

Discussion Forum on “Improving Tax Administration: A New View from the Theory of Tax Evasion in a Corrupt Regime”¹

14 November 2000

NEDA Makati Bldg., Legaspi Village
Makati City

FORUM HIGHLIGHTS²

Opening activities started at 9:25 a.m. Hon. Felipe M. Medalla, Secretary of Socio-Economic Planning and Chairman of LEDAC Exec. Committee, gave the opening statement. Dr. Mario B. Lamberte, President of the Philippine Institute for Development Studies (PIDS), acted as the moderator during the open forum.

Opening Statement of Hon. Felipe Medalla

Let me inform everybody that the revised revenue targets this year will be revised downward again. In view of this, it is really important to do something about tax administration and the issue of tax evasion. Why is it that the BIR collection has been much worse than the performance of the economy?

Perhaps we should take a look at our accounting system. It is time, I think, that our accounting system is carefully examined especially in relation to analyzing the relationship between the revenue and the GNP. Suppose that you produce a lot, thinking that it will be sold. However it turns out that it is hard to sell these things so you sold them at prices way below. The problem with the national income accounting is that the output goes up but the demand contracted. But since you already produced the units you will sell them anyway. The accounting system is capturing the outputs and the inputs but what a prim observer sees is that nothing has happened. What happens to the usual relationship between taxes and GNP? We may actually be mistakenly attributing what may be, in further analysis, attributable to a boom-bust cycle, to the worsening performance of the BIR.

There must be way of evaluating tax administration and evasion. Unfortunately, the only measure we have now is the ratio between the collection of BIR and GNP. We must focus on improving tax administration because a substantial portion of this so-called market-friendly-pro-poor agenda cannot be delivered unless tax administration is improved.

We are already behind the basic social services and infrastructure targets of Angat Pinoy 2004. Tax collection is falling behind the Medium-Term Plan's targets. What do we do? Will we adjust pro-poor targets downwards or can we still do something about the BIR and BOC performances? Clearly we have to look at the role of evasion and administration. Tax evasion is much more than a moral issue; it is an issue of systems. For instance, with the kind of rewards and penalty systems that we have for BIR employees, why are we expecting much better performance? In addition, there are really opportunities for evasion. Lastly, the track record of the justice system in punishing people who evaded taxes is to be considered. So where does the solution begin? This is an extremely important issue.

Perhaps in Dr. Manasan's presentation, we can see some possible solutions.

¹ A joint undertaking of the Legislative-Executive Development Advisory Council (LEDAC), National Economic and Development Authority (NEDA) and Philippine Institute for Development Studies (PIDS).

² Prepared by Ms. Eden C. Villanueva, Senior Research Specialist, PIDS

1) **“Improving Tax Administration: A New View from the Theory of Tax Evasion in a Corrupt Regime”** by Dr. Rosario G. Manasan, Senior Research Fellow, Philippine Institute for Development Studies (PIDS)

Dr. Manasan presented estimates in terms of tax compliance and tax evasion from the mid-seventies to recent years. She then presented recent developments in the literature on tax evasion – the expansion of the basic model of tax evasion to that of the second-generation models wherein the respective motives of the taxpayers and tax collector and the interplay between the two are considered endogenous.

Finally, she looked at actual developments and results in the Philippines, vis-à-vis the possible implications of certain provisions and assumptions in the second-generation models of tax evasion.

Below are some details.

Recent Efforts in Tax Restructuring

- ❖ In 1986, we had a series of tax reforms. We had a comprehensive tax reform package that focused more on the efficiency goals rather than on the revenue goals. Since 1987, more tax changes have been introduced to respond to the need to raise more revenues in the context of a series of fiscal adjustment programs.
- ❖ Tax measures installed in 1986 were meant to simplify the tax structure and broaden the tax base. With expanded coverage and stricter implementation of tax withholding schemes, it should have improved tax compliance.
- ❖ Significant gains in tax effort have indeed been achieved. The tax effort to GNP ratio rose from an average of 11% in 1975-1985 to a peak of 16% in 1997. However, with the Asian crisis, it dropped to 14.8%. The deterioration has continued thereafter despite the economy posting recovery in 1999.

Tax Evasion

- ❖ Updated estimates of tax evasion confirm improved tax compliance between 1985 and 1995.
- ❖ However, as noted earlier, from 1995 onwards, deterioration in tax evasion has become pronounced both in terms of individual income tax and value added tax. In short, while there were improvements in tax compliance and thereby less tax evasion from 1985-1995, the years that followed were characterized by deterioration in the tax effort and an increase in tax evasion. These developments suggest that one cannot rely on modifications in the tax structure alone to correct shortcomings in tax administration.
- ❖ Certainly, mechanical approach to tax administration based entirely on logistics and which excludes the taxpayer and tax collector motivations may not be useful.

Theoretical Literature on Tax Evasion

Basic Model

- ❖ In the *basic model* of tax evasion, what you have is an income-maximizing taxpayer deciding how much of his income to declare for tax purposes given some constant probability that evasion is detected and penalized. How the taxpayer decides to act is, then, largely dependent on the relative magnitude of the temptation and the punishment attendant to tax evasion.

- ❖ Implications of the model:
 - a. Tax compliance improves as the penalty rate and the probability of being caught increases.
 - b. Penalty rate is typically fixed in the tax laws.
 - c. The probability of detection is determined by the ability of government to enforce tax laws.
- ❖ In the Philippines, we saw the introduction of stiffer penalties, creation of special tax courts in the early 1990s and more vigorous efforts to prosecute tax offenders during the Aquino and Ramos administrations. These are steps in the right direction.
- ❖ None of the cases handled by the BIR between 1980-1984 resulted in a conviction up to 1986. In contrast, the number in effectiveness of tax fraud investigations increased from 1986 onwards with the prosecution of tax fraud cases and the jailing of some individuals. However, from 1998, there were no convictions despite numerous cases filed.
- ❖ The impact of increasing the tax rate on compliance is not straightforward. An increase in the tax rate increases the temptation to cheat. At the same time though, it increases the penalty for cheating especially if the fines are imposed on an *ad valorem* basis.
- ❖ If the taxpayer's aversion to the risk of being caught does not increase with his income level, punishment effect will dominate and an increase in the tax rate leads to better compliance. This is in contrast to the conventional wisdom that follows from the so-called Laffer curve.
- ❖ The Philippines has reduced the tax marginal rate from 50% to 35-40% then down to 32%. In terms of the corporate rate, this was reduced from 35% to 32%. Yet, despite this, we don't see much improvement in terms of collection efficiency.
- ❖ Imposing maximum penalties for small amounts of evasion may induce taxpayers to evade by large amounts. Penalties as well as the effort to prosecute must be graduated with the scale of evasion.

Second Generation Models

- ❖ In the second-generation models, the probability of detection becomes endogenous in the system because of the presence of corruptible officials. Tax evasion thus depends not only on the incentives to the taxpayer but also on the incentives to the tax collector and the interaction between the two players.
- ❖ One aspect considered in the second-generation models is the probability of evasion being detected is a function of the cost to the taxpayer of under-reporting income depending on the penalty rate and the amount of effort put in tax enforcement.
- ❖ When a tax collector discovers the evasion, he decides on whether to report it or not. If he under-reports evasion successfully, he gets a bribe in addition to his salary. If he gets caught, he is punished in the form of a fine, transfer to another assignment or at worst, dismissal from the office.
- ❖ The probability that the errant tax collector gets caught depends on the quality of supervision over tax examiners and the third-party audit. If a tax collector decides to report the delinquent taxpayer, he may be allowed to retain, as a reward or bonus, some portion of the additional revenue that is generated because of his vigilance.
- ❖ The tax collector's decision is thus dependent on the relative strength of the carrot and the stick, namely, 1) the amount of the bribe, 2) the amount of the reward or bonus, 3) the amount of the fine or penalty, and 4) the probability of being caught.

- ❖ If a taxpayer decides to evade taxes, corruption will occur if the collective benefit of the taxpayer and the tax collector is positive. In a corrupt regime, the taxpayer will select the amount of tax to evade while the tax collector will select the effort devoted to monitoring and thus, the probability of detecting evasion.
- ❖ For a given class of taxpayers, audit frequency and declared income ought to be negatively related. A tax administration system that unduly focuses on high income tax returns encourages taxpayers to evade by large amounts. Conversely, a system may deter taxpayers from evading “too much” by threatening to audit low income tax returns just as intensively as high income returns.
- ❖ The Philippines has offered 10 tax amnesties between 1972 and 1981 and still another one in 1986. In addition, “last priority” audit was given in 1982, 1987, 1993 and 1999. It was supposedly a last priority audit but in fact it was immunity from audit and investigations.
- ❖ Some model findings relative to tax amnesties indicate that if tax enforcement is weak, the amnesty rate may have to at a very low rate in order to induce a significant response from delinquent taxpayers. In such a situation, the expected cost of not disclosing hidden income is small because the probability of said evasion being detected is also small. Thus, expected compliance gain from amnesty is minimal. Also, if the tax amnesty is anticipated, there will be an increase in tax evasion prior to the amnesty. If tax enforcement is poor, anticipated amnesties cause aggregate revenues to fall. A point of fact is that the tax take from numerous tax amnesties offered by the Philippines government has progressively gotten smaller.
- ❖ The second-generation models also look at the possibility of having compensation incentives for tax collectors in terms of salaries that are higher than the market rate and/or performance-based bonuses scheme. Can this help prevent tax evasion? The finding is that where the government’s ability to punish corruption is weak, it may be better not to pay tax collectors higher than market salaries because higher compensation may simply increase the bribe level. Another drawback of performance-based incentives is the possibility that they may induce the harassment of taxpayers. The higher the bonus rate and cost of taxpayer appeal is and the lower the rate of success of taxpayer appeal is, the greater the likelihood of taxpayer harassment.

Conclusion

- ❖ Piecemeal incentive reform may increase corruption. Because reforms in incentive systems and organizational procedures are complementary, reforms are more likely to succeed if they are comprehensive rather than incremental.
- ❖ List of organizational reforms:
 1. Improving personnel quality – Increase flexibility with regards to hiring and firing of personnel. More stringent criteria for screening new recruits and for promoting existing personnel will enhance the quality of tax administration. Clear procedures for dealing with reports of corrupt behavior and even-handed application of sanctions for the same should be strictly observed at all times.
 2. Institutionalizing independent third-party audits – Examining the tax examiners or auditing the tax collectors.
 3. Limiting discretionary authority of tax examiners – Centralized audit system could reduce the scope for discretionary authority of tax examiners. For this you need a centralized information base and strict procedure for audit selection.
 4. Introducing functional specialization in tax administration – Organizing the tax administration agency along functional line will minimize collusion of taxpayers and tax collectors.

5. Increasing computerization – Makes possible the matching of tax returns with third-party information. It enhances the ability of tax collection agency to automate the generation of overdue notices which enhances voluntary compliance. It also facilitates automated audit selection, thus reducing the discretion of tax examiners.
6. Improving the appeal mechanism -- Appeals process can be enhanced by improving the procedures for the filing of complaints, setting of time limits for judgments, and establishing appropriate burden of proof.
7. Reducing high-level political interference -- Efforts to eliminate bureaucratic corruption are quixotic at best in systems with strongly entrenched political corruption. If tax evaders have recourse to political influence such that tax audit exposes the tax examiner to disciplinary action from higher-ups, then no reform of the incentive structure will work.

Epilogue

- ❖ Widespread consensus - simplification of the tax structure (in the direction of fewer exemptions, less differentiation of tax rates across sectors and activities) will ease tax administration. Many of the tax laws enacted in the Philippines in the last 15 years were justified on this ground.
 - ❖ The tax structure has been the subject of unnecessary fine tuning, at best, and excessive flip-flopping, at worst (moving from schedular to global, then global to schedular with respect to income tax and from specific to *ad valorem*, then *ad valorem* to specific with respect to excise tax.)
 - ❖ Frequent changes in the tax code simply and necessarily impose an additional burden on tax administration without addressing the complexities that naturally accompany economic development.
- 2) **“Comments on Dr. Rosario G. Manasan’s Paper on Improving Tax Administration”** by Hon. Gil Beltran, Assistant Secretary, Department of Finance (DOF)
- ❖ The problem of flip-flopping efforts at tax restructuring is obvious. Former USEC Milwida Guevara is a witness to how tax reforms are butchered beyond recognition. For instance, in the last CTRP, we wanted fewer income tax brackets, a presumptive income tax for hard-to-tax groups, broad VAT coverage with few exemptions, an MCIT based on net assets, a fiscal incentive system devoid of tax holidays, etc., but we were unable to get these.
 - ❖ The evasion estimates of Dr. Manasan for domestic VAT are very close to DOF’s estimates although the DOF has a higher individual income tax estimate because they have imputed the informal economy in their income figure.
 - ❖ Agrees that audit rates are very low; at 1.5%, the Philippines has a poor record. Other countries, despite their lower evasion rates, generate revenues from audit in the range of 4%-5% of total revenues.
 - ❖ The audit program of the BIR is still at its infant stage. It still has to develop industry benchmarks and even has not developed its data sources. Its planning office has not been aggressive enough in making use of survey data from NSO, NIA from NSCB, data from SEC or PSE or industry associations or supervising agencies, or information provided by bidders in government projects to run after dishonest taxpayers.

- ❖ BIR has a poor record on tax cases. Its commissioner is looking into the possibility of hiring private lawyers to handle BIR tax cases but this might go against the confidentiality provision in the National Internal Revenue Code.
- ❖ We have had too many tax amnesties such that taxpayers now look forward to them as periodic events. While tax amnesties generate revenues in the short run, compliance in the long run is compromised.
- ❖ Under Sec. 285 of the NIRC, BIR enjoys an incentive not given to other government offices. Five percent of the excess collection over the target of BIR goes to a fund from which bonuses could be allocated for their personnel (BIR received bonuses from this collection only thrice for the last ten years).
- ❖ A centralized audit selection system is already being developed in the BIR. An independent third-party audit is being proposed but this proposal is being objected to by the BIR because it says that under the NIRC, all data in tax returns are confidential.
- ❖ The BIR is already organized along functional lines. Separate units handle assessment, collection, audit, administrative appeals, and litigation and prosecution.
- ❖ Full computerization is already in the BIR's medium-term program. Along with it, the third party information program is being expanded. Despite the good computerized database of some revenue districts, such information has not been analyzed with the objective of increasing collections.
- ❖ Penalties are imposed whenever bureaucratic corruption is discovered. Every quarter, the BIR reports about 20 employees being removed or suspended for violations.
- ❖ Most important reform not mentioned in the study is a change in attitude of its officials and employees. They hold intra-agency seminars and occasions emphasizing on their crucial role in nation-building to motivate their staff members to work harder.
- ❖ Some other things that may affect collection are perception of the government and the quality of taxpayers' services being given by the institution.

OPEN FORUM

Comments/Observations	Response
<p>Dr. Ponciano Intal</p> <ul style="list-style-type: none"> ❖ There's a need to improve the audit rate. In addition to incentives, there must be a great probability that a person would be audited. ❖ Must have very centralized, computerized and clear criteria for audit selection. It has to be fair. ❖ There is a need for third party audit. ❖ Could there be a legal force that when there is a clear case of tremendous disparity between what is taxable, the tax agency will have legal authority to check all the books of other banks or other agencies where that particular person is dealing with? ❖ In Mexico, they realized that computerization was useless. What was important for them is jailing and the dramatic increase in the of audit rate. 	
<p>Randy Naval</p> <ul style="list-style-type: none"> ❖ In terms of tax effort, where are we compared with other countries? ❖ Do we have a one-on-one correspondence with the definition of tax effort used in other countries? 	<p>Dr. Rosario G. Manasan</p> <ul style="list-style-type: none"> ❖ Indonesia has the lowest tax effort, this is relative to GDP, and then we are next. Malaysia has the highest. But we have to keep in mind that we have different structures. In Indonesia and Malaysia they have huge oil revenues which get counted as tax on government shares in petroleum product exploration. When you compare the Philippines with Thailand you can have a good gauge on where we are.
<p>George Labadia</p> <ul style="list-style-type: none"> ❖ How big is the underground economy and what are the efforts of the government to tax it? 	<p>Dr. Rosario G. Manasan</p> <ul style="list-style-type: none"> ❖ The data that we used in the study is the Family Income and Expenditure Survey. What was done was to group each income bracket in the FIES according to distinct taxpayer characteristics, that is, as to the number of income earners, the number of dependent children and the kind of income received, whether from salary, from business or mixed. Then we applied the statutory tax rates on the typical household. Thus, in a sense, it captures the underground economy although no independent estimates were made. <p>From NTRC</p> <ul style="list-style-type: none"> ❖ NTRC has an estimate on tax gap. An average of 20% tax gap on wages and

	80% on business. Businesses are under-reporting income and over-reporting deductions.
<p>Victor Abola</p> <ul style="list-style-type: none"> ❖ UA&P is developing a micro-simulation model and is gathering returns from different firms and individual returns. The whole problem is systemic. BIR cannot track records very readily. It has numerous cases of obvious taxpayers' mistakes. Like in the case of VAT, inter-quarter carryovers are not matching. They need major overhauling. ❖ We need to consider also the law makers to make it a little more simpler, taxpayers to be educated and the Judiciary to address tax cases adequately. We need a national consensus. ❖ In the case of corporate tax returns, 50% of deductions are not even detailed. ❖ With regard to tax amnesty, the best experience is in 1973 in the Philippines when the collections improved due to martial law. Because of fear there was power to enforce and there was perception that they will be jailed. 	
<p>Tita Flores</p> <ul style="list-style-type: none"> ❖ What is the level of evasion as far as foreign investors are concerned? There are many complaints of foreign investors on frequent tax audit. They also don't get the tax credit due to them. ❖ In some municipalities, VAT implementation is dependent on how much the owner wants to pay. 	<p>Dr. Rosario G. Manasan</p> <ul style="list-style-type: none"> ❖ We do not have estimates at that level but logically they are better taxpayers. <p>Vic Abola</p> <ul style="list-style-type: none"> ❖ VAT ratio to total output VAT is higher in larger firms
<p>From NTRC</p> <ul style="list-style-type: none"> ❖ BIR knows the recommendations of Dr. Manasan. For the last 25 years there have been ideas about reforming the bureau. It is the intention of the BIR management to have very concrete criteria for selecting tax audit cases. These are not new things but up to now, BIR has not come up with a solid reform program that would address the problems of personnel attitude, motivation and the moral issue of personnel in a tax administration machinery. There's a perception that even if someone evades, just know the right person within the political system and he can get away. 	

<p>Dr. Ponciano Intal</p> <ul style="list-style-type: none"> ❖ Can it be possible that the returns filed be in a separate corporation attached to DOJ? ❖ 25 years of determining the audit criteria is too long. 	<p>Hon. Gil Beltran</p> <ul style="list-style-type: none"> ❖ It's better but we have provisions in the law. <p>Dr. Rosario G. Manasan</p> <ul style="list-style-type: none"> ❖ The system lacks simple procedures. ❖ In audit criteria, there are a lot of models that can be used. The question is not so much mechanical. Corruption is systemic. People in the BIR refused system. We've borrowed 40 Million for computerization but what do we have? What is the net result considering that we've had technical assistance and we've invested? <p>Hon. Raphael Lotilla</p> <ul style="list-style-type: none"> ❖ We have legislation in place which needs to be implemented. ❖ On the political will side: putting the responsibility and authority to DOF Secretary and BIR Commissioner for the reform and reorganization of BIR. ❖ Create an insulated unit within BIR, possibly under the office of the Commissioner, which will be the core of the computerization system.
<p>Atty. Romero – Asst. Chief, Tax Fraud Division, BIR</p> <ul style="list-style-type: none"> ❖ The problem is not legal but more political. ❖ The estimate of 200-Billion tax evasion is so small. ❖ Tax laws if properly enforced will not only solve money laundering but will improve the economy a lot. 	
<p>Eugenio Inocentes</p> <ul style="list-style-type: none"> ❖ DOF is asking 1 Billion additional budget for computerization but should we still put more money or not considering its success rate? 	
<p>From BOC</p> <ul style="list-style-type: none"> ❖ Is there any data on the amount of revenue forgone through tax evasion on customs? 	<p>Dr. Rosario G. Manasan</p> <ul style="list-style-type: none"> ❖ PIDS doesn't have study on the customs side except on the VAT part of BOC collection. <p>From NTRC</p> <ul style="list-style-type: none"> ❖ NTRC has tried to relate the amount collected from the findings generated by SGS in terms of additional collection of tariff duties resulting from SGS investigation. Compared to the fees that the BOC pays to SGS, there's no much difference. The additional revenue we

	get is not that much to justify the very large fees that the government pays to SGS.
<p>Atty. Romero – Asst. Chief, Tax Fraud Division, BIR</p> <ul style="list-style-type: none"> ❖ The BIR has instituted values integration program. ❖ The cost per P100 collection is P1.00 while the enforcement rate is 5 centavos for its enforcement activities. ❖ With the computerization, examiners are given 90-100 days to finish a case. ❖ BIR's position is that if third party will examine an already audited return there will come a time that the third party will have an authority to interpret the laws. In the tax code it is the commissioner who has the power to interpret tax law. ❖ My personal view is to be transparent, create another committee to review BIR's work. 	