Tax Reform Case Study: Philippines

INTRODUCTION

In December 2012 the Philippines passed the Sin Tax Reform Act of 2012 (Sin Tax Law), which became landmark legislation under President Aquino’s administration. With the two main goals of curbing smoking and alcohol consumption and raising the much-needed funds for government programs, the Law greatly simplified and increased excise taxes and earmarked a substantial share of the new revenue to a health fund dedicated to universal health care. Just three years into its implementation and less than one year before the final transition to a unitary tobacco excise tax in 2017, the STL had already reached its two goals, representing a Win-Win for tobacco tax reform. Evidence shows that by 2015 the prevalence of current tobacco use among adults was 23.5%, a 1/5th reduction from its level in 2009. The decrease in prevalence among women was particularly large with only 5.8% of females using tobacco in 2015, compared to 10.1% in 2009. Tax revenue from tobacco excise taxes more than doubled in just one year, and had tripled by 2015 to PHP 100 billion. Earmarking Sin Tax Law tax revenue to health programs has greatly contributed to increase health insurance coverage and spending, especially among the poor.

TAX SYSTEM AND THE REFORM UNDER THE SIN TAX LAW

The Philippines levies a specific excise tax on tobacco products. Before 2013, the Philippines’ excise tax system included four tiers based on the “net retail price” (NRP). This multiple tier system provided opportunities for tobacco companies to avoid taxation by using various strategies aimed at keeping high market shares among low-tax brands. Further contributing to the flawed tobacco taxation regime in the Philippines was the “price classification freeze” that defined the NRP until 2012. As a result of the freeze, the vast majority of cigarettes sold in the country (more than 80% of the market in 2012) were taxed at extremely low rates of PHP 2.72 (less than $0.06) based on their 1996 prices. If instead they had been taxed based on their current price levels, most of these brands would bear a tax of at least PHP 12, as the net-of-tax retail prices (NRP, as most of the cheapest brands’ prices were above the second tier price limit. The tax on the most popular brands was estimated at less than one-tenth of the tax per pack levied on other brands.

TAX REFORM

In 2012, the Philippines passed the Sin Tax Reform Act (Republic Act 10351) including:

1. An immediate significant increase of excise tax rates in the first year of the reform, with the largest increase for the lowest tiers from PHP 2.72—a rate locked under the provisions of the old law—to PHP 12 or more than fourfold its level in 2012.

2. A significant simplification of the tax system
   » Multi-year transition to a unitary rate system: immediate reduction from four tiers in 2012 to two tiers in 2013 and until 2016, with ultimately a single uniform specific excise tax of PHP 30 per pack beginning 2017.
   » After 2017, a continued increase in the excise rate by 4% annually as a proxy for inflation adjustment.
Simplification of the tax base: by removing the "price classification freeze" the most popular brands were eventually re-classified to new tax tiers based on their current value instead of their 1996 value, which significantly increased their effective tax burden and automatically indexed the tax base to inflation of tobacco products.

3. Earmarking of tax revenue towards healthcare:

» 85% of incremental revenue from the Law was earmarked to universal health insurance coverage, other investments in health facilities and other health programs.4

» The remaining 15% was earmarked to alternative livelihoods for tobacco farmers and funding economic development projects in provinces producing burley and native tobacco.

The STL significantly increased the average price of cigarettes with the largest increase in 2013 from PHP 24.2 to PHP 35 (an increase by 44%) up to PHP 43.3 in 2017 or 78% more than its level in 2012.5

With the immediate elimination the "price classification freeze", the STL also eliminated an important inefficiency in the tax system by reclassifying the most popular cigarettes into their proper tiers based on current retail prices. The Law also greatly simplified the tax system by immediately reducing the number of tiers to two tiers in 2013, and eventually to a uniform excise tax in 2017. It also included an automatic adjustment of the tax to account for inflation from 2018 onwards.

As the largest tax increase was for low-tiers, from PHP 2.72 to PHP 30 per pack between 2011 and 2017 or more than a ten-fold increase, the price on some of the cheapest tiers more than tripled between 2012 and 2017.6 The excise tax share in the price (excise tax burden) significantly increased for the most popular low-tier brands from 15.8% in 2012 to 45.2% in just one year, and up to 76.2% by 2017.

As price changes do not necessarily ensure a decrease in tobacco users' purchasing power, especially in countries with high income growth—which is the case of several low and middle income countries (LMICs) including the Philippines—changes in affordability are an essential driver of changes of consumers' responses to tax reform because affordability indices account for both income and price changes.7 All cigarettes became immediately and significantly less affordable in 2013 by more than one third on average—as measured by the Relative Income Price (RIP). For some of the cheapest brands affordability more than halved between 2012 and 2015.
IMPACT ON TOBACCO USE

From 2009 to 2015, the prevalence of current tobacco smoking among adults significantly decreased from 28.3% to 22.7% (a reduction by 1.5 million smokers), including from 47.7% to 40.3% among males (about 545 thousand less smokers among males). Smoking prevalence among females has almost halved from 10.1% to 5.8% of adult females (about 956 thousand less females). Although there is no recent comparable survey on smoking prevalence among students, adults surveys shows that the reduction in smoking was even greater among young adults, (18 to 24 years old) than among the general population, decreasing by one-third from 35% to 22% between 2012 and 2015.

In 2015, more than 76.7% of current smokers wanted to quit smoking, compared to 60.4% of smokers in 2009, and the prevalence of smokers who made successful quit attempts in the previous 12 months increased.

IMPACT ON SALES

Between 2012 and 2015, sales of domestic taxable cigarettes decreased by 28.1%, from 115.9 million to 83.3 million sticks, more than offsetting the increase in taxable cigarettes observed in 2012 due to frontloading.
INDUSTRY REACTION

Philip Morris International/Fortune, which holds a majority of the tobacco market, and other local tobacco companies engaged in various activities aimed at avoiding the full impact of the tax reform including:

- Frontloading sales: Producers managed to avoid some of the new tax by shifting a significant part of their 2013 sales to 2012 through early warehouse releases to be taxed under the old tax system.
- Cross-subsidizing cheaper brands: To maintain market shares under the two-tier tax structure, companies increased the price of less price-sensitive premium brands to simultaneously subsidize price cuts on cheaper brands, resulting in a less than full pass-through of the new excise tax to the retail price of popular brands. The action serves to encourage smokers to switch to cheaper cigarettes rather than quit smoking.

The advantages of these tactics for the industry are reduced with the unitary high tax rate.

More recently and just before the shift to the unitary system scheduled for January 2017, the industry failed in promoting a bill re-introducing a two-tier system, arguing the unitary system would negatively affect farmers’ livelihoods.

IMPACT ON GOVERNMENT REVENUE

As a result of the tax reform, government revenue from tobacco taxes dramatically increased just one year into the reform, from PHP 32.9 billion in 2012 to PHP 70.4 billion in 2013 in nominal terms, and more than two-fold in real terms. Excise revenue continued to increase every year after the reform even as cigarette sales declined. In addition, tobacco excise revenue significantly increased as a share of all excise revenue (which include alcohol and tobacco) from 45% to 63% from 2012 to 2016, and as a share of total tax revenue (from 3.1% to 3.9% in the same period).

Figure 6: Tobacco Tax Revenue and Shares of Excise and Total Tax Collections

Sources: Bureau of Internal Revenue, Annual Reports (tax revenue); Real revenue is computed using the end-of-the-year annual CPI index on all products, from the Philippines Statistics Authority (PSA). *BIR revenue goal for 2016.

IMPACT ON THE DOH BUDGET AND UNIVERSAL HEALTH COVERAGE

Due to earmarking of additional tax revenue to health, the budget for the Department of Health has more than doubled since the implementation of the STL, from a baseline if PHP 53.2 billion (excluding incremental revenue from the STL) to PHP 141.1 billion projected for 2017. This has allowed for the near-universal expansion of Philippines’ National Health Insurance Program, with 15.4 million poor and near-poor families covered by the end of 2016, compared to 4.6 million before the implementation of the STL in 2012.

Figure 7: Sin Tax Revenues for Health and Near-Poor Families Enrolled

LESSONS LEARNED

1. The Sin Tax Law has successfully reached its purpose of significantly simplifying the tax system, quickly reducing tobacco use, and raise high incremental revenue needed to fund universal health coverage—especially among the poor—as well as additional revenue for health and economic development programs. The earmarking scheduled for 2018 and after should be carefully monitored to ensure the continuation of the progress already done, especially in the light of increased cigarettes sales in recent years.

2. Government policy that increases tobacco taxation will spur adjustments by the tobacco industry. Frontloading sales and cross-subsidizing sales were two tactics employed by the tobacco industry to mitigate—albeit initially—the full impact of tobacco tax increases. In the case of the former, it was also the basis for the industry’s claim in early 2013 that the Government’s policy was not working as planned in light of below-anticipated first quarter revenue. The Government had anticipated both tactics and knew they could not be sustained, resulting in no reconsideration of the policy as the tobacco industry likely wanted. Even as the Sin tax law approached full implementation, the tobacco industry sought to prevent it by introducing new legislation in December 2016. Congress declined to consider any legislation on the tobacco tax until after it completed its review of the law in 2017.

3. The government can strengthen its stamping and tracking systems to reduce the risk of illicit trade. Tobacco tax increases are not responsible for illicit tobacco trade. A few months into the implementation of the Sin Tax Law and to mitigate smuggling and tax evasion, which represented an increasing risk for health and revenue due to lower retail prices, the Bureau of Internal Revenue (BIR) issued a memorandum in late 2014 that requires the use of an Internal Revenue Stamp Integrated System (IRISIS) for ordering, distribution, affixure and monitoring of tax stamps on imported and locally manufactured cigarettes. This new stamping system coupled with proactive tax administration and oversight measures has permitted the BIR to assume full control and supervision over the production and issuance of excise stamps, and ensures that all taxes due to tobacco products are accurately and fully paid. Recent concerns about leakages to untaxed sales has raised awareness that a more high-tech tracing system could be considered in addition to improving the existing stamping system.

4. Government tobacco tax policy aimed at reducing tobacco prevalence should factor in potential income growth. The STL has been able to significantly curb smoking and raise revenue for health and development programs. Nevertheless, the government still has several challenges to face and should carefully monitor the ability of the STL to continue increase taxes at levels high enough to reduce tobacco use. In particular, careful consideration of the annual increase in the excise tax currently planned for 2018 and beyond should at least take into account both inflation and increasing income growth. The Republic Act 10351 (STL) is currently under congressional review to assess its effectiveness in reducing alcohol and cigarette consumption and increasing revenue and to consider any amendments to the law.

---


13. BIR Annual Reports. Ibid citation 11.

14. BIR Annual Reports. Ibid citation 11.

15. BIR Annual Reports. Ibid citation 11.


