

Implementing PERA, the Philippine's Personal Equity and Retirement Account

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Preface

This report summarizes the results of work conducted in the role of a short-term pension policy advisor to the Philippine government. This technical assistance on PERA reform issues is being provided through the USAID-funded AGILE project. The first section of the report contains comments on the tax-revenue effects of alternative PERA reforms. These comments are based on quantitative estimates produced by an updated version of PERATAX, which is a microsimulation model of individual income tax and PERA policy and behavior that utilizes as its database the 1997 Family Income and Expenditure Survey. The main focus of the report is a discussion of various implementation issues that will arise after a PERA reform is passed into law. The purpose of the second section of the report is to identify implementation and administration issues raised by the current House version of the PERA bill, which was introduced on February 27, 2002. In addition to identifying issues, the discussion makes suggestions about how to approach several regulatory and tax administrative issues.

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Foreword: Words of Optimism

This foreword was written after the rest of the report was composed. After considering the implications of our tax revenue and economic growth analysis, and after documenting the tax administration difficulties involved in implementing PERA, it is appropriate to begin with an overall assessment of the PERA reform's prospects. It is possible to be pessimistic about the merits of PERA, but it is also possible to be optimistic. I outline the grounds for pessimism and then make the more optimistic case for PERA.

During 1999, when I was last in the Philippines to offer advice on pension reform, the PERA bill was part of a broader agenda to reform the Philippine retirement income system. PERA made sense in that context because other elements of the reform agenda were going to establish a strong mandatory pension system. But none of those other reforms have been implemented and little, if any, progress has been made in solving long-standing tax compliance issues. It could be argued that establishing a voluntary, tax-favored individual retirement account without first establishing a sound mandatory pension system and a sound tax administration system, is like skipping the nutritious meal and eating only the dessert. Most other countries have introduced a voluntary, tax-favored individual retirement account after ensuring that its mandatory pension system was adequate and sound and that its tax administration system was efficient enough to administer voluntary individual retirement accounts.

But the situation of the Philippines is such that this conventional perspective may be too pessimistic. The Philippines has a set of mandatory pension programs, including both public-sector retirement programs and private-sector occupational pension plans. The single biggest problem with the public-sector programs is that they have been run in a way that generates an enormous amount of political risk for participants. This risk arises from political pressure to invest program funds at below-market rates, which produces meager returns on program contributions. This has happened with Pag-IBIG, for example, and the consequences of that program's insolvency are being dealt with through the new securitization bill, which will allow Pag-IBIG to sell off its below-market-rate home mortgages in order to raise funds for participant withdrawals. A more positive view of the PERA reform effort is that providing individuals with the opportunity to make investment decisions on their own behalf will eventually create a public demand for better administration by politicians of public-sector programs that make collective retirement investments for the program participants. In other words, the introduction of individually managed retirement accounts could set in motion a political reform process that would lead to better management of public-sector pensions.

At the very beginning of the current mission I was more pessimistic than I am now at the end of the mission. Over the course of the mission, I found that high-level people in both the public and private sectors were open to advice about how to improve the PERA bill, and in many instances the advice has been taken and the bill has been changed for the better. And the bill appears to have substantial political support from the President, the Secretary of Finance, Senators, Representatives, and prominent private-sector actors. My

experience shows that these high-level policy people are flexible about adopting new approaches to PERA, but that there are two main impediments at the technical level.

The first of these impediments is that DOF does not have the capability of estimating the likely volume of PERA contributions, and hence, the likely cost of PERA in foregone tax revenues. This shortcoming is caused by the lack of saving data in the spreadsheet model used by DOF, which forces DOF to estimate revenue loss under the extremely unrealistic assumption that every income tax filer makes the maximum allowable contribution, which is 25 percent of income. This lack of capability hinders the discussion among policy-makers of different approaches to providing tax-favored treatment of PERA contributions because they are told by DOF that the tax losses are quite large, when less extreme assumptions about the volume of contributions produce much more modest tax revenue loss estimates. One solution to this problem would be to update the PERATAX microsimulation model (see below) so that it uses data from the Family Income and Expenditure Survey for 2000 rather than for 1997, and train DOF staff and others in Manila how to use the model and how to modify it as the focus of the policy debate evolves.

The second of these two main technical impediments is that Bureau of Internal Revenue will have difficulty implementing and administering a PERA law. Doing this will require computerization, but that agency does not have a good track record with computerization. The earlier problems appear to have been caused by the fact that the database system development was conducted by an outside contractor with insufficient cooperation with internal staff. My experience over the past few years with the Yemen civil-service pension indicates that a relatively small, sensibly structured group of qualified internal staff focused solely on developing a system to administer PERA would have a high likelihood of success. Such an approach to PERA implementation and administration would create an “island of innovation” at the Bureau, which could provide an example of how the new Commissioner could accelerate the pace of innovation at the Bureau.

Comments on PERA Tax-Revenue Effects

Although PERA implementation issues are the main focus of this report, it will be to update the tax revenue estimates developed during our earlier technical assistance mission during late 1999. Such an update is useful because the nature of the current PERA proposal differs substantially from proposals being discussed in 1999. Also, an analysis of tax revenue effects, and the pressures this issue has placed on the design of the current PERA proposal, provides an introduction to a number of implementation and administrative issues that must be addressed after the proposal becomes law. In this section of the report, we (1) describe the current PERA reform proposal, contrasting it to those being discussed two years ago, (2) present estimates of the first-year loss in income tax revenues caused by PERA, (3) present estimates of the PERA-induced growth in labor earnings that needs to occur in the longer-term for PERA to be revenue neutral, and (4) critique the longer-term revenue analysis conducted recently by a research fellow of

the Philippine Institute of Development Studies (PIDS).

Characteristics of Current PERA Proposal

The current PERA reform proposal described here is based on the bill that was presented on February 27, 2002, during a public hearing of the House Committee on Economic Affairs. During that hearing the Committee requested comments on the PIDS analysis of the longer-term tax-revenue effects of PERA from the Department of Finance (DOF), and requested comments on implementing rules and regulations from a group of agencies that regulate the financial institutions that would offer PERAs to the public (BSP, SEC, OIC) and from the Bureau of Internal Revenue (BIR), the agency that would administer the tax aspects of PERA.

The bill calls for the establishment of individual retirement accounts that would receive favorable tax treatment in order to encourage more private saving for retirement. An important secondary objective of the PERA reform is to induce capital-market innovation through competition among financial institutions trying to attract savers to open PERAs. PERA contributions would be completely deductible under the income tax, but subject to a flat five percent tax (the DOF advocates a flat 15 percent tax) on contributions. All PERA investment earnings are to be tax exempt. All withdrawals are to be excluded from income taxation, while early withdrawals, defined as those made before age fifty, may be subject to penalty, the level of which is to be established by DOF. In the parlance of tax analysis, this tax treatment of PERA cash flows may be characterized as tEE, with the t being lower case to represent the partial taxation of contributions, the middle capital E representing the complete tax exemption of investment earnings, and the final capital E representing the complete tax exemption of withdrawals. This tax treatment differs from the most common international practice (EET) primarily because of DOF concerns about short-run revenue loss.

PERA contributions for each person would be limited to 25 percent of that person's annual income up to 200,000 pesos, which implies a maximum annual contribution of 50,000 pesos per person. Even though the contribution limit is expressed in terms of annual income, there is no assurance that the contributions represents new saving. In fact, there is every reason to believe, based on international experience, that most of the PERA contributions, except perhaps those from the lowest income contributors, will represent what might be called old saving: either savings from prior years or current saving that would have been done without the PERA tax incentives.

The current PERA bill is more generous in its tax treatment than the proposals that were being discussed in late 1999. For example, in 1999 the contribution percentage was 15 percent of wage and salary income up to a limit of about 100,000 pesos, which implies a maximum annual contribution of 15,000 pesos. The most common tax treatment of contributions discussed in 1999 was that they were not deductible, but would produce a 15 percent non-refundable income-tax credit. Given these significant shifts in the tax treatment of contributions, it is important to revisit the issue of tax-revenue effects.

Estimates of First-Year Tax-Revenue Loss

The income-tax revenue losses of the favorable tax treatment of PERA contributions is estimated using an updated version of PERATAX, a policy simulation model that was originally developed during our 1999 technical assistance mission. PERATAX is a microsimulation model of individual income tax and PERA policy and behavior that utilizes as its database the 1997 Family Income and Expenditure Survey.¹ The database has been aged to represent the population and its earnings in 1998. The model's assumed tax filing behavior has been specified so that the total income tax revenue and number of returns approximate actual 1998 revenues and returns. The estimates reported here assume that the top tax rate is 32 percent, which is down from the 34 percent that was in effect during 1998.

The standard set of assumptions concerning PERA contribution behavior is the same as Set B used in the 1999 analysis: members of families that save less than fifteen percent of income are assumed to never make a PERA contribution, members of families that save thirty percent or more of their annual income are assumed to always make a PERA contribution, and members of families that save between fifteen and thirty percent of their income are assumed to make a PERA contribution with a probability that rises from zero to one steadily over this 15-30 range of saving rates. Those who are simulated to make a PERA contribution are assumed to contribute a share of their income that equals their saving rate minus fifteen percent, subject to the 25 percent contribution rate maximum. The reason we assume that not all of annual saving will be contributed to the PERA is that families save for many shorter-term reasons than retirement. They save in order to have a cushion against income fluctuations and unexpected expenses, they save to buy a house, they save for their children's educational expenses, etc. It is not reasonable to expect that all saving will be funneled into a PERA because it is for longer-term, retirement saving, and there will be penalties for early withdrawal. This set of assumptions assumes that the first fifteen percentage points of saving are devoted to shorter-term, non-retirement objectives, and that only saving in excess of fifteen percent of income is undertaken for longer-term objectives, and therefore, may be considered retirement saving. All this means that this set of assumptions assumes that no new retirement saving is undertaken in response to the introduction of PERA incentives, and therefore, we call this the "same-saving" behavioral assumption set.

Estimates of first-year losses in income tax revenues are produced for two policy assumptions and two behavioral assumptions. The two policy assumptions differ only in the flat tax rate on PERA contributions: 5% (as in the House bill) and 15% (the DOF position). The two behavioral assumptions are the standard set of assumptions described in the prior paragraph and an alternative set of assumptions that assume an enormous amount of new saving in response to the PERA tax incentives.

1 For a detailed description of the Family Income and Expenditure Survey and the PERATAX simulation model, see Martin R. Holmer, *Estimating the Consequences of Philippine Pension Reform*, Washington, DC: Policy Simulation Group, October 1999. <<http://www.polsim.com/PERA/rep99oct.pdf>>

In this alternative set of behavioral assumptions, members of families who have positive saving rates always make a PERA contribution and they are all assumed to contribute at the maximum allowable rate, which is 25 percent, even if their pre-PERA saving rate is less than 25 percent. This means that under the alternative set of assumptions people are assumed to increase the rate of saving for retirement by an unrealistically large amount in response to the PERA tax incentives, and therefore, we call this the “maximum-saving” behavioral assumption set.

Given the set of assumptions concerning tax filing and income reporting behavior that were developed in 1999, PERATAX produces estimates of 2.265 million returns in 1998 with a total income tax liability of 50.941 billion pesos. This is somewhat below the actual 1998 revenues because we have reduced the top tax rate from its 1998 value of 34 percent to its current value of 32 percent.

The following table contains estimates of the 1998 first-year income tax revenue losses:

<i>Contribution Behavior:</i>	<i>... same-saving ...</i>		<i>... max.-saving ...</i>	
<i>Contribution Tax Rate:</i>	<i>5%</i>	<i>15%</i>	<i>5%</i>	<i>15%</i>
PERA contributions (bP 1998)	34.0	34.0	78.4	78.4
PERA accounts (million)	1.7	1.7	3.2	3.2
Avg. PERA contribution (tP)	19	19	24	24
Income tax revenues (bP 1998)	47.3	49.6	43.4	48.4
Income tax revenue loss (bP)	3.6	1.3	7.5	2.5
Income tax revenue loss (%)	7.1%	2.6%	14.8%	5.0%

The revenue loss estimates shown above under the maximum-saving assumptions are quite close to those produced by a different kind of maximum-saving assumption, which assumes that some people with negative pre-PERA saving rates participate, everyone with a positive saving rate participates, and every participant has a contribution rate that is fifteen percent higher than the participant's pre-PERA saving rate, subject to the 25 percent maximum contribution rate.

How do these 1998 PERATAX estimates compare with the income tax revenue loss estimates produced by DOF? A briefing by DOF staff on their aggregate spreadsheet modeling methodology and an examination of the DOF spreadsheets that produce the official PERA estimates reveals that DOF does not have the technical capability of producing estimates under the same-saving assumptions, but can produce estimates of income tax revenue loss under the highly unrealistic maximum-saving assumptions used as the extreme case in our analysis. Assuming a 15 percent tax rate on PERA contributions, the DOF model produces an estimate of income tax revenue loss in 2000 of 3.06 billion pesos, which is 21 percent higher than our estimate of 2.532 billion 1998 pesos, which is rounded to 2.5 in the table above. Given two years of income growth and the bracket creep caused by the non-indexed income brackets in the income tax, these two estimates are remarkably close, particularly if one considers the very different methodologies being employed in the two models. This comparison of the model estimates suggests that the 1998 estimates shown above can be converted into 2000

estimates by simply scaling them up by about twenty percent.

The estimates shown in the table above underscore the significance of the tax rate on PERA contributions. The five percent tax rate in the House bill produces a substantially higher revenue loss than does the fifteen percent tax rate favored by DOF. And the additional lost revenue caused by the reduction from fifteen to five percent grows as people respond to the PERA tax incentives and save more. The loss estimates above are in 1998 pesos and do not include the lost final-withholding revenues from the exemption of PERA investment returns from all taxation. Another conclusion is that there will be a substantial revenue loss, the size depending on the contribution tax rate, even if the PERA incentives induce no new savings, and therefore, do not generate any acceleration in the rate of economic growth.

Considering a Tax Credit Rather Than a Tax Deduction

The House bill calls for the complete deductibility of PERA contributions combined with a flat 5 percent tax on the contribution. We have seen that this tax treatment of PERA contributions results in a very large first-year income-tax revenue loss with little prospect for revenue neutrality in the longer run. Until recently the DOF position was complete deductibility combined with a 15 percent flat tax on contributions. While such a position limited the initial tax loss to a manageable amount, it has generated criticism that the tax treatment provides little or no financial incentive for those in or below the fifteen percent marginal tax bracket. There is a simple way to respond to this legitimate criticism by dropping the deductibility-with-flat-tax approach and substituting in its place a simple tax credit. Rather than reducing taxable income as does a deduction, a credit reduces tax liability directly. For example, a five percent tax credit on contributions would imply that a twenty thousand peso contribution would reduce the amount of tax owed by one thousand pesos. If the tax credit was no refundable, then the tax credit, no matter how large, could never reduce tax liability below zero.

What rate should be set for a non-refundable tax credit on PERA contributions if our objective is to have a first-year income-tax revenue loss that is appropriately equal to that generated by the deductibility-with-flat-fifteen-percent-tax policy? As described above, both the DOF spreadsheet model and our microsimulation model agree the the tax loss is about 3.0 billion 2000 pesos, or about 2.5 billion 1998 pesos under the maximum-saving assumptions. What tax credit rate would generate a first-year income-tax revenue loss of about this same amount using the more realistic same-saving assumption concerning PERA contribution behavior? Results from the PERATAX microsimulation model indicate that, under the same-saving assumptions, a ten percent tax credit on contributions produces a first-year income-tax revenue loss of about 2.6 billion 1998 pesos, which is roughly equivalent to 3.1 billion 2000 pesos, the DOF estimate for the deductibility-with-flat-fifteen-percent-tax policy.

Estimates of Longer-Run Tax-Revenue Effects

The PERATAX model is not a dynamic macroeconomic model, so it cannot estimate the

longer-run tax-revenue effects of PERA in a direct manner. It is possible, however, to estimate how much earnings would have to grow in order for income tax revenues to rise back to their pre-PERA level. The growth in earnings required to achieve income-tax revenue neutrality provides another measure of the magnitude of the first-year revenue loss. After presenting these estimates of the longer-run income-tax-revenue effects of PERA, we discuss the recent longer-run revenue estimates produced using the PIDS dynamic macroeconomic model.

The growth in earnings required for income-tax revenue neutrality ranges from 1.9 percent in the case of same-saving behavior with a 15 percent tax rate on contributions, on the one hand, to 8.1 percent in the case of maximum-saving behavior with a 5 percent tax rate on contributions, on the other hand. The other two cases presented in the table on page 4 fall in between these two extremes. While having earnings be 1.9 percent higher than in the pre-PERA situation is not much of an increase, it is not clear how even this modest increase can be achieved because, by assumption, there is no new saving in this case. It is unclear how the rate of growth in earnings will increase without any new saving. In the other extreme case, 21.1 billion pesos of new saving is assumed to be elicited by the PERA tax incentives, which causes the first-year revenue loss to be 7.5 billion pesos under the 5 percent contribution tax rate policy. In this case, the government will have to borrow an additional 7.5 billion pesos to replace the lost revenue, leaving 13.6 billion pesos available for productive investment. The central question is whether an additional 13.6 billion pesos of saving can produce in the long run an increase in earnings of 8.1 percent.

According to the Family Income and Expenditure Survey data used in the PERATAX model, total family saving in 1998 was 77.4 billion pesos, but national saving was certainly much larger because family saving does not include saving by corporate businesses. The 13.6 billion pesos of net new family saving represents somewhat less than an 18 percent in family saving, and a smaller percentage increase in national saving. The question now becomes whether an increase in saving of less (probably much less) than 18 percent is likely to produce an increase in investment, production, and hence, earnings as large as 8.1 percent.

We can get an approximate answer to this question by using the standard neoclassical macroeconomic growth model, developed by Solow in the 1950s, with a Cobb-Douglas production function that has a 0.3 capital coefficient.² In long-run steady state, a per capita output level 8.1 percent higher than the baseline level requires a capital-labor ratio that is 29.644 percent higher than the baseline ratio. And this increase in the capital-labor ratio requires a national saving rate that is 19.93 percent higher than the baseline national saving rate. In other words, an increase of about 20 percent in the national saving rate is required to raise per capita output (and earnings) by 8.1 percent. The maximum-saving assumptions produce an increase in the rate of national saving of less (probably much less) than 18 percent, so the PERA reform would not be revenue neutral with a 5 percent

² For an introduction to the neoclassical economic growth model, see Robert J. Barro and Xavier Sala-i-Martin, *Economic Growth*, New York, NY: McGraw-Hill, 1995.

tax on contributions. With a 15 percent contribution tax rate, and a smaller loss in tax revenue, it is more likely that the reform would be revenue neutral in the long run. But remember, this analysis ignores the non-trivial loss in tax revenue from the exemption of PERA investment earnings from all taxation. All this makes it seem unlikely that the longer-run tax revenue situation would improve all the way to revenue neutrality.

Critique of PIDS Estimate of Longer-Run Tax-Revenue Effects

How can the above conclusion be reconciled with the more optimistic conclusions of the recent PIDS analysis of the longer-run tax-revenue effects of PERA? The PIDS analysis uses the PIDS Annual Macroeconomic Model and concludes as follows:

It should be emphasized that the results are only indicative and the numerical values cannot be taken at face value. The simulation exercise merely demonstrates that the PERA can benefit pension holders without sacrificing tax revenues.³

The PIDS analysis *assumes* that the annual revenue loss from enacting PERA will be 4.0 billion pesos per year. The analysis also *assumes* that the new saving induced by PERA — an amount which is not specified in the analysis — would lower the interest rate on government debt by a substantial amount. In fact, the PIDS analysis must be implicitly assuming that the amount of new saving is quite large, and furthermore, that all the new saving will be invested in government securities, because the assumption is that the Treasury bill rate will be lowered by an 1.76 percentage points in the first year, 2.34 in the second year, 2.90 in the third year, and 3.00 percentage points in the fourth year after PERA implementation. In assuming that the new saving channeled into the government securities market will be large enough to reduce rates by these amounts, the PIDS analysis ignores that the revenue loss will increase the government deficit and require more government borrowing. There is no explanation for the statement that “the widening of the [government] deficit will impact on [that is, raise] interest rates but this channel is not taken into account in the simulation exercise.” This is a very important issue, which the PIDS analysis completely ignores.

Given these two assumptions, the macroeconomic model predicts that investment in the sixth year after PERA implementation will be 10.6 percent higher than it would have been if PERA had not generated the new saving. The simulated result of this higher investment is a 3.1 percent rise in GDP in the sixth year. The higher output results in a larger tax base, leading to revenue neutrality in the fourth year following PERA implementation.

The basic problem with the PIDS analysis is the unsupported assumption that PERA will induce enough new saving to lower interests rates by three percentage points. This is just assumed without any supporting evidence. As we saw above, the assumed 4.0 billion peso revenue loss is consistent with the assumption that no new saving is done following

³ Josef T. Yap, *A Macroeconomic Evaluation of the Proposed Personal Equity and Retirement Account (PERA)*, Manila: Philippine Institute of Development Studies, February 27, 2002, presentation to House Committee on Economic Affairs.

PERA implementation. If new saving is actually induced by PERA, then the tax revenue loss will be much larger than 4.0 billion pesos per year, as shown above.

So, while our longer-term revenue-effect analysis suggests that a PERA policy that taxes contributions at 15 percent may come close to being revenue neutral in the future, the PIDS analysis provides no credible evidence on the issue of revenue neutrality in the future. It is simply an exercise in spinning out the implications of several unsupported assumptions, and therefore, by its own admission is “only indicative and the numerical values cannot be taken at face value.”

Discussion of PERA Implementation and Administrative Issues

The second section of this report discusses a number of regulatory and tax administration issues that must be addressed in order to implement PERA after it becomes law. Some of these issues are particularly difficult to handle in the present Philippine regulatory and tax environment. The discussion here is based on the PERA bill introduced on February 27, 2002, by the House Committee on Economic Affairs, and on the full-day discussion of this bill by an inter-agency group with representatives from the BSP, SEC, OIC, and BIR, which took place on Friday, March 1, at the request of the House Committee. The discussion of each set of topics introduces the issues, describes how other countries have handled the issues, and sometimes suggests approaches that might work in the current Philippine situation. It must be said at the outset that international best practices are not always feasible in the current Philippine situation. Even though international best practice might not always be feasible in the Philippines, the experience of other countries will be useful in identifying an approach that best fits the Philippine situation.

This section contains five subsections, the first two of which discuss the regulation of PERA administrators and financial products, and the last three of which focus on tax administration issues. In all of these topical areas, we focus on the relationship between five PERA groups: (1) participants, the people who participate in the PERA program by establishing an individual retirement account; (2) administrators, the financial institutions that offer the accounts to participants; (3) employers, the organizations for which participants work, which is the same as the participant in the case of the self-employed; (4) BIR, the tax administration authority of the government; and (5) regulators, the government agencies that regulate the financial institutions that are PERA administrators. Sometimes there are peripheral groups, but most PERA implementation issues involve specifying relationships between these five main groups.

Common Regulation of PERA Administrators

In this subsection, we discuss four topics: (1) the need for consistent regulation of administrators, (2) the difference between an administrator and investment manager, (3) the difference between an administrator and custodian, and (4) regulation of the maximum allowable account administrative costs.

Common Regulation of Administrators

It is essential for the PERA business of each kind of financial institution that is a PERA administrator to be subject to a common regulatory regime. Otherwise, the PERA marketplace is not a level playing field with some administrators having advantages over other administrators. A level playing field is required if there is any hope that PERA will stimulate genuine innovation in the offering of financial products to the public.

A common PERA regulatory regime does not require a separate PERA regulatory agency. Other countries routinely establish a common regulatory regime through cooperation among the existing regulators of different kinds of financial institutions. For example, the Hong Kong mandatory provident fund, which is not centrally administered, has set up its administrator regulation in this way. And the United States handles individual retirement account (IRA) administrator regulation in this way.

The meeting of Philippine regulatory agencies on Friday, March 1, was cooperative and productive, indicating that such a cooperative approach to regulating PERA administrators can work.

Administrator versus Investment Manager

It is essential for participants to have one point of contact concerning their accounts. Otherwise, the confusion and time wasted by dealing with several institutions will mean fewer people will establish accounts. The House bill provides for that single point of contact by establishing the role of the PERA administrator. But the bill also talks about investment managers and custodians. The inter-agency regulatory group discussed the relationships between these three at length, and arrived at a sensible position, which I describe here and in the following discussion of administrators and custodians.

It is not clear why the role of the investment manager is specified in the House bill because international practice is for individual retirement accounts to be self-directed, meaning that the participant makes decisions about how to invest account funds. If it is thought that many participants will not be able to make informed decisions about which financial products to buy for their account, then requiring administrators to offer a standard set of easy-to-understand products would be a simpler way to address this issue. The need for a list of required financial products that must be offered by each administrator is discussed in more detail in the next subsection.

If the investment manager role is retained in the PERA law, it should be clear that the investment manager *is* an administrator, with all the duties and responsibilities of a PERA administrator. In addition, an administrator who is an investment manager handling non-self-directed accounts, should be considered under the law as having the full range of fiduciary responsibilities towards the participant whose PERA funds are being managed.

Administrator versus Custodian

While it may be good idea to require some separation in duties between the administrator and the custodian, this division of responsibility should be invisible to the participant in

order to avoid the confusion and time costs involved with multiple points of contact.

The key issue here is whether or not administrators will be allowed to set up separate custodial divisions within their institutions or whether they will be forced to buy custodial services from a separate institution. The latter option may seem to offer more protection to the participant, but it may entail higher administrative costs, which is not in the interest of participants.

Administrative Costs of Accounts

The House bill specifies that the DOF secretary will establish maximum administrative cost levels for the accounts. I am not aware of any country that does this. The standard practice is to let the competition among administrators for participants determine the annual administrative fees charged for the accounts. Although it must be said that despite this competition, one of the more common problems with individual retirement accounts experienced by other countries, both developed and developing, is that the administrative costs of the accounts are very high, and often so high that much of the investment earnings on small accounts are siphoned off in administrative fees rather than increasing the participant's account balance.

International experience shows that the only effective way to reduce administrative costs is to require a simple individual account program, with centralized record-keeping and a limited set of financial products. These issues were discussed in our prior report⁴ and they are central to the debate in the United States concerning transforming part of social security into an individual account.

It is an illusion to think that the problem of high administrative costs can be solved by simply instructing the DOF secretary to establish limits on administrative costs. If the limit is set above the cost of actually administering an account, then there is no effective limitation. If the limit is set below cost, then administrators will not offer accounts, or worse yet they will recover losses incurred in account administration by building high fees into their PERA financial products.

The only effective way to ensure reasonable administrative costs is to design a simple account program, far simpler than that specified in the current House bill, and then let competition between the administrators hold down administrative fees close to the actual cost of administering an account.

Common Regulation of PERA Financial Products

This subsection discusses regulations concerning the financial products offered to PERA participants by PERA administrators.

Need for List of Permitted Financial Products

There is a need, and the House bill provides, a list of financial products that can be offered by administrators to participants. Having such a list of permitted products is

⁴ See Martin R. Holmer, *Estimating the Consequences of Philippine Pension Reform*, Washington, DC: Policy Simulation Group, October 1999. <<http://www.polsim.com/PERA/rep99oct.pdf>>

good, but the list includes some products that are not well defined, namely “annuity contracts” and “pre-need pension plans.” Section 7(h) of the House bill provides for the DOF secretary to approve financial products not listed in Sections 7(a)-7(g) as long as the “concerned regulator may allow [them] by rule.” But there appears to be a loophole in that ill-defined “annuity contracts” and “pre-need pension plans” are explicitly permitted.

There is a need to specify a procedure by which these ill-defined financial products would be reviewed for approval before they become permitted PERA financial products. If these “annuity contracts” and “pre-need pension plans” require the participant to make annual payments, they would not be appropriate for accounts because a participant might not have any earnings in a particular year, and therefore, would be legally barred from making an account contributions that year. If the participant had no other account funds to pay the annual payment required by the annuity contract or pre-need pension plan, the participant would lose the accumulated pension rights. This is a highly undesirable situation, one that should be avoided in any individual retirement account.

Need for List of Required Financial Products

Even more important than a list of permitted products, it is essential to have a list of financial products that every PERA administrator *must* offer participants.

This list of required products would include a liquid, sweep-account investment, like the money-market mutual funds available to all IRA participants in the United States. This product serves as repository for all PERA funds not invested in other products. For example, when interest is paid to a participant, the interest would be automatically placed in the money-market fund to earn interest while the participant decides how to invest the funds. If such an investment product does not exist in the Philippines, then it will be created if it is required to be offered by PERA administrators. The creation of such money-market mutual funds would be an example of the capital-market innovation that is an important secondary objective of the PERA reform.

In addition to the money-market mutual-fund product, the list of required PERA financial products should include several very simple to understand products that are targeted to participants who are less experienced investors. These could be products like a certificate of deposit having a longer-term maturity appropriate for a retirement account. These required products would be standardized so that people could easily compare the offerings of different PERA administrators. Without required product standardization there will be little effective competition between administrators, and hence, limited capital-market innovation induced by the PERA reform. Standardization of required products will put pressure on professional investment managers to develop investment strategies that will allow them to offer participants high yielding standardized products.

It is far better to put professional investment managers under pressure to develop simple, easy-to-understand products that offer high yields than it is to put PERA participants under pressure to choose among complex financial products that are unfamiliar to them. The House bill provides the role of the investment manager to compensate deal with this

problem, but this is expensive in terms of administrative costs and does nothing to induce capital-market innovation.

Tax Administration of PERA Contributions

This subsection is the first of three that discusses the tax administration issues raised by the House PERA bill. Here we focus on issues related to opening a new account and administering the tax-favored annual contribution to the account. Subsequent subsections focus on administering the tax exemption on PERA investment earnings and on handling account withdrawals.

Opening an Account

The House bill specifies that opening a PERA account requires a person be of legal age, have a TIN (that is, a tax identification number), and be currently “earning an income.” Rules and regulations must be developed to facilitate the checking of these requirements by the PERA administrator. And just as important, there is a need to develop a system by which the administrator reports to BIR the creation of the new account. These two issues are discussed in turn.

It became clear during the inter-agency group meeting on Friday, March 1, that BIR *must* administer PERA with a fully computerized relational database management system (like Oracle or Sybase), and that any attempt to administer the tax aspects of PERA using paper records is doomed to failure. This BIR database would include the basic relationship between the TIN and the PERA account id number, which we call here AID. This PERA database would also contain the name and age of the person associated with the TIN. The database would include everyone who has a PIN, even though they have not been assigned an AID. A copy of this database would be made accessible to account administrators via the Internet, just as the Philippines customs database is accessible via the Internet. When a prospective PERA participant wanted to open an account, the administrator would query the database to verify the name, age, and TIN supplied by the person, and to verify that an account had not already been opened for this TIN. The only thing left for the administrator to verify is that the person is currently “earning an income.” Wage and salary workers would be required to present a recent pay slip to verify that they are currently employed. The self-employed would be required to present an income tax return for the prior year.

Once this information had been verified, the administrator would then query the online BIR database for the AID. This transaction provides the administrator with the PERA account id number (AID), permitting quick activation of the account, and provides BIR with the information it needs to ensure that only one account is opened for each person with a TIN. This information will also allow BIR to determine whether or not every person opening a PERA actually reported income for the year during which the account was opened.

Making a Contribution

The main tax administration issues related to PERA contributions are how to ensure that

the contribution is not larger than allowed by law and how to deliver the tax refund to the participant. We discuss these two issues in turn.

When a participant makes a PERA contribution, the size of that annual contribution must be compared with the maximum allowable by law, which is the lesser of 25 percent of income and 50,000 pesos. One strategy would be to do no checking at the time of the contribution and have BIR check the contribution against reported income on the income tax return for that year. This approach is not likely to work well because of the several year lag in processing tax returns. While this approach serves as the ultimate check, it might be desirable to require the PERA administrator to ask for the most recent income tax return when the contribution is made. This procedure would be likely to catch gross inconsistencies between actual account contributions and the maximum allowable under law.

The more difficult issue is how to deliver the tax refund due to the participant who makes a contribution. The standard practice in other countries is for a person making a contribution to declare it as an income tax deduction, and then receive the refund a few months later as a tax refund. Given that BIR takes several years to refund excessive tax withholding, this approach is not likely to be effective in the Philippines. The following procedure would provide more of an incentive to contribute to an account. The deduction on the contribution translates into a reduction in tax liability, the size of which varies by the marginal income tax rate of the participant. This reduction in tax liability could be delivered by means of a temporary reduction in the amount withheld by the employer of the participant. This reduction in withholding would be done by the employer upon being presented with a form issued by the PERA administrator that shows the amount of the contribution. The administrator would also report the annual contribution amount to BIR. At the time of the contribution, the PERA administrator would collect the tax on the contribution. The inter-agency group that meet on Friday, March 1, felt this procedure would be the best of many options because it would provide refunds in a timely fashion and it would ensure the collection, even from the self-employed who are not subject to withholding, of the tax on the contribution.

Tax Administration of PERA Investment Earnings

This is a particularly complex issue because of the Philippine reliance on an array of taxes other than the income tax to collect taxes on investment earnings. Other countries with tax-favored, individual accounts tax investment earnings as part of a reasonably efficient income tax system. We discuss these issues first for direct investments and then for pooled investments such as mutual funds.

Tax Exemption of Direct Investments

The situation in which a PERA participant purchases a stock or bond is no different than when an occupational pension plan makes the same kind of purchase. In both cases, these securities should be exempt from taxation. BIR has been exempting investments of pension plans for years, so the only difference with PERA is that the number of exempt

accounts will be much larger than the number of occupational pensions. Here again, the only way this can work efficiently is for BIR to maintain a database system with account id numbers (AID) that can be accessed via the Internet by those charged with withholding investment earnings. In this way, the investments, which would be identified as being for a specific AID, could be verified to be tax exempt by simply checking for the validity of the AID in the BIR database.

One ambiguity in the House bill is the range of taxes from which the investment earnings are exempt. Does this include the documentary stamp tax, the one-half of one percent stock transaction tax? If so, then institutions that withhold those taxes will have to make the same distinction between investments from PERA accounts and other investments.

Tax Exemption of Pooled Investments

When a PERA participant invests in a mutual fund, the mutual fund pools the funds of that participant with the funds of many other people and purchases primary securities with those pooled funds. If a mutual fund contains a mixture of PERA and non-PERA funds, there is no effective way for the primary security withholding agents to know what fraction of the investment earnings are exempt from the withholding. It appears as if the only practical way around this problem is to require PERA participants to buy into mutual funds and other pooled investment products only if those products accept PERA funds exclusively. In other words, the unusual nature of the Philippine tax system seems to require that mutual funds and other pooled products be specialized into serving the non-PERA market or the PERA market, and not mingling funds from both markets. This is not ideal from the capital-markets development approach because the mutual funds and other pooled products will not be able to exploit the economies of scale available if they had been able to accept funds from both the PERA and non-PERA market segments.

Tax Administration of PERA Withdrawals

The tax administration issues related to withdrawals are relatively simple in comparison to the issues discussed above. Withdrawals after retirement, defined as age fifty in the House bill, are not subject to taxation, but early withdrawals may be subject to early withdrawal penalties. Most other countries with tax-favored individual accounts impose early withdrawal penalties, and these penalties are collected out of the withdrawal by the account administrator, who then transfers the withheld penalty to the government tax authority. This seems like a sensible approach for the Philippines. Many of the financial institutions who will be PERA administrators are already withholding agents for BIR, so this will not be a new role for them. This appears to be a rare instance where the Philippines can easily implement an international best practice.