (NNHS) results. Meanwhile, on the revenue front, collections from tobacco excise taxes nearly tripled from 2012 (0.3% of GDP) to 2015 (0.8% of GDP), or around an estimated PHP86.5-billion in incremental revenues during those years. This, in turn, has paved way for a tremendous expansion in government health spending: on account of the earmarking of sin tax revenues, the 2016 budget of the Department of Health (DOH) increased threefold to PHP122.6-billion from PHP42.2-billion in 2012, while the number of low-income individuals with free coverage

[38] Oscar Borrero Ochoa, "Betterment Levy in Colombia: Relevance, Procedures, and Social Acceptability," *Land Lines*, April 2011, http://www.lincolninst.edu/publications/articles/betterment-levy-colombia (Accessed September 17, 2017)
[39] Oliver Wainwright, "Gentrification is a global problem. It's time we found a better solution," *The Guardian*, 29 September 2016, https://www.theguardian.com/cities/2016/sep/29/gentrification-global-problem-better-solution-oliver-wainwright (Accessed December 4, 2016)

under the government's National Health Insurance Program (NHIP) rose from 5.2-million (2012) to 15.4-million individuals (2015)[40].

Table 10. Retail Prices of Most Popular Local Cigarette Brand, and Tobacco Tax Rate

Country	Local Cigarette Prices (USD, 1 pack)	Tobacco Tax Rates (% of SRP)
Singapore	9.62* (only foreign brands)	66.2%
Malaysia	4.17	50-60%
Thailand	1.94	70%
Indonesia	1.42	57.5%
Philippines	1.08	53%

Source: SEATCA, ASEAN Tobacco Tax Report Card (2016)

But evidence suggests that Philippine tobacco excise taxes can be further increased. Despite the sin tax increases, cigarette retail prices in the Philippines as of 2016 remained at the bottom of the ASEAN-5, both in terms of the standard retail prices of locally-produced cigarette prices and its tobacco tax rates (see Table 9). Yet even more than raising the Philippines to prevailing international standards, the health case for increasing tobacco taxes remains pressing. Even while proving successful in implementation over the past four years, leading epidemiologists from the UP College of Medicine have increasingly argued that both population growth trends and rising income levels are poised to erode the public health gains secured in the past by the 2012 sin tax law. If such trends are left unchecked, according to the latest estimates, an additional 1-million smokers will be added the country's pool of regular tobacco users by the end of the current administration in 2022[41].

Table 12: Projected Incremental Revenues with Tobacco Excise Tax Hikes

Target by 2022	Tobacco Excise Tax Proposal/s (2018 to 2022)	Additional Revenue per Year (average for 2018 to 2022)
13.5-million smokers ***(at least 1 million less smokers)***	2018: P60 per pack 2019-2022: 4% annual increase	P 68 billion
	2018: P54 per pack 2019-2022: 6% annual increase	P 61 billion
	2018: P48 per pack 2019-2022: 9% annual increase	P 56 billion
14.5-million smokers	2018: P32 per pack	P33 billion

[40] Jeremias N. Paul Jr. "Philippine Sintax Reform: A Win-Win for Revenues and Health" (Presentation). *World Bank.* http://pubdocs.worldbank.org/en/471521464893076072/6-VI-Jeremias-Paul-ppt-WB-Tax-Conference.pdf

[41] GMA News. "Tobacco tax in TRAIN pushed". 14 September 2017. http://www.gmanetwork.com/news/news/nation/625817/tobacco-tax-in-train-pushed/story/

(Number of smokers unchanged)	2019-2022: (9% annual increase)	

Source: Diosana and Dans (2017)

Based on analyses which have been conducted on the possibility of including heightened tobacco excise taxes in the CTRP-1, we make the following observations:

- **Raising tobacco excise taxes can bring between PHP23-billion to PHP35-billion in additional revenue.** Even while proving successful at diminishing smoking prevalence, there remains much scope to continue raising tobacco taxes. Indeed, NNHS data from 2013 to 2015 suggests that the overall effect of the 2012 tobacco tax reform has been more to deter would-be smokers from becoming regular tobacco users, and that current smokers would require even higher levels of cigarette prices to quit smoking[42]. This is consistent with the view that the price elasticity of tobacco is highly inelastic among regular smokers— which the World Health Organization estimates to be clustered around -0.5 in low and middle-income countries[43]. Significantly, this was the same elasticity level estimated by the DOF in its revenue projections during sin tax deliberations in 2012[44].

  The continuing potential of tobacco taxes to generate revenues and to curb tobacco smoking is also borne out by recent analyses: estimates by Dans and Diosana (see Table 8), indicate that raising tobacco taxes from their present levels of Php30 per pack, by an additional 60% (PhP48 in all), 80% (Php 54), and 100% (Php60), could net an extra PhP23-billion, Php28-billion, and Php35-billion respectively, relative to existing proposals in the House of Representatives (HB 4144). Even beyond even greater projected levels of incremental revenues, however, health considerations align with increasing tobacco taxes by such substantial levels, with either a 60%, 80%, or 100% increase in cigarette levies predicted to reduce absolute levels of current smokers to more than 1-million below their present levels by 2022.

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[42] According to the NNHS, the single largest factor behind the decline in smoking prevalence from 2013 to 2015 was growth in the proportion of the population who had "*never smoked*" (a 4.6 percentage point increase)— which had led to an overall decline in smoking prevalence despite a decrease in the share of "*former smokers*" (a 2.5 percentage point decline) (Action for Economic Reforms 2017).

[43] https://www.g24.org/wp-content/uploads/2017/09/JPaul_G24Presentation_Tobacco-Taxation-for-health-and-development.pdf

[44] Harvard Medical School and Brigham and Women's Hospital. "'Sin Taxes and Health Financing in the Philippines'". *Cases in Global Health Delivery.* October 2015. http://www.globalhealthdelivery.org/files/ghd/files/ghd030_philippines_tobacco_control_teaching_case.pdf

- **A unitary rate for tobacco taxes will maximize revenue and health dividends, and is vital to protect the Philippines' economic reform credibility.** Beyond simply raising tobacco tax levels, it is also vital that future excise tax systems for tobacco taxation retain other reform features advanced by the 2012 sin tax law. Prior to the approval of R.A. 10351, tobacco excise taxes in the Philippines were characterized by a four-tiered system that made the cigarette levies complex to administer, vulnerable to corruption and manipulation, as well as ineffective tools for reducing tobacco consumption[45]. The attainment of a unitary tax on cigarettes in 2017, from a transitional two-tiered structure from 2013 to 2016, here stands as an important advance, able to maximize the potential of tobacco taxation for both revenue (i.e. by taxing all cigarettes at the same high rate) and health objectives (i.e. by preventing cigarette downshifting by consumers).

  Such features must be maintained in the face of recent efforts to return to a multi-tiered system. Last December 2016, the Lower House approved HB 4144, which aims to revert Philippine excise taxes on tobacco to a two-tiered system, with lower-priced cigarette brands being taxed at a rate of Php32 and more expensive brands at Php36[46]. Not only is this likely to compromise the potential of the tobacco excise taxes in the Philippines to deliver continued gains for government revenues and public health— given the importance of the sin tax reform to the Philippines' attainment of its credit-rating upgrade in 2013[47], a reversal of law could tarnish the country's credibility in pursuing economic reforms in the eyes of investors and the international community. The inclusion of a tobacco tax provision in final version of the CTRP-1, in this light, may not only serve to generate substantial additional revenue, but equally important, safeguard past economic reform dividends that have been achieved under previous administrations.

4. Conclusion

The thrust for comprehensive tax reform by the current administration is one whose time has come. Indeed, there is little debate that formulation of the CTRP-1 represents the first major opportunity in two decades to address some of the most salient challenges of public finance in the Philippines— the overburdening of the middle class due to bracket creep in the PIT tax scheme, and the incoherence resulting from an exemption-ridden VAT system

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[45] Kai Kaiser, Bredenkamp, C. and Roberto Iglesias. "Sin Tax Reform in the Philippines: Transforming Public Finance, Health, and Governance for More Inclusive Development" (Presentation). *World Bank Group.* https://openknowledge.worldbank.org/bitstream/handle/10986/24617/9781464808067.pdf?sequence=2

[46] Sonny Valencia and Nicole Cordoves. "A closer look at HB 4144". *Manila Bulletin.* 15 December 2016. http://news.mb.com.ph/2016/12/15/a-closer-look-at-hb-4144/

[47] Gerardo P. Sicat, "Credit rating agencies and Philippine macroeconomic fundamentals". *The Philippine Star*. 30 January 2013. http://www.philstar.com/business/2013/01/30/902549/credit-rating-agencies-and-philippine-macroeconomic-fundamentals

being two of the most prominent examples. Espousing a wide range of reforms, the CTRP-1 has played host to an equally wide range of objectives such as the raising of revenues for long-term investment, the attainment of public health and environmental objectives, and the promotion of efficiency, equity and competitiveness in the tax system.

Locating itself in the midst of these related— but ultimately distinct— objectives, this paper has focused specifically on the impact on income inequality of the CTRP-1, in the process highlighting clear gaps that continue to exist in the formulation of the tax reform package. Not only do we find that the overall gains of poorer deciles are less certain and significant, once leakage and targeting issues in the delivery of targeted transfers are considered; due to much higher increases in disposable income from the reform package that accrue to higher deciles, post-tax income inequality increases significantly, which even perfect execution of transfers only marginally improves upon. That such an outcome occurs even despite the framing of the CTRP-1 by the administration as a measure for "*inclusive growth"* suggests that reducing inequality has only been an issue of secondary importance in the crafting and design of the CTRP-1's components.

Given the goal to also reduce inequality, assessments of different options pertaining to (a) measures that adjust existing features of the CTRP-1, such as by the latest Senate version of the tax package (SB 1592), and (b) new measures altogether that can raise revenues in pro-poor fashion. With regards to the former, lowering the PIT exemption threshold from PHP250,000 to PHP150,000 (as done in SB 1592) appears to regain some of the erosion of the Gini index that occurs with the House version of the bill; while increasing the transfer (from PHP2,400 with HB 5636 to PHP3,600 with SB 1592) makes further gains in restoring the Gini. We determine, moreover, that effectively transferring PHP7,800 per household per annum (at the PHP150k PIT exemption level), whether through cash transfers or earmarked programs, will serve to lower the Gini index by one full point from pre-tax levels— an outcome which can be reinforced by increasing the earmarked share of petroleum excise taxes for social spending from 40% to 65%. Should even additional resources for development-related public spending prove necessary, three revenue-raising option were extended, the combined revenue potential of which exceeds PHP105-billion at its more conservative: namely, bank transactions taxes on demand deposits, a national windfall or betterment levy, and increased sin taxes on tobacco products.

For the longest time, economists have spoken of an intractable trade-off between efficiency and equity, including in matters such as taxation and transfers— yet if there is a central theme that underpins the assessment above, it is that a middle ground exists with regards to the formulation of the CTRP-1, that can continue to fulfill its efficiency functions yet delivering much more robustly on the redistributive function of taxation. While not all the options assessed above may be the first-best choices for all the stakeholders involved in the formulation and approval of the tax reform package, it would be prudent for them to view prioritizing inequality-reduction in the tax reform package as an indispensable part of re-establishing a mutually-beneficial contract between government, taxpayers, business, civil society, and the broader citizenry— where government will be resourced to fully realizing its Constitutional goal of providing equal access to increasing quality of life and social and economic opportunities for all, especially the underprivileged, while taxpayers (both individuals and businesses) foster a culture of tax compliance and of contributing to the attainment of inclusive national development. Equitable taxation, in the manner just mentioned, can serve as a foundation for such a forward-looking social consensus. In its spirit, we urge the multiple stakeholders and proponents of the CTRP-1 package to take strides in the days ahead towards achieving it.

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