THE EXPERIENCE OF THE PHILIPPINES IN TAXING ITS NONRESIDENT CITIZENS

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I. INTRODUCTION

Whether a less developed country should tax the income of its citizens who reside abroad has been the subject of at least four international conferences since 1975.[1] This attention is attributable to Professor Jagdish Bhagwati of Columbia University, who has written extensively about the "brain drain": the large-scale movement of skilled labor from less developed countries (hereinafter LDCs) to developed countries (hereinafter DCs).[2] Professor Bhagwati has proposed a

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1. These conferences include: Brain Drain and Income Taxation, Bellagio, Italy (Feb. 15-19, 1975); United Nations Conference on Trade and Development (UNCTAD) Group of Governmental Experts on Reverse Transfer of Technology, Geneva, Switzerland (Feb. 27-Mar. 7, 1978); Fifth Session of UNCTAD, Manila, Philippines (May 7-June 2, 1979); Extending Income Tax Jurisdiction over Citizens Working Abroad, New Delhi, India (Jan. 12-15, 1981).

2. Skilled workers also migrate among DCs. Indeed, the term "brain drain" apparently made its contemporary debut in a 1962 report by the British Royal Society concerning the emigration of scientists and engineers from Britain to North America. CONGRESSIONAL RESEARCH SERVICE FOR SUBCOMM. ON INTERNATIONAL SECURITY AND SCIENTIFIC AFFAIRS OF THE HOUSE COMM. ON FOREIGN AFFAIRS, 93D CONG., 2D SESS., BRAIN DRAIN: A STUDY OF THE PERSISTENT ISSUE OF INTERNATIONAL SCIENTIFIC MOBILITY 1057 (Comm. Print 1974). Migration also occurs among LDCs; for example, many Filipinos work in the Middle East. UNCTAD, Case Studies in Reverse Transfer of Technology (Brain Drain); A Survey of Problems and Policies in the Philippines, U.N. Doc. TD/B/C.6/AC.4/5, at iv (1977) [hereinafter cited as Case Studies in Reverse Transfer]. Many countries also experience an internal brain drain when persons migrate from a country's less developed rural areas to its relatively more developed urban areas. *See id.* As the title of the UNCTAD document suggests, the United Nations prefers the term "reverse transfer of technology" to

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tax to transfer revenue to LDCs that experience a brain drain.[3] The Bhagwati proposal has generated considerable controversy because the brain drain raises fundamental moral and political questions about a citizen's right to self-realization and fulfillment.[4] The controversy is also fueled by a lack of consensus on the causes and effects of the brain drain.[5]

Initially, three versions of the Bhagwati proposal were discussed: a tax levied by the United Nations, a tax levied by the country of immigration (the host DC), and a tax levied by the country of emigration (the LDC). An income tax levied by an LDC on its nonresident citizens emerged from international discussion as the most feasible version.[6] This form of the Bhagwati proposal is attractive because any LDC can

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the term "brain drain." The former is thought to be more neutral in connotation because it does not prejudge the issue of whether the emigration of skilled labor is, in fact, harmful to the LDCs. For stylistic convenience only, the term "brain drain" is used in this Article.

The terms "developed countries" and "less developed countries" have no precise definitions and for purposes of this Article it is unnecessary that any be formulated. *See generally* Pomp & Oldman, *Tax Measures in Response to the Brain Drain*, 20 HARV. INT'L L. J. 1, 3 n.7 (1979).

3. *See* Bhagwati, *The United States in the Nixon Era: The End of Innocence*, 101 DAEDALUS 25, 41-44 (1972). Bhagwati's proposal was first discussed at a conference entitled Brain Drain and Income Taxation held in 1975. *See supra* note 1. Some of the papers presented at that conference were published in volume three of WORLD DEVELOPMENT and volume two of the JOURNAL OF DEVELOPMENTAL ECONOMICS. Additionally, papers were reprinted in TAXING THE BRAIN DRAIN I: A PROPOSAL (J. Bhagwati & M. Partington eds. 1976) and THE BRAIN DRAIN AND TAXATION II: THEORY AND EMPIRICAL ANALYSIS (J. Bhagwati ed. 1976). The Bhagwati proposal was also debated at UNCTAD's 1978 and 1979 meetings. *See* UNCTAD, Reverse Transfer of Technology: A Survey of its Main Features, Causes and Policy Implications, U.N. Doc. TD/B/C.6/47 (1979); UNCTAD, Technology: Development Aspects of the Reverse Transfer of Technology, U.N. Doc. TD/239 (1979). In 1981, Bhagwati's proposal was the centerpiece of a conference in New Delhi, India. *See supra* note 1. The proceedings of this conference will be published in INCOME TAXATION IN THE PRESENCE OF INTERNATIONAL PERSONAL MOBILITY (J. Wilson & J. Bhagwati eds. forthcoming 1986).

4. *See* Pomp & Oldman, *supra* note 2, at 13-15.

5. *See id.* at 15-16.

6. This version of the tax was first proposed in Pomp & Oldman, *The Brain Drain: A Tax Analysis of the Bhagwati Proposal*, 3 WORLD DEV. 751, 754-60 (1975).

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adopt it unilaterally.[7] Moreover, precedent for taxing citizens and emigrants abroad already exists. For a number of years, the United States,[8] the Philippines,[9] and, until recently, Mexico[10] have levied an income tax on the worldwide income of their citizens, both resident and nonresident. None of these countries, however, adopted this broad assertion of jurisdiction in response to the brain drain.

In contrast to the United States and the Philippines, most countries view citizenship as irrelevant for tax purposes. In these countries, residency is the relevant jurisdictional nexus.[11] In other words, residents are taxable on their worldwide income, but nonresidents are not taxable on their income from abroad even if they are citizens of the taxing country.[12] Although definitions of "resident" vary among countries, and may include persons temporarily living and working abroad, persons who have emigrated—the group most likely to constitute the brain drain—do not fall within any of the traditional definitions.[13] An LDC that relies on residency jurisdiction is therefore unlikely to tax the income earned abroad by its emigrant citizens.

An LDC that desired to implement the Bhagwati proposal could follow the precedent of the United States, the Phil-

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7. *See* Pomp & Oldman, *supra* note 2, at 25-44.

8. *See* Internal Revenue Code of 1954, Pub. L. No. 83-591, § 1, 68A Stat. 5-7 (codified as amended at 26 U.S.C. (I.R.C.) § 1 (1982)); Treas. Reg. § 1.1-1(b) (1956).

9. *See infra* Section II.

10. Effective January 1, 1981, Mexico ceased taxing the worldwide income of its nonresident citizens. *See* Massone, *The Mexican Income Tax*, 35 BULL. FOR INT'L FISCAL DOC. 389 (1981).

11. Countries that assert citizenship-jurisdiction rely on residency for taxing noncitizens. In other words, either citizenship or residence status is sufficient for taxation. Resident noncitizens are taxable on their worldwide income in the same manner as resident citizens. Once the jurisdictional nexus of residency has been severed, however, nonresident noncitizens will no longer be taxed on their income from abroad, whereas nonresident citizens will continue to be taxed on their worldwide income. Pomp & Oldman, *supra* note 2, at 28-33.

12. Nonresidents will remain taxable on income received from within the taxing country. *Id.* at 28-33. In a minority of countries, the source of income is the only jurisdictional nexus relied upon. These countries tax income from domestic sources regardless of the taxpayer's status; income from foreign sources is exempt. *Id.* at 28-29.

13. *Id.* at 30.

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ippines, and Mexico and assert jurisdiction on the basis of citizenship.[14] Before adopting such an approach, however, an LDC would have to be confident that it could administer this broad assertion of tax jurisdiction effectively.

Problems that an LDC might encounter in implementing a tax on nonresident citizens have been predicted in the theoretical literature.[15] Empirical evidence does not exist, however, to indicate whether these administrative problems would actually materialize. Neither the Philippine nor the Mexican experience in enforcing a tax on nonresidents has been studied before. Although information on the U.S. experience is available, it is of limited value[16] and not helpful in

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14. Alternatively, an LDC could adopt an idiosyncratic definition of residence, one that relies heavily on a person's prior contacts with the country. Because this approach would deviate from international practice and custom, it could undermine the acceptability of the tax. *Id.* at 31.

15. *Id.* at 39-43.

16. At the New Delhi conference, *see supra* note 1, Gary Hufbauer, a former U.S. Treasury Department Deputy Assistant Secretary for Trade and Investment Policy, reported that the United States was generally successful in administering citizenship jurisdiction. He emphasized, however, that the United States has typically provided generous exemptions for income earned abroad, which have mitigated its administrative problems by reducing the number of nonresidents subject to the income tax. For example, from 1926 to 1953, U.S. citizens abroad generally could exclude from U.S. taxable income all of their foreign earned income. From 1952 to 1976, a ceiling was placed on the exemption. From 1978 to 1981, the exemption was eliminated for many persons and was replaced with a system of special deductions to adjust for certain living expenses abroad. Starting in 1982, the United States reinstituted the exemption. Field & Greeg, *U.S. Taxation of Foreign Earned Income of Private Employees*, in ESSAYS IN INTERNATIONAL TAXATION 99 (1976). *See also* I.R.C. § 911, 913 (1976), *amended by* I.R.C. § 911 (1982).

More recently, the General Accounting Office (GAO) conducted a study of nonresident U.S. taxpayers. The GAO estimated that 61 percent of its sample of nonresident citizens did not file a U.S. tax return. Because of the limited data available to the GAO, however, this figure may be seriously overstated. The Internal Revenue Service (IRS) believes too that many U.S. citizens abroad are not filing income tax returns. J. Finch, Statement Before the Subcommittee on Commerce, Consumer and Monetary Affairs on United States Citizens Living in Foreign Countries and Not Filing Federal Income Tax Returns 2-4 (May 8, 1985) (unpublished statement available in files of NYU J. Int'l L. & Pol.) (hereinafter cited as Finch Statement). The Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations will publish hearings including the Finch Statement in Fall 1985.

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predicting the problems that an LDC might encounter.[17]

Without information about the administrative feasibility of an LDC tax, international discussion of the Bhagwati proposal has reached an impasse. Debate continues over the fairness, political, and human rights issues posed by such a tax, but these issues are neither easily resolved nor susceptible to empirical inquiry.[18] Moreover, the debate will be moot if the administrative difficulties of implementing an LDC tax prove insurmountable.

In order to gain some insight into the administrative aspects of the Bhagwati proposal, the World Bank commissioned the author to conduct a case study of the Philippine taxation of nonresident citizens. By documenting the Philippine experience, the World Bank hoped better to predict problems that other LDCs might encounter in implementing a tax on nonresident citizens. This case study provides the focus for this Article.

Section II describes the experiences of the Philippines in taxing its nonresident citizens during three time periods: before 1970, 1970-1972, and 1973 to the present. In each period, the Philippines tried a different approach to the taxation of nonresident citizens.

Analysis of these three approaches illuminates two general sets of problems. The first involves the question whether an LDC should tax nonresidents in the same manner as residents or use special rules. Prior to 1970, the Philippines taxed resident and nonresident citizens identically; since that time, however, it has applied special rules to non-

17. Most LDCs are less sophisticated than the United States in enforcing their tax systems. *See generally* READINGS ON INCOME TAX ADMINISTRATION (P. Kelley & O. Oldman eds. 1973). The inefficiency of LDCs in administering their taxes domestically suggests that attempts at asserting jurisdiction over nonresidents may pose difficult administrative problems. Moreover, LDCs may face the additional problem that many of their nonresident citizens may be emigrants who intend to become citizens of their host DCs. Emigrants may feel little pressure to comply with an LDC tax, especially if they do not anticipate returning to their LDCs. The United States is not faced with this problem on a large scale; commonly, its citizens working outside the country alternate periods abroad with periods within the United States. The awareness of taxpayers abroad that they will eventually return home is likely to offset any inclination to ignore their tax obligations.

18. *See* Pomp & Oldman, *supra* note 2, at 3-4 nn.8-9.

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residents.[19]

The second set of problems centers around the administrative difficulties of imposing a tax on persons abroad. The Philippines appears to have been markedly unsuccessful in enforcing its tax on emigrants. Noncompliance among this group is apparently widespread, and the Philippines lacks any effective response or sanctions.

Section III analyzes the implications of these problems for the Bhagwati proposal. That section proposes a possible resolution to the structural problem of designing an LDC tax suitable for nonresidents. The administrative problems of the Bhagwati proposal, by comparison, are less easily resolved. To enforce the tax equitably for all nonresidents, an LDC will need the cooperation of each host DC. The necessity of obtaining DC cooperation, however, undercuts one of the attractive features of an LDC tax—that it can be adopted unilaterally by an LDC.

Section IV poses the dilemma that Professor Bhagwati and his supporters face. If they are unable to convince the DCs to cooperate in policing an LDC tax on nonresidents, the tax will fall disproportionately on transient nonresidents. Because most of the transient nonresidents are unskilled workers, the LDCs would inevitably tax the "muscle drain" rather than the brain drain.

II. THE PHILIPPINE EXPERIENCE WITH THE TAXATION OF NONRESIDENT CITIZENS

A. *Before 1970*

The early Philippine reliance on citizenship as a basis for tax jurisdiction reflects more the country's colonial legacy from the United States than a carefully developed policy. Initially, Philippine citizens were taxed under the U.S. Revenue Act of 1913.[20] This Act, adopted shortly after ratification of

19. *See* Philippines Bureau of Internal Revenue, Revenue Memorandum Circular No. 40-71, § 1 (hereinafter cited as Bureau of Internal Revenue, Mem. Cir. No. 40-71).

20. Revenue Act of 1913, Pub. L. No. 63-16, § II(A)(1), 38 Stat. 166 (1913). Internal revenue officers of the Philippine government administered the Revenue Act of 1913 within the Philippines. The revenue collected accrued to the Philippines and not to the United States. *Id.* § II(M).

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the sixteenth amendment in the United States,[21] taxed the worldwide income of U.S. and Philippine citizens, regardless of where they lived.[22]

In 1918, the United States authorized the Philippines to adopt its own tax code.[23] Pursuant to this power and without extensive discussion or debate, the Philippines adopted a tax code based substantially upon then-existing U.S. tax law,[24] and taxed all citizens identically, regardless of their residence. Thus, early in its history, the Philippines incorporated citizenship jurisdiction into its own law following the U.S. model.

The Philippines taxed all citizens uniformly, regardless of residence until 1970. Their worldwide net incomes were subject to progressive rates that started at 5% on net incomes of up to 2,000 *pesos* and reached 70% on net incomes exceeding 500,000 *pesos*.[25]

Philippine citizens could either deduct any income taxes paid to a foreign country from gross income or credit those taxes against their Philippine income tax.[26] This option was intended to mitigate the burden of multiple taxation which can result when a taxpayer or his or her income is subject to the tax jurisdiction of more than one country. For example, both the United States and the Philippines could tax Philippine citizens working in the United States.[27] These taxpay-

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21. U.S. CONST. amend. XVI ("The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.").

22. Citizenship jurisdiction was adopted by the United States without any debate or discussion of alternatives and the Philippines hardly can be faulted for doing likewise. According to Professor Surrey, the U.S. decision was "apparently automatically made, without discussion, and apparently as an intuitive matter." Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 817 (1956).

23. Revenue Act of 1918, Pub. L. No. 65-254, § 261, 40 Stat. 1087-88 (1919).

24. *See* I. EVANGELISTA, PHILIPPINE INCOME TAX LAW 1 (1961).

25. *See* Philippines National Internal Revenue Code of 1939, §§ 21, 22, Comm. Act No. 466.

26. *Id.* § 30(c)(1)(B). Presumably, this provision was modeled after a similar one in the Internal Revenue Code. *See* I.R.C. § 904 1954 & Supp. 1985; *see also* Revenue Act of 1916, Pub. L. No. 64-271, § 5(a)(3), 39 Stat. 759 (1916).

27. If the United States government were to consider these Filipinos

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ers would presumably choose to credit their U.S. taxes against their Philippine taxes rather than to deduct their U.S. taxes from gross income. A credit would produce a *peso*-for-*peso* offset against their Philippine taxes, whereas the benefit of a deduction would be limited to the product of their Philippine tax rates and the *peso* equivalent of their U.S. taxes.

Three sets of problems emerged from this pattern of taxation. The first arose around 1970, when the *peso* floated and the exchange rate of the *peso* to the U.S. dollar increased dramatically from 2:1 to 7.5:1.[28] Because of the devaluation, even modest foreign salaries made nonresident Philippine citizens living in the United States appear wealthy by Philippine standards. Consequently, many nonresidents were thrust into the highest tax brackets of the progressive Philippine rate schedule.

For example, at a 2:1 exchange rate, the Philippine 70% marginal tax rate was applicable to incomes of $250,000 (500,000 *pesos* divided by 2) or more. At a 7.5:1 exchange rate, however, the highest tax rate was reached at incomes of $66,667 (500,000 *pesos* divided by 7.5). The effect of the devaluation was that Filipinos working in the United States were viewed for tax purposes as having incomes in *pesos* 3.75 times (7.5 divided by 2) larger than before. They conse-

as residents for tax purposes, it would tax their worldwide income. *See* Treas. Reg. § 1.1-1(b) (1984). Otherwise, it would tax them only on income from U.S. sources. *See* I.R.C. § 871 (1982).

Multiple taxation often arises because one country taxes individuals on the basis of residency or citizenship, and the other taxes them on the basis of the source of their income. International law has never required a country to provide relief from multiple taxation, although most countries that tax foreign income normally grant some relief by providing either a deduction or a credit for foreign taxes. *See* Pomp & Oldman, *supra* note 2, at 36-37.

28. Discussions with officials of the Central Bank in Manila (July, 1980). In conducting research for this Article the author interviewed numerous officials at all levels, with the understanding that comments and statements would not be attributed to specific individuals. Officials were extremely cooperative and provided complete access to the existing data. Unfortunately, numerous weaknesses and gaps in the data make rigorous analysis and inquiry difficult. Consequently, some of the observations in this Article are based on the impressions of experienced and candid Philippine officials. The views of these officials, which were neither self-serving, uncritical, nor defensive, are consistent with the limited empirical data. *See infra* notes 98-120 and accompanying text.

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quently experienced a sharp increase in their tax burdens, even though in dollars their incomes had not changed.[29] It is not surprising that many nonresident Filipinos complained to their government about inequitable Philippine tax burdens and questioned the propriety of being subject to the

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29. For another example, consider a Filipino couple residing in the United States with $8,000 of taxable income. Assuming that a joint return was filed, the couple paid $1,380 in U.S. taxes for 1970. For a table of 1970 tax liabilities, see W. ANDREWS, BASIC FEDERAL INCOME TAXATION 793 (2d ed. 1979). Assume for simplicity that the couple's taxable income under Philippine law was also $8,000. At a conversion rate of 2 *pesos* to 1 U. S. dollar, the couple had a taxable income of 16,000 *pesos*. Their Philippine tax liability, prior to a credit for their U.S. tax, would be 1,960 *pesos* ($980). For the 1970 Philippine tax rates, see JOINT LEGISLATIVE-EXECUTIVE TAX COMMISSION, A SHORT GUIDE TO PHILIPPINE TAXES REVISED (1970). The credit for their U.S. tax of $1,380 completely eliminated their Philippine tax of $980. Consequently, at a conversion rate of 2:1 this couple did not owe a Philippine tax. The overall effective tax rate on this couple was 17.3% ($1,380 divided by $8,000) and was determined solely by the U.S. tax rate.

After devaluation of the *peso*, this couple had taxable income of 60,000 *pesos* ($8,000 times 7.5), *see supra* text accompanying note 28, and a Philippine tax liability of 18,360 *pesos* ($2,448). The credit for their U.S. tax of $1,380 reduced their Philippine tax to $1,068 ($2,448 minus $1,380). The overall effective tax rate on this couple was 30.6% ($2,448 divided by $8,000) and their total taxes, U.S. and Philippine, increased from $1,380 to $2,448, an increase of 77%.

The devaluation more dramatically affected a couple having an income of $20,000. Their U.S. tax in 1970 was $4,380. Prior to devaluation, their Philippine taxable income was 40,000 *pesos*, generating a pre-credit Philippine tax liability of 9,480 *pesos* ($4,740). After credit for their U.S. tax, the couple paid tax at an overall effective tax rate of 23.7% ($4,740 divided by $20,000). After devaluation, the couple had a taxable income of 150,000 *pesos* (20,000 times 7.5) and a pre-credit Philippine tax liability of 69,640 *pesos* ($9,285). The credit for their U.S. tax of $4,380 reduced their Philippine tax to $4,905 ($9,285 minus $4,380). Their overall effective tax rate after the devaluation was 46.4% ($9,285 divided by $20,000). Their total taxes, U.S. and Philippine, increased about 96% from $4,740 to $9,285.

As these examples demonstrate, the effective tax rate for nonresident taxpayers was determined by the higher of the U.S. (or other DC) effective tax rate or the Philippine effective tax rate. Even though salaries in the United States were generally higher than those in the Philippines, the interaction of the fixed exchange rate of 2:1 and the respective rate structures of the United States and the Philippines did not necessarily generate a Philippine effective tax rate that exceeded the U. S. effective tax rate. At an exchange rate of 7.5:1, however, the Philippine effective tax rate for most taxpayers would exceed that of the United States.

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same rate schedule that applied to residents.[30]

A second set of problems involved the determination of net income. Some nonresidents complained that Philippine tax law was unduly restrictive and therefore ill-suited to cope with conditions and practices abroad. They argued that the Philippine tax law did not allow deductions for certain types of expenditures incurred abroad.[31] Some of those expenditures were evidently allowed as deductions by the tax laws of the host DCs, which suggested to nonresidents that Philippine tax law was too harsh.

The third and most severe set of problems centered around the administration of the Philippine tax. Measures that facilitated the administration of the income tax at home, such as the use of withholding, information returns, audits, the seizure and sale of assets, garnishment, and civil and criminal fines and penalties[32] were unavailable or ineffective abroad because the taxpayers, their assets, and the payors of their incomes were outside the jurisdiction of the Philippines. The national boundary was a formidable impediment to the enforcement of a tax on nonresident citizens.[33]

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30. Filipinos living in the United States were well organized, which enabled them to voice their complaints effectively. Discussions with officials of the Bureau of Internal Revenue (hereinafter the BIR) in Manila (July, 1980).

31. *Id.* This argument evidently had two facets. The first was that the Philippine tax code allowed certain deductions only if the expenditure was paid or incurred in the Philippines. For example, medical expenses and high school tuition payments for a taxpayer's dependents were deductible, subject to certain ceilings, only if incurred and paid in the Philippines. *See* Philippines National Internal Revenue Code § 30(a)(2)(A) & (B).

The second facet was directed at the BIR's interpretation of the statutory requirement that deductible expenses be "ordinary and necessary." *Id.* § 30(a)(1). Some nonresidents complained that the BIR was too inflexible in its interpretation of the statute. They stated that the BIR denied deductions for expenditures that were commonplace abroad because they were uncommon within the Philippines. In some cases, the BIR placed a ceiling on the amount of the deduction. This ceiling was based on what would have been reasonable had the expenditure been incurred in the Philippines, notwithstanding that the amount of the expenditure was reasonable under the standards of the DC where it actually was incurred.

32. For a discussion of these measures, see generally Oldman, *Controlling Income Tax Evasion*, in READINGS ON INCOME TAX ADMINISTRATION, *supra* note 17, at 485-510.

33. *See generally* Surr, *Intertax: Intergovernmental Cooperation in Taxation*,

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Three obstacles confronted the Bureau of Internal Revenue (hereinafter the BIR).[34] First, many nonresident citizens failed to file a return. The Bureau did not have a master taxpayer roll that listed all nonresident citizens and thus could not determine the identities of those nonresidents who did not file.[35] Compiling an accurate master list would have been difficult, however, because detailed records of emigrants were not kept until recently.[36] Moreover, although these emigrant records specify the country of initial destination, they do not provide current addresses.[37] Without such addresses, the BIR would have had difficulty contacting those nonresidents whom it identified as nonfilers.

In addition, the prolonged and expensive effort involved in determining a nonfiler's current address would not necessarily be productive, because the absence of a tax return might be due to such causes as death, marriage, change of citizenship, unemployment, retirement, or receipt of nontaxable income. For these reasons, the BIR still has not attempted to generate a master roll of nonresident taxpayers.[38]

Second, the BIR had difficulty verifying the information contained in those returns of nonresidents which were filed.[39] The BIR did not have powers, beyond those held by private citizens, to conduct an investigation or an audit in a foreign country. As a result, the BIR generally relied on cor-

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7 HARV. INT'L L. J. (1966). Although the Surr article was written in 1966, it generally still reflects current practices.

34. Discussions with officials of the BIR in Manila (July, 1980).

35. The United States also lacks a taxpayer roll of nonresident citizens. *See* Finch Statement, *supra* note 16, at 5-6. The creation of a master taxpayer roll is essential for an efficient tax administration. *See* Lemus, *Establishment and Maintenance of a Register of Taxpayers*, in READINGS ON INCOME TAX ADMINISTRATION, *supra* note 17, at 16. "The identification and register of taxpayers is absolutely essential for an efficient tax administration, and it might well be said that it constitutes one of the basic programs of highest priority, without which the other programs will lack assurance and effectiveness." *Id.*

36. Discussion with officials of the Ministry of Labor in Manila (July, 1980).

37. *Id.*

38. Discussions with officials of the BIR in Manila (July, 1980).

39. *Id.*

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respondence to verify information.[40]

Audits by correspondence proved unsatisfactory, however.[41] The normal delays in the mail between the Philippines and the host DCs made these audits time-consuming. The problem was exacerbated by the ability of nonresidents to drag out these audits interminably, either by design or otherwise. They would ask for clarifications of BIR questions, raise diversionary issues, and request extensions of time in order to gather requested information.[42]

Even if the information was eventually supplied, the BIR often had trouble determining its authenticity. For example, nonresidents would sometimes be required to submit a copy of their DC tax returns so that the BIR could check the Philippine tax returns for consistency. The BIR suspects that some of the copies it received were bogus foreign tax returns specifically prepared for purposes of the audit.[43] Moreover,

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40. Rarely do tax administrators from one country conduct their own investigation in another country. *See* Surr, *supra* note 33, at 182. Occasionally, in cases involving potentially large sums of money, the BIR attempted to conduct audits at a consulate in the host DC. Taxpayers could, however, ignore requests to bring their books and accounts to the consulate and the BIR was powerless to deal with this recalcitrance. Furthermore, consulates were not always located near the taxpayer. Thus, the problem of enforcement from a distance still remained. The BIR did have leverage over nonresident citizens, however, because it had the power to deny recalcitrant taxpayers the benefit of assistance from the consulate should they need help in the future. Discussions with officials of the BIR in Manila (July, 1980).

41. *Id.*

42. *Id.*

43. Until mentioned by the author, some BIR officials were unaware of a procedure in the United States whereby taxpayers may obtain certified copies of their tax returns from the Internal Revenue Service. *See* I.R.C. § 6103(p)(2)(A) (1982); Rev. Proc. 66-3, 1966-1 C.B. 601-06. Requiring taxpayers to submit a certified copy would reduce the BIR's problem of receiving copies of bogus U.S. returns. Appropriate safeguards would be necessary, however, to ensure that taxpayers would submit new certified copies every time they were to amend their U.S. returns. Otherwise, nonresidents could file U.S. tax returns that were specially prepared to mislead the BIR, obtain certified copies, and then file amended U.S. returns that corrected their early returns.

If a host DC were willing, a nonresident's DC tax return could be made available to the Philippines. Such an arrangement could be made as part of a tax treaty, although it would exceed the current practice of the United States and other DCs. *See* Pomp & Oldman, *supra* note 2, at 41-43.

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some nonresidents simply ignored BIR requests for supplementary information and documentation.[44]

Third, the BIR had difficulty collecting taxes due.[45] If the BIR knew of any assets held by nonresidents within the Philippines, it could seize and liquidate them. Otherwise, the BIR was unable to compel payment through normal attachment or garnishment procedures.

Some of these problems also blunted one of the BIR's primary tools for dealing with recalcitrant taxpayers—the tax clearance certificate.[46] This certificate, issued by the BIR, is evidence that a taxpayer has no outstanding tax liabilities or delinquencies.[47] A citizen is prohibited from leaving the Philippines without obtaining a tax clearance certificate, and diplomatic and consular officers have the power to refuse to issue or to renew Philippine passports unless the applicant presents such a certificate.[48]

The tax clearance certificate was ineffective for dealing with certain delinquent nonresident taxpayers. First, non-

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44. Discussions with officials of the BIR in Manila (July, 1980).

45. *Id. See generally* Surr, *supra* note 33, at 219 (discussion of the problem of collecting taxes from persons outside the country).

46. *See* 72 PHIL. ANN. LAWS § 346 (1956).

47. Bureau of Internal Revenue, Rev. Reg. No. V-32, 49 Off. Gaz. 443 (Feb., 1953), *amended by* 72 PHIL. ANN. LAWS § 346 (1956).

48. This power apparently is discretionary. Discussions with officials of the BIR in Manila (July, 1980). *See also* Passport Regulations, *reprinted in* 3 PHIL. ANN. LAWS § 22 (1956).

At one time, the IRS also attempted to identify nonresident citizens who did not file returns when they sought to renew their passports. In the mid-1960s, the IRS, in cooperation with the Department of State, requested U.S. citizens living abroad to complete IRS Form 3966 (Internal Revenue Service Identification of U.S. Citizen Residing Abroad) when they renewed their passports. The form set forth the tax obligations of nonresident U.S. citizens and provided information on the availability of IRS taxpayer assistance abroad. The form requested information concerning the taxpayer's occupation and when and where he or she last filed a federal income tax return. In general, the IRS's only source of information on nonresident citizens was Form 3966.

The IRS hoped that Form 3966 and the publicity surrounding it would encourage voluntary compliance abroad. The IRS experience was disappointing, however, primarily because there was no legal duty to file the form. A nonresident citizen was not precluded from renewing his or her passport if the form was not filed. Also, taxpayers complained that the form violated their privacy rights. As a result, in 1979, the IRS discontinued the use of Form 3966. *See* Finch Statement, *supra* note 16 at 9-10.

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residents who did not renew their passports, did not return to the Philippines, or returned but did not leave afterwards had no reason to apply for certificates. Second, some nonresidents became citizens of other countries and returned to the Philippines under foreign passports. As "tourists" in the Philippines, they were not required to obtain tax clearance certificates before departing (even for those years in which they were Filipino citizens), provided they had not "engaged in commerce."[49]

The system of tax clearance certificates had a third weakness that reduced its effectiveness in the case of taxpayers abroad. Certain nonresidents filed returns that stated an incorrect amount of income, paid the tax owed on that amount, and therefore had no outstanding liability or delinquency. Unless the BIR had reason to suspect that the income reported on the return had been understated, it routinely issued a tax clearance certificate.[50] In some cases, nonresidents visiting the Philippines and anticipating a challenge by the BIR brought specially prepared documentation with them which purported to corroborate their tax returns.[51]

Even when the BIR uncovered cases of nonfiling by nonresidents through the tax clearance certificate requirements, special problems still confronted the agency.[52] The absence of a tax return might become apparent when a nonresident's records were reviewed for outstanding liabilities and delinquencies, but the problem of determining tax liability remained. Some nonresidents would claim that they had no taxable incomes because they were unemployed, retired, or being supported by friends or relatives. Lacking an easy and inexpensive way of investigating the taxpaying status of these nonresidents, the BIR reluctantly accepted their explanations and usually issued the certificates requested.[53]

Because of the weaknesses in the system of tax clearance certificates, many embassies and consulates were less than

49. *See* 72 PHIL. ANN. LAWS § 346 (1956).

50. Discussions with officials of the BIR in Manila (July, 1980).

51. *Id.*

52. *Id.*

53. If a nonresident claimed he or she was being supported by others and thus had no taxable income, the BIR occasionally required an affidavit to that effect from the person providing the support. *Id.*

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vigilant in requiring nonresidents to produce such a certificate before renewing their passports.[54] Furthermore, some embassy and consular personnel felt that the strict enforcement of the tax clearance requirement might be counterproductive in the case of an emigrant who had applied for DC citizenship. The tax clearance certificate system may have induced these emigrants to postpone travel to the Philippines until they had obtained new citizenship and new passports, which made it unnecessary for them to obtain a certificate and renew their Philippine passports. As a result, the Philippines not only failed to collect delinquent taxes, but also forfeited the revenue and foreign exchange which would have been generated by their visits.[55] Thus, rigorous enforcement of the tax clearance certificate system may have provided emigrants with an additional inducement to obtain DC citizenship.

In order to respond effectively to the administrative problems posed by nonresident citizens, the BIR would have needed the assistance of the host DCs. The tax administrations of the host countries might already have had information in their files on the income of Filipino taxpayers. Even if they did not, they could have conducted the necessary investigations.[56] In addition, the host DCs had jurisdiction not only over resident Filipinos, but also over their assets in the DCs. This authority could have facilitated a solution to the BIR's collection problems.

Most DCs, however, offered a limited amount of cooperation in assessing and collecting foreign taxes. The degree of assistance needed by the BIR greatly exceeded that avail-

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54. *Id.*

55. Between September 1, 1973 and July 1, 1974, 59,534 overseas Filipinos visited the Philippines spending an average of $500 each. Letter of Instruction No. 210 (1974). Assuming an average exchange rate of 7.4 *pesos* to $1, each person spent an average of 3,700 *pesos*. By comparison, for 1972 the tax collected per return under the 1-2-3 system, *see infra* text accompanying notes 79-98, averaged 329 *pesos*. The 1974 average was 171 *pesos*. *See infra* text and Table 1 accompanying notes 98-108.

56. If the BIR had provided the names of Filipinos living in the host DC, the DC tax administration would have been able to check its files to see if a DC tax return had been filed. Information from this tax return could have been given to the BIR. But DC tax administrations would not have been in a position to help the BIR identify Filipinos who did not file Philippine tax returns. *See* Pomp & Oldman, *supra* note 2, at 56.

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able through normal DC practices,[57] and the BIR rarely approached the host DCs for additional help. Access to DC courts was also unavailable.[58]

The widespread lack of compliance by nonresidents, including their failure to file returns, is evidence of the administrative difficulties that confronted the BIR in attempting to follow the U.S. model of citizenship jurisdiction. The existing data do not provide a firm basis for evaluating the extent of noncompliance during this period. All BIR officials interviewed, however, felt that taxpayer noncompliance was rampant, especially among transient nonresidents.[59] The officials distinguished between emigrant nonresidents and transient nonresidents, such as contract workers, seamen, and other unskilled and semi-skilled Filipinos who contracted to work abroad for a specific period of time. The migration of these emigrant nonresidents constitutes the so-called muscle drain, rather than the brain drain.[60]

Tax officials believed that emigrant nonresidents had a

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57. Most DCs will not furnish tax information or collect foreign taxes except under limited and specific conditions delineated in a tax treaty. A typical tax treaty, however, is unlikely to provide a mechanism for dealing with the problems encountered by the BIR. The amount of information exchanged under a tax treaty is limited, and commonly does not involve areas relevant to the enforcement of a tax on nonresidents. Assistance in collection of foreign taxes is even more limited. *Id.* at 41-43.

The current tax treaty between the Philippines and the United States does not commit the United States to cooperate in the collection of Philippine taxes on nonresidents. U.S. cooperation is limited to situations in which Filipinos wrongfully seek to obtain treaty benefits and would not cover nonresidents who refused to pay Philippine taxes. *See* Assistance in Collection, 2 TAX TREATIES (CCH) ¶ 6630 (1970).

The United States receives tax information from 17 of the 34 countries with which it has a tax treaty. In general, the information pertains to investment income, such as data on interest and dividends, and not to data on wages and income earned through the performance of personal services. About one-third of the information returns that the United States receives as a result of these treaties are incomplete or are received too late to be of use. *See* Finch Statement, *supra* note 16 at 10-12.

58. Courts in the United States, Canada, and England generally do not recognize foreign tax judgments. *See* Pomp & Oldman, *supra* note 2, at 41 n.140.

59. Discussions with officials of the BIR in Manila (July, 1980).

60. *See* Ecevit & Zachariah, *International Labor Migration*, 15 FIN. & DEV. 32 (1978); H. SINGER & J. ANSARI, RICH AND POOR COUNTRIES 222-24 (1977).

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higher rate of noncompliance than transient nonresidents.[61] In some instances, noncompliance may have been unintentional because emigrants may have been unaware that their Philippine tax obligations continued even after moving abroad. In other cases, noncompliance may have been deliberate. Those who left the Philippines for political reasons may have refused to pay Philippine taxes. Those who left because of a lack of professional opportunities may have also resented any obligation to pay. The longer emigrants stayed abroad, the more they may have questioned the right of the Philippines, rather than the right of the host DC, to tax their incomes. Also, physical distance from the Philippines could have bred a sense of security that encouraged emigrants to disregard their Philippine tax obligations. Emigrants would have easily justified their noncompliance if they considered their Philippine tax burden onerous or excessive. Finally, noncompliance may have been encouraged by the BIR's inability to discover and punish emigrants' noncompliance.[62]

In contrast to emigrants, transient nonresidents usually could be identified and the amount of their earned incomes ascertained, since their employment often was controlled and regulated by the Philippine government.[63] In addition, any assets owned by transient nonresidents were usually located in the Philippines and thus could be liquidated by the BIR to satisfy outstanding tax liabilities. Transients also knew that they would eventually return to the Philippines where they would be within close reach of the BIR. Such pressures probably induced transients to comply with their tax obligations.

As this Section suggests, the Philippine tax regime before 1970 clearly was unsatisfactory. After the devaluation of the *peso*, the extension of the normal Philippine rate schedule to nonresidents produced harsh tax burdens. The BIR had difficulty policing the tax abroad, and noncompliance apparently was widespread. Complaints voiced both by taxpayers and by the BIR led to changes in 1970.

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61. Discussions with officials of the BIR in Manila (July, 1980).

62. *Id.*

63. The number of transient nonresidents was small until 1975 or 1976. *See infra* text accompanying notes 111-14.

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B. *1970 and 1971*

In 1970, the Philippine tax law was changed to distinguish between nonresident and resident citizens. Nonresident citizens were allowed three special deductions that were not available to residents.[64] In addition, the rules governing the credit for foreign taxes were liberalized.[65] Each of these changes was intended to alleviate special hardships suffered by nonresident citizens[66] and to increase compliance.

The first of the new deductions directly responded to the complaint that the Philippine tax law was too restrictive in that it did not allow nonresidents to deduct certain expenditures incurred abroad.[67] Nonresidents were now allowed to deduct on their Philippine tax returns those expenditures which were deductible in the country where they earned their income.[68] The second change introduced a deduction for transportation expenses incurred in obtaining employment abroad.[69] Lastly, nonresident citizens were allowed to deduct their housing costs, either in the amount of rent actually paid or the fair rental value of an owner-occupied residence.[70]

In addition, the scope of the foreign tax credit was broadened. Nonresidents were allowed to credit not only the income taxes they paid to a foreign country, but also the income taxes paid to the state, county, or city in which they earned their income.[71]

These new deductions and the expansion of the credit did not mollify the overseas community. Nonresidents complained that even after these changes, a modest foreign income, when converted into *pesos*, could still generate a large

64. *See* Bureau of Internal Revenue, Mem. Cir. No. 40-71.

65. *Id.* § 3.

66. *Id.*

67. Discussions with officials of the BIR in Manila (July, 1980).

68. Bureau of Internal Revenue, Mem. Cir. No. 40-71, § 1.

69. *Id.* § 2. The deduction also applied to transportation expenses incurred in moving from one country to another. *Id.*

70. *Id.* § 3.

71. *Id.* The deduction for foreign taxes also was expanded to include city, county, and state income taxes, but most taxpayers presumably would have still chosen the credit rather than the deduction. *See supra* text accompanying note 27.

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Philippine tax liability.[72] Apparently, none of the 1970 changes was generous enough to offset completely the effects of allowing the *peso* to float.[73]

The 1970 changes not only failed to satisfy the overseas community, but also aggravated the verification and enforcement problems of the BIR. The Bureau now faced two new problems. First, it had to verify deductions allowable under unfamiliar foreign tax laws. The BIR attempted to solve this problem by requiring nonresidents to attach copies of their foreign tax returns to their Philippine tax returns.[74] Nonresidents routinely frustrated this approach, however, by submitting copies of bogus foreign returns.[75]

An ambiguity in the Philippine tax law further compounded the difficulties of the BIR. The statute was unclear about whether a nonresident could claim the same deduction twice: once under Philippine tax law and a second time under foreign law.[76] The BIR took the reasonable position that a double deduction for the same expenditure was not permitted. But it was not always obvious from a nonresident's return whether the same expenses were being deducted twice.[77]

The BIR's second new problem involved the near im-

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72. Discussions with officials of the BIR in Manila (July, 1980).

73. For an illustration of the problem caused by the floating of the *peso*, see *supra* note 29 and accompanying text.

74. *See* Bureau of Internal Revenue, Rev. Reg. No. 9-73, § 3(D).

75. Discussions with officials of the BIR in Manila (July, 1980).

76. The law stated:

> All allowable deductions contained in the income tax returns filed in the country where [the taxpayers] earn their income [shall be allowed as deductions on the Philippine income tax returns]. Such deductions will be allowed . . . in addition to the deductions allowed under the Income Tax Law of the Republic of the Philippines.

See Bureau of Internal Revenue, Mem. Cir. No. 40-71, § 1.

The BIR interpreted the language "in addition to the deductions allowed under the Income Tax Law of the Republic of the Philippines" as intending to clarify that foreign tax law did not displace Philippine law. Hence, a nonresident did not lose any deductions available under Philippine tax law that were not allowed under foreign tax law. According to the BIR, the language was not intended to allow taxpayers to deduct the same item twice. Discussion with officials of the BIR in Manila (July, 1980).

77. For example, expenses identified or labeled in one manner on the Philippine tax return might be categorized differently on the DC tax return. *Id.*

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possibility of verifying a nonresident's housing costs. Tenants could easily manufacture bogus rental receipts, and homeowners could exaggerate the fair rental value of their home, in order to increase their deductions. Consequently, the 1970 changes did little to eliminate the source of the problems that both taxpayers and the BIR were experiencing.[78]

C. *1972 to the Present*

Because of the general dissatisfaction of both the BIR and Philippine taxpayers with the pre-1972 regime,[79] the taxation of nonresidents was overhauled in 1972. Under the new scheme, which is still in effect, nonresident citizens are taxed under a special rate schedule. These rates are: 1% on the first $6,000 of adjusted gross income,[80] 2% on amounts exceeding $6,000 but not over $20,000, and 3% on amounts exceeding $20,000.[81] Because of these rates, the tax regime is known as the "1-2-3 system."

Since 1973, nonresident citizens have been allowed two deductions: a personal exemption of $2,000 for a single taxpayer or $4,000 for a married taxpayer or a head of household, and a deduction—but not a credit—for income taxes paid to the foreign country where the taxpayer resides or for income taxes paid to the foreign country where the income was derived.[82] The 1-2-3 system is tied to the U.S. dollar: the deductions and the brackets of the rate schedule are all stated in U.S. dollars, and nonresidents are required to report their incomes in U.S. dollars.[83]

Only Philippine citizens who qualify as nonresidents are subject to the 1-2-3 system. From 1972 to 1978, a citizen had to be physically abroad for an uninterrupted period that

78. Discussions with officials of the BIR in Manila (July, 1980).

79. *Id.*

80. Adjusted gross income is equal to gross income less the personal exemption and deduction for income taxes paid to the foreign country where the income was earned.

81. Presidential Decree No. 69 (1972). The 1972 changes apply only to foreign income received by nonresident citizens. Income received from domestic sources is taxable under the same rules that apply to resident taxpayers.

82. Presidental Decree No. 323 (1973).

83. *See* Presidential Decrees Nos. 69 (1972), 323 (1973).

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included an entire year in order to qualify as a nonresident.[84] The requirement that the period abroad be uninterrupted was not interpreted literally, however; home visits by a taxpayer employed abroad on a regular basis did not interrupt the required period.[85] The definition of a nonresident was broadened in 1978.[86]

The 1-2-3 system was designed to mitigate the problems that had plagued the earlier approaches.[87] First, by allowing almost no deductions, the Philippines tried to eliminate the BIR's administrative problems of auditing a wide range of expenditures. Second, the country kept its tax rates low in order to compensate for the small number of deductions and to induce taxpayer compliance.[88] Third, the Philippines intended the multiple rates, in combination with the personal exemption, to achieve a modest degree of progressivity. Fourth, the country provided a deduction for foreign taxes in order to alleviate the burden of multiple taxation.[89] Finally, by tying the tax system to the U.S. dollar, the Philippines hoped to avoid the pre-1972 problems caused by the floating of the *peso*.[90]

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84. Bureau of Internal Revenue, Rev. Reg. No. 9-73.

85. *Id.*

86. *See infra* note 117.

87. Discussion with officials of the BIR in Manila (July, 1980).

88. To illustrate the modest burden imposed by the Philippine tax, consider an unmarried taxpayer with $29,800 of salary income who lives and works in the United States. In 1983, assuming the taxpayer did not claim any itemized deductions, his or her U.S. income tax is $6,045. For purposes of the 1-2-3 tax, the adjusted gross income is $21,755 ($29,800 less a $2,000 personal exemption and less the U.S. tax of $6,045), generating a Philippine tax of $375 (1% of $6,000 plus 2% of $15,755). Put differently, this taxpayer experiences a 6% increase in income tax burden ($375 divided by $6,045).

89. Because the rates of tax (1%, 2%, 3%) are so low, a nonresident's foreign income taxes typically will exceed the Philippine tax. If the Philippines had continued its prior practice of allowing a credit for foreign taxes, *see supra* text accompanying notes 26-27, the Philippine tax would have been eliminated for most nonresidents.

90. *See supra* text accompanying notes 28-30. Nonresident citizens receiving income in a currency other than the U.S. dollar must convert such income into dollars. The conversion is made at the average annual rate of exchange of the foreign currency and the U.S. dollar. Bureau of Internal Revenue, Rev. Reg. No. 9-73, § 4(A)(1). Theoretically, the pre-1972 problem can still affect nonresidents receiving income in currencies

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Although the tax imposed by the 1-2-3 system is in effect a tax on gross income, many of the policy makers viewed the system at the time of its inception as a proxy for a tax on net income.[91] A tax on gross income can serve as a proxy for a tax on net income if either of two conditions is satisfied. First, if the available deductions are a very small percentage of gross income for all taxpayers, the tax is almost a tax on net income. Second, even if the available deductions are not a very small percentage of gross income, but constitute nearly the same percentage of gross income for all taxpayers, then any set of tax rates that might be applied to net income can be translated into an equivalent, and lower, set of tax rates that could be applied to gross income.[92]

In 1972, BIR officials assumed that most nonresidents were employees, and that deductions denied under the 1-2-3 system constituted either a small percentage of gross income, or the same percentage of gross income, for most nonresidents.[93] Policy makers viewed the 1-2-3 approach as being roughly equivalent to a net income tax having none of the administrative problems caused by the need to scrutinize a panoply of deductions.[94]

Although the 1-2-3 system eliminated the need to audit a vast array of deductions, the BIR must still verify each nonresident's gross income and the amount of foreign taxes paid. While the BIR requires nonresidents to submit copies of their foreign tax returns and evidence of payment of foreign taxes,[95] it suspects that it continues to receive copies of bogus tax returns.[96] Moreover, many nonresidents fail to submit any documentation at all. As one official stated: "If they fail to submit proof of their foreign taxes, we could deny them a deduction for their foreign taxes and increase their

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stronger than the U.S. dollar. The low rates of Philippine tax, however, greatly reduce the severity of this problem.

91. Discussions with officials of the BIR in Manila (July, 1980).

92. For example, assume that deductions constitute 20% of gross income for all taxpayers. Any rate of tax [r] levied on net income can be translated into an equivalent rate of tax [.80r] levied on gross income.

93. Discussions with officials of the BIR in Manila (July, 1980).

94. *Id.*

95. Bureau of Internal Revenue, Rev. Reg. No. 9-73, § 3(D).

96. Discussions with officials of the BIR in Manila (July, 1980). *See supra* text accompanying notes 43-44.

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tax liability. But, so what? We wouldn't be able to collect the increased taxes anyway."[97] This comment nicely captures the passivity and frustration that mark the BIR's administration of the 1-2-3 system. Most of the administrative problems that characterized the pre-1972 tax regimes continue to plague the BIR. Because the BIR still lacks any effective means of collecting delinquent taxes, it makes few attempts either to identify nonfilers or to conduct audits.

The extent of noncompliance by nonresidents is difficult to evaluate. Data regarding the 1-2-3 system are presented in Table I, which summarizes the number of returns filed by nonresident citizens and the amounts of revenue collected during the period from 1973 to 1982. Data were not available for 1972, the first year of the system.[98] For purposes of comparison, data for 1971, the last year of the old system, are also included.

TABLE I
NUMBER OF RETURNS AND REVENUE COLLECTED FROM NONRESIDENT CITIZENS

Calendar Year	Number of Returns	Increase (Decrease) Over Prior Year	Revenue Collected (Mill. of Pesos)	Increase (Decrease) Over Prior Year
1982	184,053	23%	44.2	53%
1981	149,172	20%	28.9	24%
1980	119,338	42%	22.0	12%
1979	83,543	17%	19.5	20%
1978	71,625	24%	16.2	100%
1977	57,791	7%	8.1	1%
1976	54,055	29%	8.0	(29%)
1975	41,755	49%	11.3	135%

97. Discussions with officials of the BIR in Manila (July, 1980). The BIR has never charged a nonresident with evasion of the 1-2-3 tax. The small amounts of tax involved in most cases and the difficulty of enforcing a conviction make it futile to pursue such cases.

98. The BIR's Office of International Operations, which administers the 1-2-3 system, was created in 1973. The collection of data prior to the creation of this office was somewhat erratic. Events leading up to the declaration of martial law in 1972 interfered with the orderly processes of the government and made data collection difficult.

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Calendar Year	Number of Returns	Increase (Decrease) Over Prior Year	Revenue Collected (Mill. of Pesos)	Increase (Decrease) Over Prior Year
1974	27,956	(13%)	4.8	(55%)
1973	32,170	—	10.6	—
1972	N/A	—	N/A	—
1971	13,000	—	.342	—

Source: Data for 1971-1979 were compiled by the author from the records of the Bureau of Internal Revenue. Data for 1980, 1981, and 1982 were provided to Professor Bhagwati by the Bureau of Internal Revenue.

One technique for evaluating the success of the Philippines in administering the 1-2-3 system, and the degree of voluntary compliance, is to compare the total amount of income actually reported on tax declarations with macroeconomic data on the amount of income that would have been reported had there been full compliance by all nonresident citizens.[99] In the domestic situation, an estimate of the amount of income that would be reported if taxpayers complied fully can be based on national income data, which often is assembled by government economists and statisticians. Data on national income in the Philippines is irrelevant, however, in estimating the amount of income that should be reported under the 1-2-3 system because the relevant taxpayers are abroad. Instead, one needs an estimate of the amount of income earned abroad by nonresidents. Because no government agency has made this estimate,[100] no comparison can be made between the total amount of income reported under the 1-2-3 system and the amount of income that should have been reported.

Another technique for measuring noncompliance is to compare the number of taxpayers filing returns with an estimate of the number of taxpayers who should have filed re-

99. *See* READINGS ON INCOME TAX ADMINISTRATION, *supra* note 17, at 432; Groves, *Empirical Studies of Income-Tax Compliance*, 11 NAT'L TAX J. 291 (1958).

100. Discussions with officials of the BIR and the Central Bank in Manila (July, 1980).

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turns.[101] The BIR has estimated that the number of nonresident citizens taxable under the 1-2-3 system was 800,000 in the late 1970s.[102] For 1979, the year during the period of the estimate in which the most returns were received, less than 11% of the estimated taxpaying population filed. BIR officials were not surprised by this low rate of filing; it simply reaffirmed their suspicion that noncompliance was pervasive among nonresident citizens.

Unless the BIR's estimate of the number of returns that should be filed under the 1-2-3 system is grossly inaccurate, a more rigorous analysis of the data in Table I probably would not produce results contradicting the BIR's conclusion of widespread tax evasion. Nevertheless, a detailed analysis could be useful for other purposes, such as comparing the degree of compliance between emigrants and transient nonresidents, between employees and self-employed nonresidents, and among the members of each group.

A rigorous analysis is hindered, however, by a number of weaknesses in the data. First, not all of the tax collections shown in Table I are attributable to the 1-2-3 system. In the

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101. *See* Harris, *Underground Economy: What Can and Should be Done: The Federal Role*, 73 NAT'L TAX A.-TAX INST. OF AM. 262, 262-63 (1980).

102. Discussions with officials of the BIR in Manila (July, 1980). This estimate is based on information provided by Philippine embassies and consulates. Another estimate, not made by the BIR, places the number of Filipino workers and seamen abroad at 705,000. Although it is unclear, this estimate is evidently for 1974. *See* Case Studies in Reverse Transfer, *supra* note 2, at 20 n.28 (citing M. Abella, Export of Filipino Labor in Relation to Development (updated paper)). On the basis of this estimate, the BIR received returns in 1974 from approximately 4% of the taxpaying population. The estimate of 705,000 may be too high, however, because not all of these workers necessarily would qualify as nonresidents for purposes of the 1-2-3 tax. *See supra* text accompanying notes 84-86 and *infra* note 117.

The Office of Emigrant Affairs estimates that as of December, 1979, the total number of overseas Filipinos was 1,674,722. OFFICE OF EMIGRANT AFFAIRS, PHILIPPINES MINISTRY OF LABOR & EMPLOYMENT, A SPECIAL REPORT ON PROFILE OF FILIPINOS OVERSEAS 2 (1980) [hereinafter cited as OFFICE OF EMIGRANT AFFAIRS]. This figure, however, cannot be used for estimating the number of potential taxpayers under the 1-2-3 system because it is based solely on outflows and is not adjusted for deaths, changes of citizenship, or persons who return to the Philippines. This last factor is especially important because of the large number of contract workers only temporarily abroad. *See infra* note 113 and accompanying text.

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years 1972 to 1974, the Philippines issued a series of decrees granting amnesty for tax evasion on income realized before 1972 and 1973.[103] The BIR data used to generate Table I aggregated all taxes collected from nonresident citizens, whether attributable to the amnesties or to the 1-2-3 system. The effects of the amnesties cannot be isolated. Drawing any meaningful inferences about the success of the 1-2-3 system is therefore difficult.[104]

A second obstacle results from the government's "Balikbayan" program, which was established to encourage Filipinos overseas to visit the Philippines.[105] This program appears to have at least two objectives: first, to obtain scarce foreign exchange and, second, to demonstrate the progress that has been made in the Philippines in order to encourage expatriates to return permanently.[106] As part of this program, the use of tax clearance certificates was suspended in 1973.[107] The impact of these changes on the data presented in Table I is unclear.[108]

Third, the data do not reveal how the operation of the 1-

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103. *See* Presidential Decrees Nos. 23 (1972), 67 (1972), 68 (1972), 156 (1973), 157 (1973), 161 (1973), 370 (1974), 563 (1974), 631 (1975).

104. For example, the large increase in filers and tax revenue from 1971 (the last year under the prior tax regime) to 1973 (the first year for which data are available under the 1-2-3 system) supports a conclusion that the 1-2-3 system successfully increased taxpayer compliance. This conclusion would be erroneous, however, if the increase in filers and in revenue were attributable to nonresident citizens availing themselves of the tax amnesty. An additional complication arises from the increase in emigration that evidently occurred during this period, which would also explain the increase in filers and revenue collected. *See* Case Studies in Reverse Transfer, *supra* note 2, at 3. Measuring the increase in emigration is difficult because reliable data have been kept only since 1975. Discussions with officials of the Ministry of Labor in Manila (July, 1980). Analysis of the data in Table I is hindered further by the declaration of a new amnesty in early 1973 which applied to acts of tax evasion regarding income realized prior to 1973. *See* Presidential Decrees Nos. 157 (1973), 370 (1974), 563 (1974), 631 (1975).

105. *See* Letter of Instruction No. 105 (1973).

106. A possible third objective is to grant a certain degree of legitimacy to the Marcos government by persuading nonresidents to return home, if only for a visit.

107. *See* Letters of Instruction Nos. 105 (1973), 163 (1974), 210 (1974); Presidential Decrees Nos. 439 (1974), 592 (1974), 819 (1975).

108. If tax clearance certificates were previously effective in encouraging taxpayer compliance, their suspension would be expected to result

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2-3 system has been affected by two important changes in the nonresident community. Both the numbers of self-employed Filipinos and contract workers abroad have increased. The first increase challenges the assumptions made when the 1-2-3 system was instituted that the overseas community consisted primarily of employees and that a tax on gross income was an adequate proxy for a tax on net income.

Although statistics are not available, BIR officials familiar with the overseas community believe that the number of self-employed Filipinos, such as doctors, engineers, restauranteurs, and importers is growing.[109] According to the BIR, self-employed nonresidents regard the 1-2-3 system as unfair because it does not allow deductions for the costs of doing business such as wages, rent, depreciation, advertising, materials, and supplies. In some cases, these costs constitute a significant percentage of gross income. The impact of the low 1%, 2%, or 3% rate of tax can therefore be substantial.[110] The BIR acknowledges that it receives few re-

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in some loss of tax revenue and a reduction in the number of returns filed. The data for 1974 are consistent with this explanation.

Alternatively, if tax clearance certificates were never very effective, the 1974 data also could be explained as a return to more normal levels of taxpayer compliance after the increase in 1973 attributable to a tax amnesty. *See supra* note 104. Without disaggregating the data, it is difficult to reach a conclusion.

The 1974 decline in filers and revenue also would be explained if a large number of nonresidents decided to return to the Philippines and thus were no longer subject to the 1-2-3 system. Because no data are compiled on inflows of nonresidents, this hypothesis cannot be tested. Any inflow of nonresidents, however, would be offset by the sharp increase in emigration which occurred in 1973 and 1974. *See* Case Studies in Reverse Transfer, *supra* note 2, at 3.

109. Discussions with officials of the BIR in Manila (July, 1980).

110. For example, assume that a self-employed nonresident has gross income of $100 and business expenses of $90. Ignoring the personal exemption and the deduction for foreign taxes, a 3% marginal tax rate on the nonresident's gross income of $100 produces a tax of $3. This equals a 30% marginal tax rate on his or her net income of $10.

To the extent that the business deductions denied to self-employed persons represent a larger percentage of their gross income than do the business deductions denied employees, self-employed persons are effectively taxed on their net incomes at rates greater than those imposed on employees. For example, assume that in the preceding hypothetical, an employee had $100 of gross income and deductions of $10. A 3% marginal tax rate on the employee's gross income of $100 produces a tax of $3.

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turns from self-employed nonresidents. Apparently, the self-employed overseas community simply ignores the tax.

The other major change in the composition of the overseas community— the increase in the number of contract workers— can be traced to the burgeoning demands for unskilled and semi-skilled labor by the Organization of Petroleum Exporting Countries, which provides employment for a large number of Filipinos. In 1974, the Philippine government created the Overseas Employment Development Board (OEDB), partially in response to this new overseas demand.[111] In the years 1975 to 1979, the OEDB placed in the Middle East more than 40,000 of the 52,849 contract workers abroad.[112]

Private employment agencies also have been active; in 1979, for example, they placed over 75,000 contract workers abroad, the majority of them in Saudi Arabia.[113] The number of Filipino seamen working outside the Philippines also increased through the efforts of the National Seamen's Board. In 1979, approximately 45,000 Filipinos worked

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This is equal to a 3.33% marginal tax rate on his or her net income of $90 (ignoring the personal exemption and deduction for foreign income taxes).

Under the 1-2-3 system, uniform rates of tax on net income are not likely to result in the case of all self-employed persons. Depending on the nature of the activity, the costs of doing business probably vary as a percentage of gross income. To the extent that such costs vary, self-employed persons are taxed on their net incomes at different rates. For example, a self-employed businessperson with $100 of gross income and $90 of expenses is taxed on net income at a marginal rate of 30%. By comparison, another self-employed businessperson with $100 of gross income and $10 of costs is taxed on net income at a marginal rate of 3.33%.

111. *See* Case Studies in Reverse Transfer, *supra* note 2, at 21.

112. Office of Emigrant Affairs, *supra* note 102, at 11, 14.

113. *Id.* at 8-9. The total number of contract workers hired by these private agencies has increased dramatically since 1976. The figures for the 1976-79 period are:

	Number	Increase Over Prior Year
1976	13,960	—
1977	26,191	88%
1978	37,340	43%
1979	75,693	103%
	153,184	

Id. at 10. The workers in highest demand during these years were fitters, welders, and construction workers. *Id.* at 17.

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aboard foreign-bound ships.[114]

The percentage of the overseas community represented by transient nonresidents has increased because the number of emigrants from the Philippines has not increased rapidly[115] while the number of contract workers and seamen has grown dramatically.[116] It is unclear whether the increase in the number of nonresident filers from the years 1975 to 1979 supports the BIR view that transient nonresidents have a higher rate of compliance with the 1-2-3 system than emigrants do, because statistics are not kept on the occupations of 1-2-3 taxpayers. No breakdown is available on the number of returns received from employees, contract workers, seamen, or self-employed individuals; nor are there statistics showing whether filers were emigrants or were only temporarily outside the Philippines. It is therefore difficult to test empirically any suspected relationship between the increase in the number of transient nonresidents, the number of returns filed by nonresidents, and the amount of revenue collected under the 1-2-3 system.[117]

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114. *Id.* at 15. The number of seamen aboard foreign-bound ships has increased steadily since 1976. The figures for the 1976-79 period are:

	Number	Increase Over Prior Year
1976	28,614	—
1977	33,378	17%
1978	37,951	14%
1979	45,226	16%

Id. at 15.

115. The figures for the 1976-79 period are:

	Number	Increase (Decrease) Over Prior Year
1976	37,690	—
1977	39,451	5%
1978	38,345	(3)%
1979	49,450	5%

Id. at 5.

116. *See supra* notes 111-114 and accompanying text.

117. The increase in the number of filers from 1975 to 1979 may support the BIR's view that transient nonresidents have a higher rate of compliance with the 1-2-3 system than do emigrants. For example, in 1977, 1978, and 1979, the number of returns filed increased by more than the percentage increase in emigrants leaving the Philippines. *Compare* Table I *with* table in note 115. One way to test the BIR's views empirically would be to compare with the data in Table I the number of transient nonresidents who left the Philippines each year. Although detailed statistics have

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Many BIR officials thought that the large increase in the number of transient nonresidents introduced an inequity into the administration of the 1-2-3 system. They believed that compliance with the 1-2-3 system by emigrants was primarily voluntary. Officials thought that they could exhort, cajole, or coax the emigrant community into recognizing its tax obligations, but that they lacked effective tools for persuading recalcitrants to pay. Transient nonresidents, however, generally were believed to be paying the proper amount of taxes.

This author's interviews with BIR officials indicated overall support of the 1-2-3 system despite its problems. Although these BIR officials perceived that the enforcement of the 1-2-3 system could not be uniform, they did not recommend its elimination. Instead, they emphasized that the revenue and foreign exchange raised by the system greatly outweighs the system's administrative cost and any inequity suffered by particular nonresidents. Their attitude was that the tax revenue collected, great or small, was a windfall.[118]

No reasonable estimate of the cost of administering the 1-2-3 system, however, was available. Since BIR officials did not spend a significant portion of their time working on the

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been kept since 1975 on the number of contract workers and seamen going abroad annually, no data exist on the number returning to the Philippines each year at the expiration of their contracts. Without this data, the net increase in transient nonresidents cannot be calculated and compared with the increase in filers and tax revenue shown in Table I.

Estimating the number of returning contract workers from the data on outflows is difficult because information on the length of contracts and on the number of Filipinos who renew their contracts while abroad is not available. A change in the definition of a nonresident further complicates the calculations. As of 1978, contract workers are considered to be nonresidents if they are abroad for at least 183 days during the taxable year. Bureau of Internal Revenue, Rev. Reg. No. 1-79, § 2(c). This change liberalized the definition of a nonresident, *see supra* text accompanying note 84-86, and resulted in more contract workers becoming taxable under the 1-2-3 system. The large increase in the number of filers in 1978 probably is explained, at least in part, by the broader definition of nonresident rather than by an increase in migration.

118. Characterizing the revenue collected under the 1-2-3 system as a windfall assumes that the taxes otherwise would not have been collected. Such an assumption can be questioned in the case of contract workers, who, for the reasons already discussed in the text, may present few compliance problems.

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1-2-3 system, any estimate would require an analysis of the officials' workday to determine how their time was actually allocated. Administrative costs were thought to be modest because personnel performing functions relating to the 1-2-3 system were lower-paid clerical workers who checked returns for completeness, processed payments, and filed the completed returns. The returns of 1-2-3 taxpayers received little nonclerical attention.

Occasionally, the BIR's nonclerical staff lectured about the 1-2-3 system to groups who were preparing to leave the Philippines. BIR officials sometimes were sent abroad to lecture to the overseas Filipino community and to assist in the preparation of returns. These activities appeared to be minor, however, when compared with the other responsibilities of the BIR staff. Even personnel who were assigned to Philippine embassies or consulates as BIR attachés or representatives did not devote a significant portion of their time to the administration of the 1-2-3 system.[119] One official summarized the situation: "We don't waste much time going after emigrants because they won't pay us anyway if they don't want to. And contract workers pay us without our doing anything. So running 1-2-3 is cheap."[120]

III. Implications of the Philippine Experience

The present study identifies the serious problems encountered by the Philippines in asserting citizenship jurisdiction over nonresident Filipinos. The Philippine experience validates, to a great degree, problems that had been anticipated in earlier theoretical literature[121] and suggests that other LDCs may face similar difficulties if they wish to adopt Professor Bhagwati's proposed tax on nonresident citizens.

This study identifies two major groups of issues that an LDC must address if it seeks to implement an effective income tax for nonresident citizens. First, the country must

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119. In addition to assisting nonresident citizens in the filing of their returns, the revenue attaché or representative disseminates information on the tax aspects of foreign trade and investment in the Philippines and assists foreign corporations and nonresident aliens engaged in business in Philippines. Discussions with officials of the BIR in Manila (July, 1980).

120. *Id.*

121. Pomp & Oldman, *supra* note 2, at 39-43.

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develop rules or principles for defining items of income and deductible expenses, and a rate schedule appropriate for nonresidents. Second, it must develop administrative capabilities and resources needed to enforce a tax on its nonresidents, both emigrant and transient.

A. *Designing a Tax for Nonresidents*

The experience of the Philippines demonstrates that an LDC's domestic tax system may prove inadequate when extended to nonresident citizens. If a progressive rate schedule developed in the context of an LDC's cost of living, salary levels, and distribution of income is applied to nonresidents living in DCs, it may generate inappropriate tax burdens. The pre-1972 Philippine experience indicates that nonresidents who earn salaries that are modest by DC standards might appear wealthy by LDC standards when their DC incomes are converted into the LDC currency. The extension of an LDC's progressive rates to a nonresident may therefore produce a substantial LDC tax burden that many nonresidents may perceive as inequitable and harsh.[122]

The Philippines tried to cope with these structural problems in two very different ways. In 1970 and 1971, nonresidents were allowed special deductions not available to

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122. At each income level, the effective LDC tax rate generally will exceed the effective DC tax rate. *See* Hamada, *Taxing the Brain Drain: A Global Point of View*, in THE NEW INTERNATIONAL ECONOMIC ORDER: THE NORTH-SOUTH DEBATE 125, 143 (J. Bhagwati ed. 1977).

The United States has resolved the problem of designing a suitable set of rates by providing an exemption for certain amounts of foreign earned income. *See supra* note 16. For a short time, this exemption was replaced for most taxpayers with a series of special deductions to take into account the higher costs of living abroad. *See* Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, § 913, 92 Stat. 3100-06 (1978), *repealed by* Economic Recovery Tax Act of 1981, Pub. L. No. 74-34 tit. I § 112(a), 95 Stat. 194 (1981). This change increased the tax burden on many persons abroad. Because of fears that this increased tax burden was resulting in less employment abroad for U.S. citizens, the exemption was reinstituted. *See* I.R.C. § 911 (1984). *See also* U.S. COMPTROLLER GENERAL, REPORT TO THE CONGRESS: AMERICAN EMPLOYMENT ABROAD DISCOURAGED BY U.S. INCOME TAX LAWS, (1981); U.S. COMPTROLLER GENERAL, REPORT TO THE CONGRESS: IMPACT ON TRADE OF CHANGES IN TAXATION OF U.S. CITIZENS EMPLOYED OVERSEAS, (1978) [hereinafter cited as IMPACT ON TRADE]; Hirsch & Rodriguez, *Taxation-United States Expatriates-Foreign Earned Income Act of 1978*, 19 HARV. INT'L L.J. 633 (1978).

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residents, but their income remained taxable at domestic rates. Since 1972, nonresidents generally have been denied all deductions available to residents, but have been taxed at low rates. Neither of these approaches has proved completely satisfactory.

The issue of designing an LDC tax suitable for nonresidents might be resolved by an approach not yet tried by the Philippines: the use of a surtax.[123] Under such an approach, an LDC would levy its tax as a percentage, perhaps 5%, of the tax paid to the DC in which the nonresident citizen resided. To calculate the LDC tax payable, a nonresident citizen would compute the amount of income taxable under DC rules, apply the DC's rate schedule, and multiply the resulting tax by 5%.[124]

The surtax approach has a number of desirable features. First, it avoids the problem of defining a new tax base for nonresidents.[125] Because a nonresident would be taxed on the same amount of income by both the LDC and the DC of residence, an LDC would avoid the problems that the Philippines encountered in modifying its domestic definition of taxable income.[126]

Second, the surtax approach would allow the LDC to benefit from the audit procedures of the DC tax administration, thus reducing the need for the LDC to conduct its own audits. Any DC enforcement activity would benefit the LDC, at least to the extent that it determined the nonresident citi-

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123. *See* Pomp & Oldman, *supra* note 2, at 52-57.

124. Taxpayers residing in the United States could be required to submit certified copies of their U.S. tax returns. *See supra* note 43.

125. The problem of defining a tax base for nonresidents is much less severe for the United States. U.S. law is complex and sophisticated and evidently can cope with business conditions elsewhere. U.S. rules on business deductions appear to work satisfactorily when applied to situations abroad. *See generally* Pomp & Oldman, *supra* note 2.

126. The tax system for nonresidents between 1970 and 1971 was based on gross income calculated under Philippine law, and allowed nonresidents to claim deductions under both DC and Philippine tax law. These tax laws proved difficult to interpret, *see supra* note 76, and the BIR had trouble verifying deductions allowed by Philippine law. *See supra* text accompanying notes 74-75. The surtax approach would eliminate these problems because the Philippine tax would be based on the DC tax and, other than the tax rate, would not be determined by Philippine law.

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zen's DC tax liability, upon which the LDC surtax would be based.

Third, because the LDC surtax would be a percentage of the DC tax, the LDC tax burden would be related to the DC tax burden. Assuming that the DC employs a fair and equitable tax rate, a modest LDC surtax would also be reasonable. The burden of multiple taxation would be minimal, and resort to special relief mechanisms would be unnecessary.[127] Also, the problems caused by currency conversion, which troubled the Philippines prior to 1972, and the need to design a special rate schedule would be avoided. Demands for progressivity would be satisfied because the surtax would reflect the progressive nature of the DC tax rates.[128] A disadvantage of the surtax approach, however, is that it cannot be applied easily to nonresidents who are not subject to DC taxes, such as employees of international organizations and certain contract workers.[129]

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127. For example, a 5% surtax ensures that the additional burden arising from both the LDC and the DC taxing the same income is limited to 5%. An alternative characterization of the 5% surtax is to view the LDC as levying its tax at an effective rate equal to 105% of the DC effective tax rate, with a credit provided for the DC tax.

128. If an LDC wanted to deviate from the DC rate schedule, it could design its own rates. These rates could be a function of the DC tax. For example, an LDC might wish to levy a 5% surtax as long as the DC tax were less than a certain amount, but might wish to either increase or decrease the rate of the surtax if the DC tax were to exceed a certain amount. This approach would allow an LDC to obtain more or less progressivity than that reflected in the DC rate structure. Additional flexibility could be achieved by choosing a different rate of surtax for different DCs.

129. Employees of international organizations such as the World Bank or the United Nations usually are exempt from DC taxation on their earned income and therefore do not necessarily compute their DC taxable incomes. For the U.S. rules, see I.R.C. § 893 (1982). These employees could, of course, be required to compute their income as if they were taxable under DC law, but the LDC tax administration then would be faced with having to ensure that the employees' computations were accurate.

Contract workers raise a somewhat similar problem because they might not be subject to an income tax. For example, several of the Middle Eastern countries that employ contract workers, *see supra* text accompanying notes 111-13, do not have an income tax, or exempt salaries earned by foreigners. *See* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, TAXES AND INVESTMENT IN THE MIDDLE EAST § 8.1 (1977 & Supp. 1983). Seamen

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B. *Administrative Considerations*

Although the surtax provides a pragmatic design for a tax on nonresidents, it would do little to overcome the second of the two major issues: enforcement of the tax. Voluntary compliance would, of course, be encouraged if nonresidents viewed the LDC tax as reasonable or equitable

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also may not be subject to a DC tax because of the limited amount of time they spend within the jurisdiction of any foreign country.

Tax policy theorists might argue that the surtax approach has another disadvantage: it deviates from a concept of horizontal equity. According to this concept, two taxpayers who have the same incomes and who are similar in all other respects should pay the same amount in income tax. The surtax arguably violates this concept because nonresidents and residents earning the same incomes would pay different amounts in tax (although horizontal equity would be improved by the surtax approach if compared to the Philippines' present approach, which taxes residents on their net income but taxes nonresidents on their gross income).

It is unclear, however, how the concept of horizontal equity should be formulated in the international context. For example, in the domestic context, nearly all theorists agree that a taxpayer's choice of where to live is irrelevant in determining his or her tax liability. In most countries, two taxpayers who have the same incomes but live in different regions nevertheless pay the same amounts in income tax. It is tempting to extrapolate from this domestic situation and argue that a taxpayer's choice of residence abroad also should be ignored in levying an income tax, and that a country should tax nonresidents in the same manner as it taxes its residents. The application of horizontal equity is not self-evident, however, when taxpayers reside abroad. Nonresidents working abroad may experience an increase in their cost of living which is greater than any comparable increase that they would experience domestically if they were to move from one area of the country to another. For a short period of time, the United States responded to these considerations by granting its nonresident citizens special deductions to offset the higher cost of living abroad, although no similar deduction was granted to taxpayers moving from low-cost areas within the country to high-cost areas. *See* Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, § 913, 92 Stat. 3100-06 (1978), *repealed by* Economic Recovery Tax Act of 1981, Pub. L. No. 74-34, tit. I, § 112 (a), 95 Stat. 194 (1981).

Formulating a concept of horizontal equity is further complicated by the problem of converting a nonresident's foreign income into LDC currency. Theoretically, a nonresident's income could be translated into its "equivalent" LDC income, based on the nonresident's purchasing power and standard of living, and this "equivalent" income could be taxed. Implementing this approach obviously would be difficult. *See generally* Impact on Trade, *supra* note 122, at 74-78; Gravelle & Keifer, *U.S. Taxation of Citizens Working in Other Countries: An Economic Analysis*, in 3 STUDIES IN TAXATION, PUBLIC FINANCE AND RELATED SUBJECTS 72 (1979).

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in amount and form. In comparison with many of the other approaches available to an LDC, some of which are illustrated by the Philippine experience, the surtax approach would be clearly preferable. Self-employed nonresidents certainly would be treated more fairly under a surtax than they would be under other approaches.

Yet an evaluation of the experience of the Philippines, though based more on impressionistic than on empirical analysis, suggests that certain nonresident citizens, especially emigrants, may choose to ignore all LDC attempts to tax their DC income, even at low rates. Is this behavior idiosyncratic to Filipino emigrants? Numerous factors affect the willingness of a nonresident citizen to comply with an LDC tax: the circumstances surrounding the departure from the LDC, the amount of loyalty felt toward the LDC of citizenship, the burden of the LDC tax, and the risk that evasion of the tax will be discovered and punished. Many commentators believe that of all of these factors, the possibility of discovery and punishment is the key to voluntary compliance.[130] The Philippine experience suggests, however, that most LDCs are unlikely to be capable of exerting the threat of discovery and punishment in a credible manner against emigrants.

Moreover, the experience of Mexico—the only other LDC that taxed nonresident citizens on their income earned abroad— appears to be similar to that of the Philippines.

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130. *See* READINGS ON INCOME TAX ADMINISTRATION, *supra* note 17, at 483-85. *See also* Crockett, *Common Obstacles to Effective Tax Administration in Latin America*, in PROBLEMS OF TAX ADMINISTRATION IN LATIN AMERICA 10 (1965). Crockett states:

> But is [widespread tax evasion in Latin America] true because the Latin American is different by nature or training or outlook from the more compliant publics of North America and Europe, as some cynical Latin Americans have seemed to think? I am convinced that no such conclusion is warranted. On the contrary, I venture to assert that if the limited enforcement powers, the operational obstacles, the administrative handicaps that are prevalent in Latin America were present in the countries of North America and Europe, a great decay would begin to permeate their presently more productive tax departments, and as their publics became increasingly aware that impunity and not penalty would follow evasion, the relatively high degree of voluntary compliance that vigorous enforcement has slowly built up in them over the years would gradually sink to very low levels.

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This explains in part why the foreign source income of Mexican nonresidents was exempted from taxation in 1981.[131]

Furthermore, the growth of the untaxed underground economy in the United States demonstrates that no country has a monopoly on noncompliance once individuals perceive that their risk of discovery and punishment is minimal. Recent studies of the U.S. underground economy indicate that taxpayer noncompliance increases dramatically whenever income is not subject either to withholding or to a requirement that the payor file an informational return with the IRS notifying it of the amount paid.[132] The noncompliance of overseas Filipinos is entirely consistent with this finding, because income received by nonresident citizens from persons abroad is not subject by the Philippines to either withholding or informational returns. If the host DC were willing, such an approach would be feasible, at least in theory.

If widespread noncompliance, at least among emigrants, is likely to be the rule and not the exception, the inability of the Philippines to respond effectively is obviously discouraging for other LDCs. Stated differently, unless LDC tax administrations can discover and punish cases of noncompliance, such behavior will not be deterred. Admittedly, the Philippines has not been overly aggressive in its attempts to enforce its tax, and the administration of the 1-2-3 system has been marked by passivity. This passivity, however, reflects the BIR's frustration at having few sanctions directed at the collection of delinquent taxes from emigrants. The BIR's resources are limited and must be concentrated where they are most productive. Unless the Bureau actually can collect the taxes owed, efforts directed at identifying nonfilers or auditing taxpayers are not productive.

The BIR's lack of aggressiveness also may reflect an underlying conflict between vigorous tax collection and the

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131. Interview with Juan Teran, former official, Ministry of Finance, Mexico (Jan., 1982). The limited evidence on the noncompliance of U.S. citizens abroad is also consistent with the experience of the Philippines and of Mexico. *See generally* Finch Statement, *supra* note 16.

132. *See* Ekstrand, *Factors Affecting Compliance: Focus Group and Survey Results*, in 73 NAT'L TAX A.-TAX INST. OF AM. 253-62 (1980); Wolfe, *Magnitude and Nature of Individual Income Tax Noncompliance*, in *id.* at 271-77; Harris, *supra* note 101, at 262-65.

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government's policy of encouraging nonresidents to visit the Philippines. The dilemma was sharply focused by the now suspended requirement that a tax clearance certificate be presented before a passport is issued or renewed. The more strictly this requirement was enforced the more likely it was that certain emigrants would simply postpone trips home until they had obtained their new citizenship and new DC passports.[133] Even before the official suspension of tax clearance certificates as part of the Balikbayan program, some embassies and consulates stopped requiring a tax clearance certificate prior to renewing or issuing a passport. Because other LDCs usually encourage visits by their overseas community—if only to obtain scarce foreign exchange—this conflict is not limited to the Philippines.[134]

If this conflict is to be avoided, an LDC must collect its tax in a manner that does not discourage visits home. The quandary is that an LDC may have no other opportunities, or leverage, to collect a tax from nonresidents who, along with their assets, are safely beyond the reach of the LDC. Tying the renewal or issuance of a passport to a tax clearance certificate is a potentially effective solution because it forces nonresidents to identify themselves.[135] While such identifi-

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133. Conceivably, former citizens could be identified at the time they entered the Philippines for a visit and a determination could be made whether they were nonfilers or had any outstanding tax liabilities that had accrued during the period that they were citizens. Such an approach, even assuming it could be implemented, could be easily thwarted. *See supra* text accompanying notes 50-51.

134. Some LDCs have adopted elaborate incentives to encourage nonresidents to return home permanently. For the incentives offered by India, see Council of Scientific and Industrial Research of India, Case Study in Reverse Transfer of Technology (Brain Drain): A Survey of Problems and Policies in India, U.N. Doc. TD/B/C.6/AC.4/6, at 21-23 (1977). Sri Lanka is reported as having tried to implement a "return-of-talent" scheme. *See* Marga Institute, Case Studies in Reverse Transfer of Technology (Brain Drain): A Survey of Problems and Policies in Sri Lanka, U.N. Doc. TD/B/C.6/AC.4/4, at 15-22 (1977).

135. The LDC could require a tax certificate in conjunction with any affirmative act requested by the nonresident, including the renewal of a medical or engineering license. Venezuela uses such a system, requiring certificates of solvency—proof of tax payment—for licenses as well as for permission to leave the country. *See* C. SHOUP, J. DUC, L. FITCH, D. MACDOUGALL, O. OLDMAN & S. SURREY, THE FISCAL SYSTEM OF VENEZUELA: A REPORT 195-96, 216-20 (1959).

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cation enables the LDC to collect its tax, it may also undermine the competing government interest in encouraging trips home.

A different manifestation of the tension between rigorous enforcement of the tax and the undermining of a competing governmental interest is exemplified by a problem the Philippines never confronted: renunciation of citizenship in order to sever the jurisdictional basis upon which the LDC levies its tax.[136] Most LDCs would probably not welcome massive, tax-induced renunciations of citizenship by their emigrants. An LDC that successfully collected its tax from emigrants, however, could face this situation.

The likelihood of tax-induced renunciations is partially related to the financial burden imposed by the LDC tax. Although some emigrants might find any LDC tax offensive, a tax that imposed only a modest burden, such as a 5% surtax, would probably not provide a strong financial inducement to renunciation.

The experience of the Philippines is of little value in evaluating the probability of tax-motivated renunciations. Nonresident Filipinos presumably had no need to renounce their citizenship in order to avoid taxation—they could simply ignore the 1-2-3 tax with impunity. A Filipino's decision to obtain DC citizenship would be made for reasons independent of tax consideration.

LDCs can respond to this potential problem of renunciation by limiting a nonresident's tax exposure to that period of time an emigrant normally must wait before becoming a DC citizen.[137] This solution would eliminate the tax incentive for nonresidents to renounce their citizenship. For emigrants living in the United States, this approach would

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136. *See* Pomp & Oldman, *supra* note 2, at 31-33, 48-49.

137. Even if the renunciation of citizenship is not a serious threat, a time limitation would be desirable for other reasons. Once individuals have been abroad for substantial periods of time, the justice of continuing to subject them to LDC taxation becomes questionable. *Id.* at 49. An LDC tax limited in time, however, would obviously not produce as much revenue as one imposed over a nonresident's lifetime. Moreover, sophisticated nonresidents might intentionally work under a deferred compensation arrangement in order to reduce their incomes during the period in which they would be subject to the LDC tax.

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limit their exposure to an LDC tax to five years, the normal waiting period to become a U.S. citizen.

IV. Summary and Conclusion

This case study questions whether Professor Bhagwati's proposal to tax nonresident citizens can be unilaterally implemented by an LDC. To be sure, generalizations based upon the experience of only one LDC are subject to obvious limitations. The available pool of evidence upon which to base a judgment, however, will never be large because the Philippines and Mexico are the only LDCs to assert citizenship jurisdiction. Although a case study of the Mexican experience would be valuable, its results probably would not contradict those of the Philippine study.[138] Unless the behavior of Filipino nonresidents is idiosyncratic, non-compliance among emigrants—the group most likely to constitute an LDC's brain drain—can be expected.

Enforcement by the LDC will require the assistance of the host DC.[139] A host DC can provide assistance at each stage of the administration of the LDC tax by compiling a tax role, assessing a nonresident's tax liability, and collecting the amount of tax owed. The most efficient way of combating widespread noncompliance would be for the host DC to collect the tax on behalf of the LDC.[140] DC collection of an LDC tax, however, as well as less interventionist roles, would far exceed the current limited amount of intergovernmental cooperation.[141]

For an LDC tax on nonresidents to be workable, a host DC would have to make costly and time-consuming changes in its existing procedures. For example, although a surtax would perhaps require fewer changes in DC practices than would other alternatives, the changes nevertheless would still be considerable. Initially, it might appear that a surtax

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138. *See supra* text accompanying note 131. The limited information on the U.S. experience is also not encouraging. *See generally* Finch Statement, *supra* note 16.

139. Certain draconian measures might in theory permit an LDC to collect the tax without the host DC's assistance. Whether an LDC would be capable of implementing highly sophisticated or intricate procedures is highly problematic. *See* Pomp & Oldman, *supra* note 2, at 39-41.

140. *See id.* at 41.

141. *See id.* at 41-43.

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would only require a DC to add a line to its tax form. This simplicity is superficial because collecting a surtax from select groups of DC taxpayers—nonresident citizens of an LDC—would be equivalent in its administrative aspects to the adoption of a new DC tax. A DC tax administration would have to revise its tax forms and instructions; compile special tax rolls of persons subject to the tax; design special withholding tables and instructions; modify current payment programs for persons not subject to withholding; expand taxpayer education programs; respond to questions; and handle disputes.

This brief outline indicates that DC collection of an LDC tax, even one levied in its simplest form as a surtax, would demand numerous changes in DC practices. These changes would require a serious commitment on the part of a DC.[142] Because of the controversy surrounding the Bhagwati proposal, a DC would not be likely to make this commitment. Even if a DC were inclined to cooperate with an LDC, it still might not be willing to do so unless convinced that other DCs were similarly disposed. Otherwise, a DC competing with other countries for specific types of emigrants, such as doctors, nurses, or engineers,[143] might fear that its efforts at policing an LDC tax would only divert immigration to those DCs not willing to cooperate.

In addition, a DC would be unlikely to participate in the enforcement of a tax on individuals who emigrated in order to escape religious, political, or social oppression. A DC might demand some guarantee that this group will be exempt from the tax.[144] Such an exemption, however, may be impossible to administer fairly.[145]

A DC would probably require that an LDC tax impose equitable burdens on taxpayers. An LDC tax that was levied

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142. *See* id. at 56-57.

143. The DCs actively compete with each other for skilled immigrants. *See id.* at 12-13.

144. Even if practicable, such an exemption might not satisfy those DCs which would refuse to cooperate with certain LDCs under any circumstances. *See id.* at 46.

145. Perhaps the exemption could be granted, at a minimum, to refugees protected by the United Nations Convention and Protocal Relating to the Status of Refugees, July 28, 1951, 19 U.S.T. 6223, T.I.A.S. No. 6577, 189 U.N.T.S. 150.

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as a modest surtax would satisfy this condition; other versions of an LDC tax might not. At the very least, a DC may insist that an LDC tax on the LDC's nonresidents will not deter individuals from emigrating.

Although a DC may view its assistance to the LDC as a form of foreign aid or as a gesture of goodwill, the DC itself is unlikely to derive any immediate benefit from such assistance. Accordingly, a DC may have difficulty justifying costly or time-consuming changes in its existing procedures or law.

If host DCs refuse to play an active role in enforcing an LDC tax on nonresidents, supporters of the Bhagwati proposal will face a serious dilemma. They can, of course, continue to encourage the LDCs to levy taxes on nonresident citizens. At a minimum, some revenue and foreign exchange will be generated. The tax will also serve as a moral statement about the responsibility of nonresidents to their country of citizenship. Indeed, over time, if enough LDCs levy a tax based on citizenship jurisdiction, perhaps the DCs will be convinced to provide the necessary administrative assistance. After a longer gestation period, the DCs might accept Professor Bhagwati's argument that the benefits accruing from the brain drain impose an obligation upon them to cooperate with the LDCs in policing the tax.[146]

If the assistance of the DCs is not provided quickly, however, a tax on nonresident citizens may fall disproportionately on transient nonresidents, such as contract workers and seamen, who tend to be unskilled or semi-skilled workers. If the Philippine experience is probative, the tax may be reduced to nothing more than a voluntary contribution by emigrants to their country of citizenship. Unless DCs actively assist in the collection of LDC taxes, Professor Bhagwati's proposal would become a tax on the muscle drain rather than a tax on the brain drain, accomplishing few of its objectives.

146. For a discussion of this argument, see Pomp & Oldman, *supra* note 2, at 16-18.

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