



**Flat is Beautiful:  
Proving the Feasibility of a 10% Flat Personal Income Tax in the Philippines**

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**Summary**

We argue that the current multiple and high personal income tax system in the Philippines is inefficient because it is confiscatory, it is anti-entrepreneurship, and it encourages cheating. Under the current set-up, out of more than 23.6 million gainfully employed Filipinos (ie, the 8.4 million underemployed out of 32.3 million employed Filipinos are not included; data from NSO April 2005 labor force survey), only about 1.8 million individuals are implied to have paid personal taxes to generate P107 billion in 2005. Or if there were 3 million individuals who paid income tax, potential collections this year should be P178 billion, not P107, implying tax evasion of around P71 billion. The higher the tax base to be assumed, the bigger the tax evasion to be seen.

We therefore propose a 10% flat personal income tax with no exemptions, for annual incomes above P40,000. The beauty and advantages of a flat tax system are as follows: it is easier to administer; it promotes fairness between the taxed individuals and those who are exempted; the rich still pays higher than the poor and thus, it is not regressive; it respects hard work and encourages entrepreneurship; it will expand collections from consumption-based taxes; it will help reduce brain drain; and lastly, it will reduce tax evasion.

From the computations we derived, the tax base need to increase from around 3 million to only 4.3 million individuals paying personal income tax to generate the BIR-projected collections of P107 billion in 2005, and around 5 million individuals paying personal income tax to generate the projected collections of P124 billion in 2006. In short, a low and flat tax rate with high tax base will generate revenue-neutral, if not larger revenue collection, result.

# **FLAT IS BEAUTIFUL: Proving the Feasibility of a 10% Flat Personal Income Tax in the Philippines**

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## **Introduction**

The personal income tax system in the Philippines is composed of seven (7) tiers or rates, from 5% to 32%, depending on the annual taxable income of an individual (Table 1). The effective tax rate increases as the level of annual taxable income goes up. When you reach the top-most annual taxable income tier of P500,000 or more, the government will get ¼ of your income for the first P500,000, and any income in excess of P500,000 will also be taxed by as much as one-third of the amount in excess.

**Table 1. Individual Income Tax Rates**

<b>Annual Taxable Income</b>	<b>Tax Due for Individuals</b>
Not over P10,000	5%
P10,000 to P30,000	P 500 + 10% of excess over P10,000
P30,000 to P70,000	P 2,500 + 15% of excess over P30,000
P70,000 to P140,000	P 8,500 + 20% of excess over P70,000
P140,000 to P250,000	P22,500 + 25% of excess over P140,000
P250,000 to P500,000	P50,000 + 30% of excess over P250,000
Over P500,000 *	P125,000 + 32% of excess over P500,000

**Exemptions:**

- (1) For single individual or married individual legally separated with no qualified dependents, P20,000
- (2) For head of family, P25,000.
- (3) For each married individual, P32,000
- (4) Additional exemption for dependents of P8,000 each, not exceeding four dependents. "Dependents" are children (legitimate, illegitimate, or legally adopted) living with the taxpayer, not more than 21 years of age, unmarried and not gainfully employed, or incapable of self-support because of mental or physical defect.

**(Source: RA 8424, National Internal Revenue Code (NIRC) of 1997, Secs. 24 and 35)**

There are exemptions in the current tax regime. For instance, the overseas Filipino workers (OFWs) are exempted from personal income tax payments. Moreover, Filipino staffs of multilateral and bilateral institutions, and employees in foreign embassies and consulates in the

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<sup>1</sup> *The Minimal Government Movement (MGM) believes in the efficiency of markets and conversely, in the inefficiencies of big governments. MGM believes that the government will have to rationalize its activities and give back to private hands the role of "engine of growth" of the economy. Subsequently, it will also give back to its constituents more of the right to decide on how to spend and invest their own incomes by pursuing tax cuts. The final result is a society that emphasizes greater personal economic freedom, but also greater personal responsibility.*

country are not subjected to the typical method of withholding a portion of the monthly salary for tax purposes, and hence, a de-facto exemption occurs. This de-facto situation is a queer result of the fact that these institutions are not required by law to have a Tax Identification Number (TIN) as employers, and therefore can not withhold taxes in behalf of the Bureau of Internal Revenue (BIR).

The table below shows tax collections of the Bureau of Internal Revenue (BIR). The collection from personal income tax is highlighted.

**Table 2. BIR Tax Collections (P Billion)**

Type of Taxes	1990	1995	1999	2000	2001	2002	2003	2004	2005	2006
TOTAL TAXES	104.0	211.5	341.3	360.8	388.7	394.5	425.3	468.2	546.9	675.4
1. Taxes on net income and profits	49.4	111.2	184.0	202.6	223.4	226.5	243.7	278.2	324.2	401.3
<b>Of which: From Individuals</b>	<b>15.7</b>	<b>38.7</b>	<b>71.8</b>	<b>83.0</b>	<b>80.2</b>	<b>86.4</b>	<b>91.4</b>	<b>96.7</b>	<b>107.7</b>	<b>124.1</b>
2. Excise Taxes (alcohol, tobacco, petrol products)	28.9	39.0	61.8	61.7	58.7	57.0	56.9	59.3	60.6	59.4
3. General Sales, Value Added Taxes	13.1	29.6	55.2	53.9	59.2	65.9	82.4	80.2	99.3	145.3
4. Percentage Taxes	7.2	17.5	22.0	24.5	27.8	24.0	18.9	14.9	17.2	20.5
5. Other Taxes (mainly doc. stamp tax)	5.5	14.2	18.3	18.1	19.5	21.1	23.4	21.5	28.6	30.4

Sources: BIR Annual Reports; Budget of Expenditures and Sources of Financing (BESF), various years.

## **Critique of the Current Personal Income Tax System**

### ***(1) It is Confiscatory***

The current personal income tax system is confiscatory. A father of three earning a gross monthly income of P20,000 will hardly make ends meet because the government takes away a huge chunk of his income. There are also instances wherein an employee may get promoted at work, but since his income tier will also move up, his income actually does not nominally increase commensurate to the increase in work load and responsibility. Often, this results in discouragement to move up the ladder.

The current taxation on personal income is a result of the Comprehensive Tax Reform Package (CTRP) of 1997. The levels of income/salary standards of the working population then were totally different. For example, a P500,000 annual personal income of a family of four (i.e., with 2 kids), will be paying P101,000 in personal income taxes, leaving them a take-home pay of only P399,000/year or P33,330/month. This maybe considered a huge income in 1997. But today, with high interest rates, high oil prices, and rising prices of basic consumer goods, P33,330/month is living on the edge. Consider the following monthly regular expenditures:

- Modest food/groceries allowance - P10,000
- Monthly rent expense of a small apartment - P8,000

- Average monthly payments for tuition, books and other educational expenses of the eldest child- P3,000
- Transportation expenses – P3,000 (inclusive of school bus service)
- Electric bill - P2,000
- Water and telephone bills - P1,000
- Milk, vitamins and vaccine shots for the youngest child - P1,000
- Amortization for appliances - P1,000
- Health-related expenses (e.g. HMO card payments) P1,000
- Miscellaneous needs (e.g. clothing and footwear) - P1,000

If the same family takes out an office loan, a SSS loan or a PAGIBIG housing loan with an amortization of P3,000 a month or more, this family will already be in a deficit. This family will have to resort to intermittent use of credit card to tide them over, for instance during the kids' birthday and other special occasions. Bank credit cards are the worst short-term financing there is. It is only a matter of time that a junior management level employee and a Master's degree holder at that is caught in the turmoil of an unmanaged credit card debt simply because the government confiscated P8,400 of his family's monthly income.

This family's situation is further exacerbated by the fact that after the personal income tax has been withheld, the household has to pay a lot of other taxes embodied in the various goods and services they consume. For instance, VAT and corporate income tax passed on to them by producers of food, clothing, electricity, water supply, and so on. Moreover, there are other taxes that the household has to contend with, among others, petroleum tax, motor vehicle tax, franchise tax passed on to them by operators of public transportation, real property tax passed on to them by owners of the apartments they are renting, and so on.

This paper does not turn a blind eye on the rationale for taxation. Government has to impose taxes in order to finance its services. However, a tax system that discourages employees to get promoted, and penalizes those who work harder in order to earn more certainly needs to be revisited, especially if the scenario wherein such scheme was based on in the first place has been totally overtaken by the realities of the time.

## ***(2) It is anti-entrepreneurship***

The so-called "progressive taxation" (the higher your income, the higher the percentage that will be taken by the state) is theoretically based on the ability-to-pay principle. The government takes away a higher absolute amount by slapping a higher income earner with a higher tax rate. Progressive taxation, in principle, is that which bears down heavily on the rich. But in a society like the Philippines wherein the rich is a small segment and the middle class occupies a wide span, the progressive taxation in place bears down much more heavily on the middle class. In this regard, the present system is counter-productive because it penalizes hard work and performance.

The current "progressive taxation" prevents millions of employees, the fixed-income earners especially, to have higher savings for future investments, especially in trying out their luck and talent in entrepreneurial projects. The more they work to accumulate capital for starting

a small business someday, the more that they have to surrender their earnings to the state. The current tax system discourages the entrepreneurial spirit, especially that the taxes collected by government from individual taxpayers are not directly linked to socially-oriented or entrepreneurial skills-enhancing programs. A person who aspires to be an entrepreneur will have to face the additional burden of paying high interests in borrowed capital instead of financing the business with pure, interest-free equity. In the aggregate, the economy is losing all the multiplier effect of what would have been an onslaught of small businesses that will help create jobs and boost the aggregate income of society. With nearly 3.0 million able-bodied Filipinos currently jobless, and another 8.4 million already employed but still wanting of additional work (National Statistics Office, Quarterly Labor Force Surveys), entrepreneurship and self-employment should be encouraged. People should create jobs for themselves, their family members, neighbors and friends. And the government should allow them to do so, by not taking away their ability to save for business capital.

### ***(3) It encourages cheating***

Note that the various taxes and fees collected by the BIR, the various national government agencies (Bureau of Customs, Land Transportation Office, Land Registration Authority, among others) and local government units (e.g., real property tax, business permit tax) are monies that actually reached the national and/or local treasury, and not the actual costs to the taxpayers. The total burden to the taxpayers can be estimated as:

Tax burden = actual taxes paid + transaction or processing cost

Thus, even if the person is a tax evader (i.e., taxes paid = 0), it does not mean that he/she did not pay anything to anyone. Hiring tax consultants (auditor, accountant, lawyer, others) plus bribes to the revenue collectors and politicians constitute the transaction or processing cost of paying nothing or little in taxes. For instance, it is not hard to imagine that some Filipino tycoons known for large-scale tax evasion are actually investing hundreds of millions to finance the election campaign of many legislators in both chambers, not to mention certain presidential and vice presidential candidates. The pay-off would come in the form of various political and economic favors, including protection from new competitors.

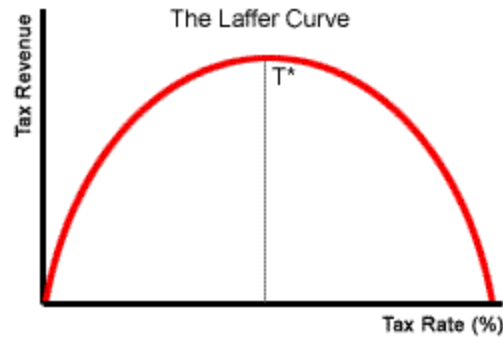
Thus, it is possible that with the high income tax rate, actual tax collections are much lower because many individual taxpayers would rather pay the transaction cost with cooperative BIR collectors and politicians in exchange for lower tax payments. In this case, government ends up collecting less than potential collections if the tax rate is lower.

### **Our Proposition: A flat tax of 10% with no exemptions**

The Minimal Government Movement (MGM), parallel to its campaign for smaller taxes, a smaller government and smaller bureaucracy (in order to increase individual freedom) proposes a flat personal income tax of 10%, with no exemptions for annual incomes of P40,000 or higher.

This proposition uses the Laffer Curve as its theoretical framework. The Laffer Curve graphically represents the argument that there exists an optimal rate of tax at which the government tax revenue is at the maximum. If tax rates are initially low, revenues will be

increased if taxes are increased; however, if rates are raised beyond the optimum point, the loss of incentive caused by the resulting low net incomes discourages production and creates a higher incentive for tax evasion, and tax revenues therefore fall. Its proponent, American economist Professor Arthur Laffer argued that lower taxes lead to lower prices (or from our view, higher buying power), higher demand leading to higher production/output, and therefore higher government tax revenues.



Below are the advantages of this MGM proposal:

***(1) It is easier to administer***

A low and flat personal income tax rate of 10% does not only respect hard work and performance, but it is also simpler to administer. There is no need for a big BIR bureaucracy to double-check claims on exemptions (number of children, whether the kids are still dependent and tax deductible or not, whether head of family or not, etc.) because our proposal espouses no exemptions in order to, (a) discourage small income families to have more children (the current system of allowing exemptions for dependents actually gives incentive to have more children, hence contributing to population boom), and (b) simplify the administration and therefore eradicate opportunities for corruption and rent-seeking.

For instance, in the above example of a P500,000/year income family of four, computing the tax due is simple:  $P500,000 \times 0.10 = P50,000$  tax. But under the current system, taxes due will be computed as follows:

Gross annual income	P500,000
Less exemptions:	P 80,000
	<i>P64,000 for the couple [32,000 each for husband and wife] + P16,000 for the 2 kids [P8,000 each child or dependent]</i>
Net taxable income	P420,000
<b><i>Tax due</i></b>	<b><i>P101,000</i></b>
	$P50,000 + 30\% \text{ in excess of } P250,000 \text{ [which is } 420,000 - 250,000 = 170,000]$
	$= P50,000 + (0.30) \times (P170,000) = P50,000 + 51,000$

Not too many taxpayers have the patience to go through this computation. If a taxpayer happens to have 4 children or dependents, a corrupt BIR assessor can harass a taxpayer by asking for the birth certificates of all 4 children (maximum number of dependents allowed) to see that they are all indeed below 21 years old, check that not one of them is already working, other forms of delaying tactics. Once the delays are made, the taxpayer might be late in paying within the deadline, of which there are penalties to be paid on top of taxes due.

In addition, under the MGM proposal, low-income individuals and households, particularly those earning P40,000/year or less, will not be paying personal income tax. The justification for this requires no rocket science: an annual income of about P40,000 translates to a daily average income of below what is mandated as the minimum wage under the law.

***(2) It promotes fairness between taxed individuals and those who are tax-exempted***

As discussed above, two groups of gainfully-employed Filipinos are exempted from paying personal income tax, or at least exempted from the monthly salary withholding tax. They are the OFWs, and Filipino staffs of multilateral and bilateral institutions, as well as foreign embassies in the country. A senior level officer at the UN office in Metro Manila for instance would be earning at least P60,000/month, and they pay no income tax. Whereas a senior staff in a small private company earning P50,000/month will be surrendering 30-32% of it in monthly withholding tax. Such discrepancy is not justified from the point of view of promoting more equity, a social goal that these multilateral and bilateral institutions adhere to. If personal income tax is slashed to only 10% flat, then the take home income of the taxed individuals will not be that far from those exempted.

***(3) The rich pays higher tax than the poor; thus, it is not “regressive”***

A person earning P500,000 a month will pay P50,000/month in personal taxes. A person earning P10,000/month will pay P1,000/month in taxes. The rich man nominally pays P49,000 in monthly taxes more than the poor man.

***(4) It respects hard work and encourages entrepreneurship***

If people know that whether they earn P5,000 or P50,000 a month, the tax rate is the same, there is greater incentive to work harder and earn bigger. Thus, performance is rewarded, not penalized with higher tax rate. A P2,000 a month savings from withholding tax cut for an ordinary employee means P24,000 a year of savings. Two to three years of savings maybe enough to start a small food shop (carinderia) or sari-sari store. Or they can pool their savings from tax cut with other fellow employees to start a bigger projects.

***(5) It will expand collections from consumption-based taxes***

For people who prefer to spend their savings from tax cut instead of investing it, such spending can be covered by the various consumption-based taxes on various goods and services. Like VAT for hamburgers, shoes, t-shirts and medical check-up; excise tax for cigarettes and beer; vehicle registration tax and real property tax for ownership of a car or house, among others.

***(6) It will help reduce brain drain***

One important reason why many Filipino workers here decide to work abroad is that while wages here are already not high compared to those available abroad, the high personal income taxes further erode their spending power. By slashing income tax, professionals like doctors and nurses thinking of leaving the country in search of higher pay in hospitals and clinics abroad will be encouraged to stay here since their take-home income will be larger. There are anecdotal evidences of Filipino professionals leaving the country to work abroad where personal income taxes are lower, e.g. in Singapore and Hong Kong.

It is not impossible that this proposal, together with other taxpayers-sensitive policies, will not only arrest and neutralize brain drain but will even reverse it. Foreign businessmen and professionals looking for low-tax places to do business will be attracted to come to the Philippines, resulting in many entrepreneurial opportunities, thereby also creating more employment and reducing poverty.

***(7) It will help reduce tax evasion***

The behavior or decision whether to pay the “right” taxes or evade paying it can be modeled as:

Tendency to evade taxes = + high tax rates (a)  
+ perception of corruption/inefficiency in government (b)  
- cost of bribing tax authorities (c)  
- perceived probability of being caught (d)  
- severity of penalties if caught (e)

The model highlights five (5) factors. Two are positively correlated with the decision to cheat, namely: (a) and (b). On the other hand, three (3) are negatively correlated with the decision to cheat (the higher they are, the lower the tendency to cheat) namely: (c) to (e). Combining them all, if (a) and (b) are high, and (c) to (e) are low, then there will be massive tax cheating. Our main concern in this paper is to reduce income tax rates (factor a), and also somehow influence the factor (d). There is reason to believe that due to the fact that the current system bears heavily down not only on the rich but also on the middle class, there is a big incentive for the wide, middle range income earners to misdeclare, or just totally dodge tax payments by not filing any tax return. The incentive to cheat is further reinforced by the notion that the BIR will not run after them anyway (factor d), since they are not that big as compared to corporate evaders, and the incidence is too high that it will require a huge BIR workforce in order to fully enforce the law. It is a case of tax dodgers exhibiting a herding behavior; acting on the cascade of information that as there are more of them not paying the right taxes, the more difficult it is for government to catch all of them.



The most often used theory in the analysis of tax evasion is the “economics-of-crime” model, which is actually a game theory. A person tries to assess the situation and maximizes the expected utility of the action (tax evasion) and assessing it against the risk of getting caught and penalized. Literature would assert that compliance could not be explained entirely by the level of enforcement. And we therefore add that in the assessment of utility versus risk, lowering the tax rates minimizes the utility side, the rational behavior would be to simply comply.

We therefore assert that the lowering of tax rates into a flat tax of 10% with no exemptions will make tax dodgers comply, provided that the enforcement side is continually pursued. And since the proposal is simplified (no exemption), it is in fact easier to administer and track. And as soon as the middle-income earners with lower incentives to cheat begin to comply, the herding behavior is disrupted and the BIR can focus on the remaining high income tax filers.

There is plenty of empirical evidence that higher taxes lead to higher incidence of tax evasion. For instance, in a study on tax evasion by James Alm of the University of Colorado at Boulder, he concluded that:

- A higher audit rate leads to more compliance, at least to a point, with an estimated reported income-audit rate elasticity ranging from 0.1 to 0.2.
- A higher fine (penalty) rate leads to marginally more compliance, with an estimated reported income-fine rate elasticity less than 0.1.
- A higher tax rate leads to less compliance, with an estimated reported income-tax rate elasticity of -0.5 to -3.0.

In another case study of tax evasion in China conducted by Raymond Fisman and Shang-Jin Wei, they found that on average, a one (1) percent increase in the tax rate results in a 3 percent increase in evasion.

On the other hand, a tax cut would actually result in higher revenue collections. Extensive studies on the tax cuts made by John F. Kennedy in 1964 and Ronald Reagan in 1981 conclude that the net result was an increase in federal tax revenue, especially from the rich. Rent-seeking behavior (bribing BIR officials to avoid paying legal taxes due) under the current "progressive" tax system is more costly than paying the 10% flat tax.

### **Basic data in comparing potential revenues, multiple vs. flat personal income tax**

The BIR conducted a survey in 2001 on individual income tax filers covering 155,360 individuals, both salaried and self-employed, and adjusting for current incomes. Please see Table 3.

**Table 3. BIR Survey, Distribution of Individual Income Tax filers by type of Taxpayers, 2001**

Gross Income Bracket	Compensation Income Taxfilers	Self-employed & Professional Income Taxfilers	Total, Sample Size	Sample Size Distribution, %
Less than P60,000	12,261	19,653	31,914	20.5%
60,0001 - 100,000	32,312	7,707	40,019	25.8%
100,001 - 150,000	25,196	7,125	32,321	20.8%
150,001 - 200,000	9,621	4,488	14,109	9.1%
200,001 - 300,000	8,427	5,572	13,999	9.0%
300,001 - 400,000	2,771	3,475	6,246	4.0%
400,001 - 500,000	1,523	2,269	3,792	2.4%
500,001 - 600,000	1,085	1,532	2,617	1.7%
600,001 - 700,000	546	1,193	1,739	1.1%
700,001 - 800,000	411	883	1,294	0.8%
800,001 - 900,000	330	720	1,050	0.7%
900,001 – 1M	229	595	824	0.5%
1,000,001 – 2M	691	2,465	3,156	2.0%
2,000,001 – 4M	265	1,079	1,344	0.9%
4,000,001 – 6M	68	289	357	0.2%
6,000,001 – 8M	50	174	224	0.1%
8,000,001 – 10M	19	71	90	0.1%
10,000,001 – 12M	11	39	50	0.0%
Over 12,000,000	24	186	210	0.1%
Total Count of Taxpayers	95,840	59,515	<b>155,355</b>	100.0%

Source: BIR

Notes:

(1) Data are from computerized revenue districts only (July 12, 2002)

(2) Partial returns encoded as a result of operations policy, whereby 1700 and 1701 returns are not priority for encoding

### **Proof of large-scale tax cheating**

As part of our methodology, we assume in our analysis the following: (i) Total population of tax filers in 2005 onwards will maintain or at the least, approximate the same distribution as in Table 3; (ii) There is already under-declaration of income in the above survey considering that it was the BIR which conducted the study. Hence, no further assumption of income under-declaration in the succeeding revenue estimates will be made.

We also used the median of each income level in the 2001 BIR Survey (column 1) as proxy for the individual incomes for each level. As shown in Table 2, projected BIR tax collection from individual tax filers for 2005 will amount to P107.7 billion. Assuming the same distribution of individual income tax filers and computing backwards, this will translate into certain figures representing the number of tax filers for each income bracket, and a total number of tax filers, for which, the figure is around 1.81 million only. In 2006, the implied number of individual tax filers will be 2.1 million only.

**Table 4. Potential Collections from Individuals under the Current Tax Rates**

Median Gross Income (Pesos) (1)	Less Exemptions, -15%, -10%, -5%* (2)	Survey size Distribution (%) (3)	(A) At current rates, per indiv., in P (4)	(a) At 1.81M** Individual Taxpayers (3)x1.81M = (5)	Potential Taxes (P Mill.) (4)x(5)=(6)	(b) At 2.1M** Individual Taxpayers (3)x2.1M = (7)	Potential Taxes (P Mill.) (4)x(7)=(8)
40,000	34000	20.5%	<b>3,400</b>	371,822	1,264	431,395	1,467
80,000	68000	25.8%	<b>10,200</b>	466,251	4,756	540,954	5,518
125,000	106250	20.8%	<b>19,125</b>	376,563	7,202	436,897	8,356
175,000	148750	9.1%	<b>29,750</b>	164,380	4,890	190,717	5,674
250,000	212500	9.0%	<b>46,750</b>	163,099	7,625	189,230	8,847
350,000	297500	4.0%	<b>68,425</b>	72,770	4,979	84,430	5,777
450,000	382500	2.4%	<b>95,625</b>	44,180	4,225	51,258	4,902
550,000	467500	1.7%	<b>121,550</b>	30,490	3,706	35,375	4,300
650,000	585000	1.1%	<b>157,950</b>	20,261	3,200	23,507	3,713
750,000	675000	0.8%	<b>189,000</b>	15,076	2,849	17,492	3,306
850,000	765000	0.7%	<b>214,200</b>	12,233	2,620	14,193	3,040
950,000	855000	0.5%	<b>247,950</b>	9,600	2,380	11,138	2,762
1,500,000	1425000	2.0%	<b>427,500</b>	36,770	15,719	42,661	18,238
3,000,000	2850000	0.9%	<b>883,500</b>	15,659	13,834	18,167	16,051
5,000,000	5000000	0.2%	<b>1,600,000</b>	4,159	6,655	4,826	7,721
7,000,000	7000000	0.1%	<b>2,240,000</b>	2,610	5,846	3,028	6,783
9,000,000	9000000	0.1%	<b>2,880,000</b>	1,049	3,020	1,217	3,504
11,000,000	11000000	0.0%	<b>3,520,000</b>	583	2,051	676	2,379
14,000,000	14000000	0.1%	<b>4,480,000</b>	2,447	10,961	2,839	12,717
		100.0%		1,810,000	<b>107,783</b>	2,100,000	<b>125,052</b>

\* 15% exemptions for incomes below P500,000; 10% for incomes from P500,000 to P1M; 5% for incomes from P1-4M; and above P4M, the exemptions (see table 1) are deemed negligible in relation to the magnitude of the gross income.

\*\* The BIR's projected collections of P107.7 billion for 2005, assuming the same income distribution as in Table 3 and no further tax evasion, corresponds to only around 1.81 million individual taxpayers in 2005. And the projected P124.1 billion collections from individuals correspond to only 2.1 million individual taxpayers. These are too low considering that there could be 20 million potential individual tax filers, discussed below.

Based on the National Statistics Office (NSO) quarterly labor force survey (April 2005), there were 32.2 million employed Filipinos, 8.4 million of whom were underemployed (already have jobs but wanting additional hours of work), leaving 23.6 million who were therefore gainfully employed. Subtracting from this those exempted from paying personal income tax (discussed above), there could be about 20 million individuals who should file income taxes. But the BIR in 1998 received only about 2.6 million individual tax returns (easily about 3 million at present), and yet implied by the BIR survey data, the Bureau expects only about 1.81 million individual tax returns in 2005, and 2.1 million in 2006.

It is axiomatic therefore that a good number of taxpayers do not file their personal income tax. Assuming that there could be 3 million (not 1.81 million implied in 2005) individuals who filed their personal income taxes last April 2005 (BIR deadline), potential collections (after exemptions have been deducted) should be P178.6 billion. But the BIR only

estimates about P107.7 billion (Table 2) from individual income tax collections. This is an outright admission that the difference of P71 billion is attributable to further tax evasion.

If one will argue that 3 million individual tax filers is understated, and assume 4 million, then potential personal income tax collections should be around P238 billion. That is, as we assume a larger base of individual tax filers, we are bound to be depressed to see even larger tax cheating as individuals preserve what to them is the fruit of their hard work. After all, there are dozens of both income- and consumption-based taxes that will hound them when they spend their earnings.

### **Towards low tax rate, high tax base, and revenue-neutral result**

Below is our estimate of revenue collections under a 10% flat personal income tax. Here, we would like to highlight the interplay of a low tax rate and the attainment of a larger tax base towards getting a revenue-neutral result (potential revenue collection is around the same as under the current system) or even better.

**Table 5. Potential Collections from Individuals Under a 10% Flat Rate, No Exemptions for Incomes of P40,000/year or Higher.**

Median Gross Income (Pesos) (1)	Survey size Distribution (%) (2)	At 10% flat rate, per indiv (P) (3)	(a) At 4.3M Individual taxpayers (2)x4.3M=(4)	Potential Taxes (P Bill.) (3)x(4)=(5)	(a) At 5M Individual taxpayers (2)x5M=(6)	Potential Taxes (P Bill.) (3)x(6)=(7)
40,000	20.5%	-	883,333	-	1,027,131	-
80,000	25.8%	<b>8,000</b>	1,107,668	8,861	1,287,986	10,304
125,000	20.8%	<b>12,500</b>	894,598	11,182	1,040,230	13,003
175,000	9.1%	<b>17,500</b>	390,517	6,834	454,089	7,947
250,000	9.0%	<b>25,000</b>	387,472	9,687	450,549	11,264
350,000	4.0%	<b>35,000</b>	172,880	6,051	201,023	7,036
450,000	2.4%	<b>45,000</b>	104,957	4,723	122,043	5,492
550,000	1.7%	<b>55,000</b>	72,435	3,984	84,226	4,632
650,000	1.1%	<b>65,000</b>	48,133	3,129	55,969	3,638
750,000	0.8%	<b>75,000</b>	35,816	2,686	41,647	3,123
850,000	0.7%	<b>85,000</b>	29,062	2,470	33,794	2,872
950,000	0.5%	<b>95,000</b>	22,807	2,167	26,520	2,519
1,500,000	2.0%	<b>150,000</b>	87,353	13,103	101,574	15,236
3,000,000	0.9%	<b>300,000</b>	37,200	11,160	43,256	12,977
5,000,000	0.2%	<b>500,000</b>	9,881	4,941	11,490	5,745
7,000,000	0.1%	<b>700,000</b>	6,200	4,340	7,209	5,047
9,000,000	0.1%	<b>900,000</b>	2,491	2,242	2,897	2,607
11,000,000	0.0%	<b>1,100,000</b>	1,384	1,522	1,609	1,770
14,000,000	0.1%	<b>1,400,000</b>	5,812	8,137	6,759	9,462
	100 %		4,300,000	<b>107,220</b>	5,000,000	<b>124,674</b>

To achieve a revenue-neutral result of P107 billion in 2005, compliance need to increase only from the current estimate of 3 million to 4.3 million (notwithstanding that there are about 23.6 million gainfully employed Filipinos). To achieve a revenue-neutral result of P124 billion in

2006, compliance need to increase only from 3+ million to 5 million individuals tax base. Beyond 5 million, everything else is gravy for government.

Table 5 is actually a numerical equivalent of the Laffer Curve. The numbers implicitly argues that there is an optimal tax rate for the Philippine economy (between 10 to 15%) and the current tax rate is way above that point. Thus, reducing the tax rate to a flat 10% will increase total revenues because it enhances the incentives to work harder and to be more productive for wage and fixed-income earners who are allowed to retain a higher portion of their income.

Some quarters may argue that our argument on the multiplier effect is flawed, considering that in the present scenario those not paying the right taxes already have the money with them, and therefore should have the capability to invest in entrepreneurial activities. We counter-argue this with the matter of rent seeking. Remember our earlier equation, Tax burden = actual taxes paid + transactions or processing cost: in order to effectively avoid taxation, pay-offs are made, which cut directly into what would have been the amount of “savings” realized from tax evasion. Therefore, the absolute amount of aggregate income legally placed in the hands of the middle-income taxpayers due to this proposal, is technically higher than the aggregate “savings” that they would have realized as tax evaders.

## **Summary and Conclusion**

To summarize and conclude, a flat 10% personal income tax system in the Philippines is feasible, due to the following reasons:

- It will be attractive to the taxpayers given its adherence to the equity principle, and the respect it accords to hard work and performance.
- It is easier to comply with, resulting in a much larger tax base. This will not guarantee though, that tax evasion will be totally eliminated. Even at 1% income tax rate, there will be people who will try to evade taxes. The 10% tax rate can only reduce, not eliminate, tax evasion.
- Initial computations show a revenue-neutral, even higher revenue results, compared with actual and projected collections under the current multiple, high tax rates system.
- Potential entrepreneurial and economic growth will be large as millions of fixed-income earners burdened by high withholding taxes will have bigger take-home income, and bigger savings for future investment projects.
- A cut in personal income tax will allow government to rethink its expenditure patterns and consequently result in a society that emphasizes greater personal freedom and responsibility, lesser state taxation and lesser dependence on state-led business activities, as envisioned by the Minimal Government Movement.<sup>2</sup>

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### ***Comments:***

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