The tax-exempt status of the central bank in the Philippines

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1. Background

The BSP and its mandate

The Philippines' central bank, Bangko Sentral ng Pilipinas (BSP), was established by the New Central Bank Act of 1993 as part of the restructuring of the old Central Bank of the Philippines (CBP), which was originally established in 1949. The BSP was set up in response to substantial deficits in the CBP's operations prior to 1993 that were incurred in connection with certain quasi-fiscal activities conducted by the CBP consistent with the policies of the national government at the time. These activities included foreign exchange forward cover contracts and swaps entered into by the CBP with certain banks and government-owned and -controlled corporations; the CBP's assumption of the foreign exchange liabilities of some of these corporations and private sector companies during the Philippines' foreign exchange crisis in the 1980s; development banking and financing by the CBP; and the CBP's conduct of open market operations and incurrence of high interest expenses on its domestic securities issued in connection with such operations.

The New Central Bank Act mandates the BSP "to maintain price stability conducive to a balanced and sustainable growth of the economy". The Act empowers the BSP's Monetary Board to control the expansion or contraction in monetary aggregates for the attainment or maintenance of price stability.

In order to fulfil its mandate under the New Central Bank Act, the BSP was granted full policy instrument independence as well as increased fiscal and administrative autonomy from other sectors of the government. As such, the BSP no longer undertakes the quasi-fiscal activities described above. Moreover, pursuant to the Act, the BSP is not permitted to engage in development banking or financing. In addition, a procedure was laid down for the liquidation of the old central bank (Annex A). Most of the provisions adopted at the time of the BSP's creation remain in force, except for its tax-exempt status, which was granted for a limited period and expired in 1998. The merits of granting the BSP renewed tax-exempt status are the main subject of this paper.

Tax treatment of the central bank

The New Central Bank Act of 1993 exempted the BSP from tax for a period of five years to July 1998. From August 1998, the BSP started to pay national, provincial and city taxes, fees, charges and assessments to the government. The national taxes payable by the BSP consist of documentary stamp taxes, tax on rental income, capital gains tax, tax on underwriting commitments, and assumed tax on interest on bonds payable and foreign exchange contracts. The local taxes payable include real property tax, firearms licence fees, radio telecoms taxes and licences, vehicle registration, notarial and other fees.

Section 121 of the National Internal Revenue Code imposes a tax on gross receipts derived from sources within the Philippines by all banks and non-bank intermediaries. Gross receipts arising from interest, commissions and discounts from lending activities, which are of short-term maturity, are subject to a 5% tax. The Bureau of Internal Revenue believes that this tax is applicable to gross receipts from interest income earned by the BSP from its lending activities (including repurchase agreements, rediscounting and liquidity support loans) and receipts from other income-generating activities such as interest income on T-bills held in its portfolio, receipts from sale of T-bills for open market operations and receipts from supervisory fees.

The BSP is also subject to the documentary stamp tax applied to borrowing transactions through the reverse repurchase facility. However, to reduce the cost to the BSP of stamp duty, a less costly alternative means of monetary management, the Multitransaction Interbank Payment System (MIPS) was adopted. The BSP's participation in MIPS eliminates the burden of paying stamp duty on its reverse repurchase transactions, particularly on overnight transactions. MIPS allows interbank borrowing and lending transactions without collateral and, therefore, does not require the presentation of collateral documents and the payment of corresponding taxes on these documents.

2. Arguments for giving tax-exempt status to the BSP

The granting of tax-exempt status to the BSP is supported by the BSP for the following reasons:

1. *The operations of the BSP are guided by its mandate to maintain price stability and not by profit considerations. It should not be taxed, particularly on its open market operations, on the same basis as profit-oriented commercial banks.*

Given the underlying objective of maintaining price stability, the BSP's monetary instruments should be differentiated from the ordinary borrowing and lending operations of banks, which are in the business for profit. While it has no products or services to sell, the BSP participates in the market because it is required by law to ensure monetary stability. The BSP's borrowing and lending activities are intended primarily to manage the domestic money supply so as to maintain stable prices conducive to balanced and sustainable economic growth. Hence, its operations are not guided by profit considerations, as indicated by the following examples:

(a) Unlike banks whose borrowing and lending rates are market-determined, the BSP rates for its open market instruments are policy-driven, ie they serve as signalling devices for the current stance of monetary policy. Thus, there are instances when the BSP borrows at above market rates or below market rates, depending on monetary conditions.

(b) Proceeds from the BSP borrowings from banks to reduce money supply are kept in its vaults instead of being lent out, and earning interest income, as ordinary banks do.

(c) The BSP lends to banks experiencing temporary liquidity problems at market-determined T-bill rates, but its volume of lending is dependent on the amount of liquidity assistance required by banks.

(d) The volume of sales of T-bills to the market by the BSP under its open market operations is also not determined by income considerations but by the need to ensure that the levels of monetary aggregates are consistent with the inflation target.

The conduct of monetary policy thus involves a range of financial risks and costs that result from policy decisions taken by a central bank. These costs, as noted above, include those associated with monetary operations such as sterilisation of capital inflows or repo costs. Monetary and exchange polices can also require the sale of foreign assets at less than favourable prices. While the underlying policy action may be successful, the financial consequences may require some explanation. *After all, while the BSP - like other central banks - does not pursue a profit objective, there is a high expectation that a profit should result from the monopoly power to issue currency granted to it*. Moreover, while the BSP is not a profit-making entity, it is expected to exercise internal financial prudence.

2. *The gross receipts tax imposed on interest income earned by the BSP from its lending activities and receipts from other income-generating activities could render the BSP less effective in fulfilling its primary mandate of keeping prices low and stable.*

Taxes add costs to the BSP's open market and other operations. The erosion of its income position due to higher expenses would render it less capable of funding its interest payments on its borrowings from banks for liquidity management purposes. This handicap could make the conduct of open market operations less effective, thus restricting the flexibility with which the BSP would be able to conduct monetary policy. Ultimately, this could adversely affect the public in terms of higher prices of goods and services.

For instance, when the BSP sees a likely acceleration of inflation, it raises its borrowing rate to mop up excess money supply and pre-empt the upward pressure on prices. However, this action will increase its interest expenses and lower its net income. Tax payment will further erode its net income. The BSP could even incur a loss. Since the BSP is expected to maintain sound financial operations, the payment of taxes effectively constrains the ability of the BSP to focus on its primary mandate of keeping prices stable.

3. *The cost of the gross receipts tax may be shifted to the banks and this could lead to higher bank lending rates.*

The BSP could pass on to banks the cost of the gross receipts tax by increasing the lending rates under the repurchase window and emergency advances or decreasing its borrowing rates under the reverse repurchase and special deposit account facilities. It must be noted that any decision by the BSP to do so would be based on its monetary stance and not on cost considerations. The shifted cost of the tax could lead to higher interest rates on bank loans and higher overall domestic interest rates, and thus pose a drag on economic growth. Based on the BSP's financial performance for 2001, it is estimated that the BSP would have to raise its lending policy interest rate by around 1 percentage point to cover the tax. The possible rise in market interest rates would increase the cost of domestic borrowings, including those for the national government.

4. *Taxing the BSP would mean a decrease in dividends and interest rebates to the national government.*

Taxing the BSP would increase its expenses and lower its net income. A lower net income would mean lower dividends and interest rebates to the government. Thus, whatever the government stands to gain in the form of taxes would be offset by lower dividends and interest rebates that the BSP would be remitting.[1] This would result in a neutral impact on the consolidated public sector financial position. Moreover, the imposition of tax on the BSP increases the level of national internal revenue collections and will benefit the local government units, as they are allotted a proportion of the national internal revenue collections. This partially offsets the impact on the budget of the increase in revenue collections.

3. Tax status of central banks in other countries

The governments of a number of countries in the Asia-Pacific region share the view that it is not appropriate to tax central banks and monetary authorities, particularly their open market operations.

A survey of the tax status of seven central banks and monetary authorities in the Asia-Pacific region found that none tax their open market operations (Annex B). The Hong Kong Monetary Authority, the Bank Negara Malaysia, the Reserve Bank of New Zealand and the Bank of Thailand are exempted from all other taxes. On the other hand, while the central banks/monetary authorities of Australia, Indonesia and Singapore are exempt from tax on open market operations, they are subject to other taxes. The governments of these countries recognise the crucial importance of ensuring the unfettered ability of their respective central banks/monetary authorities to conduct effective monetary management.

4. Conclusion

Taxes add costs to the operations of the BSP. The erosion of its income position due to higher expenses would render it less capable of funding its interest payments on its borrowings from banks for liquidity management purposes. This could make the conduct of monetary operations less effective. Likewise, if the gross receipts tax is passed on to banks through higher policy lending rates, this could lead to higher interest rates on bank loans, thus depressing the lending activities of banks.

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[1] The BSP's profit before dividends in excess of 1% of its assets is remitted to the government as an interest rebate. Of the remaining net profit after such rebate, 75% is remitted to the Bureau of the Treasury for the liquidation of the liabilities of the Central Bank Board of Liquidators (see Annex A for a note on its operations) or to the government as a dividend, and 25% is retained under the surplus account in the BSP's books. The proceeds of bonds sold by the Republic to the BSP pursuant to a Memorandum of Agreement between the BSP and the Department of Finance are maintained in special interest bearing accounts with the BSP.

The taxation of the BSP operations also means lower dividends and interest rebates to the national government. Thus, the tax gains would be offset by lower dividends and interest rebates that the BSP would be remitting to the government.

The conduct of monetary policy by the BSP entails financial risks and costs that could result from its policy decisions. As such, while the BSP is not principally pursuing a profit objective, it is nevertheless expected to operate profitably and exercise internal financial prudence. Taxing it like any corporate entity introduces complications in these respects.

Finally, it is noted that the governments of other countries do not tax central banks/monetary authorities, particularly their open market operations. These governments recognise the need to conduct effective monetary management.

Annex A:
Notes on the liquidation of the former central bank

The New Central Bank Act of June 1993 set two basic prerequisites for the BSP: the constitution of a new Monetary Board (fulfilled in August 1993) and the transfer of certain assets and liabilities from the old central bank (CBP) to the BSP.

To meet the second requirement, the Act provided for a Committee of Seven to determine which assets and liabilities of the CBP may be transferred to or assumed by the BSP. The Committee was comprised of: three members of the Monetary Board, including the Governor, representing the BSP; the Secretary of Finance and the Secretary of Budget and Management, representing the national government; and the chairmen of the Committees on Banks of the Senate and House of Representatives, representing Congress. The Committee completed its work in November 1993.

The Committee was guided by the following principles, most of which were prescribed under the Act:

1. The capital of the BSP was set at PHP 50 billion, to be fully subscribed by the government. Initial paid-up capital was PHP 10 billion, with the balance payable within two years.
2. The assets and liabilities from the CBP to be transferred to the BSP were limited to an amount that enabled the BSP to meet its responsibilities and operate on a viable basis.
3. The outstanding amounts of the Monetary Adjustment Account, the Exchange Stabilisation Account and the Revaluation of International Reserve Account, all representing paper losses, were retained in the books of the CBP.
4. Liabilities assumed by the BSP included liability for notes and coins in circulation.
5. Any asset or liability of the CBP not transferred to the BSP was retained and administered, disposed of and liquidated by the CBP. This continues to exist as the Central Bank Board of Liquidators (CB BOL), solely for this purpose, but only for 25 years or until the retained liabilities have been liquidated.
6. The BSP is a new corporate entity and, therefore, any capital that is paid in should be backed up by real assets.
7. Assets inherent to central banking were first transferred to the BSP. In the same manner, liabilities inherent to central banking but PHP 10 billion less than the corresponding assets were assumed by the BSP.
8. Fair market valuation of the fixed assets of the CBP was carried out prior to the transfer.

The distribution of the assets and liabilities of the CBP between the BSP and CB BOL was based on the CBP's balance sheet as of 2 July 1993. Of the total assets of the CBP of PHP 623 billion, PHP 291 billion (the bulk of which was in the form of international reserves) was transferred to the BSP, and the balance of PHP 332 billion was retained with CB BOL. Of the total liabilities of the CBP of PHP 612 billion, PHP 281 billion (mostly in the form of currency issued and deposit liabilities) was transferred to the BSP, while PHP 331 billion was retained in the books of CB BOL. CB BOL has not defaulted on the payment of any of its foreign obligations. As of November 2002, CB BOL's foreign liabilities had been reduced to PHP 68 billion, from PHP 110 billion in July 1993.

To further strengthen the BSP's financial position and ensure that it would not incur losses in the future, the Committee reiterated the following provisions in the BSP charter:

1. full capitalisation of the BSP at PHP 50 billion by July 1995;
2. maintenance of a positive net foreign asset position;
3. collection of interest and other charges on all loans and advances that the BSP extends;
4. issuance of BSP certificates of indebtedness only in cases of extraordinary price changes;
5. authority to charge equitable rates, commissions or fees for services which the BSP renders to the national government, its political subdivisions and instrumentalities;
6. prohibition of BSP involvement in developmental financing.

Since its establishment, the BSP has remitted to the government PHP 51 billion in dividends and interest rebates and paid taxes of PHP 23 billion for the period July 1998 to November 2002.

Annex B:
Survey results on the tax status of selected central banks

Economy	Central bank	Tax status	Types of taxes levied
Hong Kong	Hong Kong Monetary Authority	Exempted	na
Malaysia	Bank Negara Malaysia	Exempted	na
Thailand	Bank of Thailand	Exempted	na
New Zealand	Reserve Bank of New Zealand	Exempted	na
Indonesia	Bank Indonesia	Exempted for open market operations but Bank Indonesia withholds 15% tax on interest income earned by corporate buyers of its paper	Income tax; property tax
Singapore	Monetary Authority of Singapore	Exempted for open market operations	Tax on properties; goods and services tax
Australia	Reserve Bank of Australia	Exempted for open market operations and income tax; but earnings available for distribution after transfers to reserve funds maintained for contingencies are paid as dividend to the government	Local government tax paid on gratuitous basis; fringe benefit tax on non-salary component of employees' remunerations; payroll tax on salaries; sales tax on cars

Source: Executives' Meeting of East Asia-Pacific Central Banks and Monetary Authorities Survey 1998.

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