Should the Exchange Tax Law be Amended?

By J. A. Parrish
General Manager, Standard Vacuum Oil Company
President, American Chamber of Commerce of the Philippines

ALTHOUGH it is thoroughly understood that the Philippine exchange tax law applies to the nationals of all countries alike, American nationals and American capital are mentioned specifically in this article because, for the time being at least, it is from the United States only, and generally through American businessmen, that outside funds can be depended upon to assist in the development of the natural resources and the build-up of industry in this country.

Now that elections are over and the Third Session of the Second Philippine Congress is about to open, one hears and sees in the press considerable speculation as to the attitude which the new senators and congressmen may take toward taxes in general and more particularly toward the tax which is being collected on the sale of dollar exchange.

Our current exchange tax law was passed by the Second Congress as Republic Act No. 601 and was approved by the President on March 28, 1951. For convenience pertinent sections of the law are quoted verbatim or paraphrased hereunder:

SECTION 1. Except as herein otherwise provided, there shall be assessed, collected and paid a special excise tax of seventeen *per centum* (17%) on the value in Philippine pesos of foreign exchange sold and/or authorized to be sold by the Central Bank of the Philippines or any of its agents during the period of two years counting from the date of the approval of this Act.

SEC. 2. Exchange purchased in connection with the importation of certain food staples, drugs, textbooks, newsprint, etc., is exempt from the exchange tax.

SEC. 3. Exchange purchased in connection with the importation of articles or containers utilized in the packaging of local products for consignment abroad is exempt from the exchange tax.

SEC. 4. Exchange tax is not applicable to exchange sold for the following purposes:

1. Payment in respect of reinsurance.
2. Payment in respect of marine and aviation insurance.
3. Payment of expenses for drydocking and repairing abroad vessels of Philippine registry and for repairing abroad airplanes of Philippine registry.
4. Exchange purchased for payment of living expenses of students studying abroad not exceeding three hundred dollars per month and for tuition and other school fees.
5. Payment of premiums by Veterans on life insurance policies under the Government of the United States.
6. Payment of premiums and other amounts due by policyholders on life insurance policies issued before December 9, 1949.
7. Payment of machinery and or raw materials to be used by new and necessary industries as determined in accordance with Republic Act Numbered Thirty-Five.

Those who felt the greatest concern over the exchange tax measure at the time it was being promoted in the Congress will recall that the greatest influence for its passage appeared to be the general understanding that it was recommended by the Bell Economic Survey Mission. In part that understanding was correct. There are very important differences, however, between the Bell Mission suggestions in this regard and the provisions of the exchange tax bill as finally approved.

For convenience, the specific recommendation, with regard to the exchange tax, made by that group of Bell Mission experts who were assigned the responsibility for studying and reporting on the commercial and exchange policy of the Philippine Government is quoted hereunder. The quoted section is found under the heading of "Recommendations" on page 88 of one issue, and on page 66 of another, of the Report to the President of the United States by the Economic Survey Mission to the Philippines, produced in Washington, D.C., October 9, 1950. (Italics ours)

"2. *To reduce the present excessive demand for imports,* which is in part due to the high level of national income and home prices relative to those of the United States, *a special emergency import levy of 25 per cent should be imposed on all imports* except a limited number of the most essential goods. This special levy would be for a period not to exceed two years and would be coordinated with a new trade agreement to be negotiated with the United States. If such a special levy is not possible because of legal limitations, *it would be desirable to secure some reduction in the demand for imports by heavy excise taxes on luxury imports,* or through a tax on exchange remittances, although such a measure could lead to serious speculation."

From the language used in this section, the conclusion can undoubtedly be drawn that revenue was not the primary objective which the Bell Mission experts had in mind here, but rather that it was their purpose to prescribe a means for reducing imports, which were draining the country's dollar reserves faster than dollar receipts could be accumulated from exports and other sources.

The proposal which manifestly took priority among those made by the Bell Mission was "*a special emergency levy of 25%*" *on all imports* except a limited number of the most essential goods. The alternative to the above recommendation is contained in the following sentence and is so clearly expressed as to permit of no misunderstanding that a tax on the sale of exchange was mentioned only as a last resort. "If such a special levy is not possible because of legal limitation, *it would be desirable to secure some reduction in the demand for imports by a heavy excise tax on luxury imports,* or through a tax on exchange remittance, although such a measure could lead to serious speculation."

In view of the order of preference given to the different Bell Mission suggestions, one might ask why we have the exchange tax at all, instead of an import levy or an excise tax on all imported goods, graduated in accordance with the essentiality of each category of goods brought in.

One heard at the time that a levy on imports of American goods would run counter to the principle of free trade between the Philippines and the United States, as provided for in the Philippine Trade Act of 1946. Such reasoning could not have been taken too seriously, for the reason that the principle of free trade had already been abridged by the levy of a 1% tax on the value of imports in the old Import Control Board. The present Import Control Commission, with certain exceptions, collects a tax of 2% on the value of imports. Nor can it be claimed that this 2% tax is to cover the expenses of the I.C.C. because amounts being collected exceed by far the cost of maintaining the Commission and are turned over to the general fund of the Government. If the collection of a tax of 2% on imports from the United States can be looked upon as coming within the provisions of the 1946 Trade Agreement, then no maximum in the rate at which such a tax could be fixed can be said to exist. Consequently the rate of tax collected when import licenses are issued could be fixed at 17%, 25%, or at any other level which might be necessary to reduce imports and sufficient to increase revenue by a specified amount and for any purpose. Furthermore, under such a tax arrangement the desirable regulation of imports could be achieved by graduating the rate of tax in accordance with the relative essentiality of the product for which import license was sought.

It will be recalled by those who stood to make the greatest contribution under the provision of the exchange tax bill that the representatives of a certain United States government agency, who were in Manila at the time, informed congressmen here that a tax on the sale of exchange was what the United States Government wanted.

When the exchange tax proposal came up for committee consideration, representatives of American business were amazed to find that in certain of its features the bill went far beyond the purpose of diminishing imports, and that if the bill were passed as drafted the tax would also apply to repatriation of capital, to remittance of profits and dividends, and to the transfer of proceeds of liquidation of American business and savings by American nationals resident in the country. One of the explanations offered for the application of the tax to remittances made for other purposes than to cover imports, was that diffusion of the tax would take away from it the character of an import levy on goods from the United States. Apparently the same personnel in the same United States government agency assured Filipino congressmen that this extension in the application of the exchange tax was also what the United States Congress wanted.

Subsequent to the passage and approval of the exchange tax law, several American congressmen have visited the Philippines and have discussed with local businessmen the economic prospects of the country, including incentives to the investment of outside capital here. These interviews have not confirmed that in the United States capital an exchange tax was preferred over other import deterrents suggested in the Bell Report, and by no stretch of the imagination could these congressmen be accused of advocating the inclusion of profits from American-financed business, repatriation of American capital, and remittances which would normally be made by American employees in the scope of the exchange tax law.

In all probability it did not occur to the authors of the exchange tax bill that in operation the law would set up a severe penalty against business and investments financed from the United States and against American nationals employed in the Philippines. The thesis is undoubtedly accepted that foreign capital invested in the Philippines is entitled to be repatriated without restriction. It also seems entirely reasonable that the profits derived from business which is financed by citizens of other countries should be freely convertible to the currency of the mother country. American citizens normally return to the United States when their business is discontinued, or when they no longer have employment in the country, to live out their final years in the land of their origin. It is only normal and reasonable that, after settling their local obligations, these citizens would convert to the currency of their home country any resources they had remaining, whether represented by savings, assets, or proceeds of liquidation.

Because of the circumstances mentioned above, the exchange tax quite obviously places American business and American employees in the Philippines at a disadvantage to the extent of 17% of the net proceeds of their operations, investment, or employment, compared with resident citizens and major groups of other nationals who reside in the country but whose profits and earnings do not normally require to be converted. Aside from the cut which the exchange tax takes out of the net earnings of the individual American citizen when remitted, the adverse impact of the tax on American capital attraction is plain to be seen. Investment climate for foreign capital can not be considered favorable in any country where a substantial tax is laid on the repatriation of principal or on the remittance of profits derived from the employment of such capital.

On many occasions I have made the observation that one of the principal deterrents to the flow of American capital toward the Philippines was the very stiff tax of 17% which the investor would have to stand when he undertook to remit profits or repatriate his original principal. Invariably the response has been that one of the objectives of the exchange tax law was to discourage the departure from the country of capital of any kind, on the theory that capital which is already here, as well as that which might yet come in, should continue to be employed in this country for the benefit of our economy.

Obviously it would be a splendid thing if we could attract outside financial assistance on that basis, but it is probably neither a reasonable nor a sound condition to the investment of foreign funds in any country that the investor must live there in order to expend locally the proceeds of his investment or that he must forever reinvest such proceeds in the same country. More often than not, investors are handling money that belongs to groups of people, and the common practice is to spread investment over different countries as well as over different industries in the same country. While investors assume that their capital will contribute to wider employment and to the increase of wealth in the country to which it goes, they are by no means prepared to risk their funds for that purpose alone. Part of their objective is to bring about an increase in their capital, in the form of dividends which they have every right to expect to convert freely back to the currency from which the original investment was made.

One other possible explanation for the spread provided for in the application of the exchange tax was the fear that if confined to imports alone, the levy would not return the amount of revenue needed to qualify for E.C.A. aid and for other purposes. To the contrary, so surprisingly successful has been the operation of the exchange tax law that it now probably occupies first place as a single source of revenue to the Government. The Central Bank and the tax authorities will undoubtedly concede that collections under the exchange tax have exceeded original expectations and it may be true that the amount collected from imports alone is equal to the total amount originally expected to be realized from this source. Over the first six months, following the approval of the law, collections from the exchange tax amounted to ₱86,000,000. For that period the average works out at roughly ₱14,300,000 per month. Evidence of very satisfactory improvement in overall government revenue is found in an article by the Hon. Miguel Cuaderno, Governor of the Central Bank, published in the last issue of the *Journal of the Philippine Chamber of Commerce* from which the following quotation is taken:

> "The tax measures approved at the last session of Congress have not only been an important factor in arresting the resurging tide of inflation, but have also greatly improved the financial position of the Government... The net income of the National Government for the current year will probably be around ₱536.8 million... This estimated income of ₱536.8 million should be sufficient to cover disbursements authorized in the budget for ordinary, extraordinary, and fixed expenditures of ₱441.9 million, as well as a good portion of the funds needed for the E. C. A. counterpart funds, for public works, and for the payment of short term obligations of the Government."

From Governor Cuaderno's statements and with the prospect that tax collections from all sources will be still greater in 1952, it would appear that government finances could very well stand a relaxation in collections under the exchange tax, and that purchases of exchange to cover repatriation of capital, remittance of profits from foreign investment, and the transfer of proceeds of liquidation when foreigners are retiring from the country could be excluded from tax obligation. None of these transfers could be looked upon as flight of capital from the country.

SUMMARY

1. A reduction of imports was the purpose behind the suggestion of the Bell Mission that an import tax, or an excise tax, or an exchange tax be levied on imports.

2. Two other tax measures to achieve this purpose were suggested by the Bell Mission in preference to an exchange tax.

3. It does not appear to have been the intention of the Bell Mission that an exchange tax, if adopted, be applied to remittable profits from business financed from abroad, or to remittable proceeds from general investments by foreigners, or to remittances which would normally be made by foreign citizens employed in the Philippines.

4. No evidence is available that the United States Congress expressed a preference for an exchange tax over other measures suggested in the Bell Report for curtailment of imports.

5. It has not been confirmed that the United States Congress advocated or expressed views favoring the application of an exchange tax to profits or dividends from business investments or to remittances normally made by citizens of other countries employed in the Philippines.

6. Remittances for purposes expressed in "3" above should be readily distinguishable from remittances which represent flight of capital from the country.

7. The exchange tax operates to set up a penalty against American-owned business, investments from American sources, and American citizens employed in the Philippines.

8. Collections under the exchange tax have exceeded the goal which the authors had in mind and therefore the improved condition of the government finances would permit of an amendment to the exchange tax law as indicated.

Statement on Gold*

By the International Monetary Fund

THE Executive Board of the International Monetary Fund published the following statement on September 28:

"In June, 1947, the Fund issued a statement recommending to its members that they take effective action to prevent external transactions in gold at premium prices, because such transactions tend to undermine exchange stability and to impair monetary reserves. From time to time the Fund has reviewed its recommendations and the effectiveness of the action taken by its members.

"Despite the improvement in the payments positions of many members, sound gold and exchange policy of members continues to require that, to the maximum extent practicable, gold should be held in official reserves rather than go into private hoards. It is only as gold is held in official reserves that it can be used by the monetary authorities to maintain exchange rates and meet balance of payments needs.

"However, the Fund's continuous study of the situation in gold producing and consuming countries shows that their positions vary so widely as to make it impracticable to expect all members to take uniform measures in order to achieve the objectives of the premium gold statement. Accordingly, while the Fund reaffirms its belief in the economic principles involved and urges the members to support them, the Fund leaves to its members the practical operating decisions involved in their implementation, subject to the provisions of Article IV, Section 2 and other relevant articles of the Articles of Agreement of the International Monetary Fund.

"The Fund will continue to collect full information about gold transactions, will watch carefully developments in this field, and will be prepared in consultation with members to consider problems relating to exchange stability and any other problems which may arise."

In communicating this statement to the press, Mr. Rooth, the Managing Director, recalled the background of the original statement on premium gold transactions. In June, 1947, the initial par values of Fund members had only been recently agreed and were not yet tested under postwar conditions. Total dollar receipts from exports to the United States were running at a rate of about $5,500,000,000 a year. Monetary reserves outside the United States were declining rapidly. The payments difficulties that led to the Marshall plan were already visible. In these circumstances the Fund's statement helped to focus the attention of members on the dangers of an unrestricted flow of gold into hoards and was useful in limiting the supply of gold to premium markets. As world economic conditions improved in late 1949 and 1950, the flow of gold into hoards tended in fact to subside. Since the outbreak of the Korean war, however, it has again become larger.

Mr. Rooth pointed out that, in studying premium sales of gold and the drain on reserves caused by the absorption of gold into private hoards, the Fund has found that, to reduce materially the volume of gold transactions at premium prices, many members would have to institute much more rigorous controls than they now have. Moreover, the positions of different countries vary so widely that it would be impracticable to expect all members to take uniform measures to make the 1947 gold statement effective. The new statement, therefore, affirms the Fund's belief that to the maximum extent practicable gold should be held in official reserves rather than go into private hoards. The Fund urges its members to support this view. It is left to members, however, to decide the practical operating measures that they will take. Each member will be the judge of just how and to what extent it will implement this statement.

With the new statement, members are not bound to any particular procedure for handling their external transactions in gold. They are not limited to the sale of any specific amount of gold or to any particular proportion of their newly-mined production. Probably gold will now be sold by some countries that did not engage in such operations before. Other countries may continue to sell the same amounts that they did before. And some countries may even reduce the amounts they had previously been selling.

Mr. Rooth concluded with two observations on the Fund's experience with the gold statement of 1947: First, controls as such can have only a limited effect unless they are reinforced by appropriate economic policies. In a period of acute difficulty, the imposition of strong controls to prevent premium gold transactions can be justified. But as time goes on and means of evasion and avoidance are devised, the controls gradually lose their effectiveness. When this happens, the controls cannot be made to work by asking countries to impose more and more onerous restrictions.

Second, the only dependable way for getting rid of premium gold markets and private hoarding of gold is to create the economic conditions under which the private demand for gold will become negligible. In some countries, where gold is hoarded as a matter of tradition, the development of strong banks and sound financial institutions will encourage people to hold more of their savings in banks or securities or invest them in productive enterprises. In every country, the best way to reduce the demand for gold for private hoards is to follow budget and credit policies that will give people confidence in their currency. Nobody can have a good reason for hoarding gold or paying a premium for gold in a country in which the currency will remain stable in internal and external value.

*From the *International Financial News Survey*, October 5, 1951.