ALERT ♦ Issue No.2 ♦ January 11, 2005
(Alliance of Legislators Against Regressive Taxes)

Nine Reasons Against HB 3555

(RAISING THE VAT RATE BY 20% FROM 10% TO 12%)

1. The proposed 20% VAT rate increase (from 10% to 12%) is the wrong solution to low VAT collections.

The government's failure to generate substantial revenues from the Value Added Tax (VAT) can be traced to inefficiencies in administration that have allowed billions of pesos in annual leakage.

The average leakage from VAT has been estimated at 29.8% annually from 1998 to 2002, according to a study by the National Tax Research Center (NTRC). This resulted in losses of about P41.6 billion annually, or P208 billion over the five-year period.

But the VAT leakage would be much bigger if 2003 figures are factored in. On that year alone, the Department of Finance estimated the gap at P144 billion, as VAT revenues stood at P135 billion out of a collection target of P279 billion. The accumulated VAT gap is therefore roughly P393.7 billion over the six-year period, or P65.5 billion annually.

Based on these figures, there was apparently a substantial 56% jump in VAT leakage from 2002 and 2003, equivalent to P87.1 billion.

Table 1.
Estimated VAT GAP and Leakage Rate, 1998-2003

1998	1999	2000	2001	2002	2003	Average
P35.7 B	P26.9 B	P34.3 B	P54.3 B	P56.9 B	P144 B	P65.5 B
31.0%	22.6%	26.3%	33.8%	33.0%	51.6%	33.05%

Notes:
- 1998-2002 VAT leakage based on estimates by NTRC
- 2003 based on DOF estimate of VAT leakage

On the other hand, VAT effort—measured by collections from VAT as a percentage of Gross Domestic Product (GDP)—reflects an erratic and generally declining trend from 3.5% and 3.6% respectively in 1996 and 1997 to only 2.9% and 3.1% in 2002 and 2003, respectively. The bulk of the increase in collection in 2003 was even said to have been the result of VAT imposition on banks, which has been deferred since 1995.

Table 2. VAT to GDP ratio, 1988 to 2003

1988	1989	1990	1991	1992	1993	1994	1995
1.8	2.2	2.4	2.2	2.4	3.0	2.8	3.1

1996	1997	1998	1999	2000	2001	2002	2003
3.5	3.6	3.0	3.1	2.8	2.9	2.9	3.1

Source: DOF presentation to Congress, 7 December 2004
Notes:
1998 – VAT was first adopted replacing 12 kinds of indirect taxes
1996 – VAT coverage was expanded to include most types of services; it was initially applicable only to domestic sales and importation of goods
2003 – Placed banks under the VAT with the expiration of the two-year VAT deferment for the sector as per RA 9010; but by 2004, banks were again placed under the GRT (Gross Receipts Tax) system as per RA 9238

2. The "other" problem in low VAT collections is the government's overly generous exemptions.

Various fiscal incentives laws enacted by Congress have allowed firms mostly engaged in exports and those under investment priority areas to avail of various VAT exemptions and zero-rated privileges that amounted to P195.5 billion in 2003 alone—equivalent to the P194-billion budget deficit in 2004. These exemptions cornered the biggest share of tax and duty exemptions granted by the government in that year which amounted to P299.42 billion.

Table 3.
Amount of tax and duty exemption under various fiscal incentives laws
By Tax Type, 2003

1. Income Tax	P34.88 B
2. Excise Tax	P0.037 B
3. Capital Gains Tax	P0.003 B
4. Donor Tax	-
5. Withholding Tax	P0.009 B
6. Franchise Tax	P0.016 B
7. Percentage Tax	P1.989 B
8. Value Added Tax	**P195.52 B**
9. Duty	P56.05 B
TOTAL	**P299.92 B**

Source: DOF presentation to the House Committee on Ways and Means, 6 January 2004

A breakdown of this P195.5 billion figure by type of incentive law shows that P101 billion (52%) was granted through incentives primarily given by the Philippine Export Zone Authority (PEZA); P87.25 billion through various internal revenue code exemptions; and the rest through special incentive laws.

3. The problem in VAT is not the "old" nor "low" 10% rate.

Proponents of HB 3555 argue that government needs to increase the VAT rate to "keep with the changing times." But a higher VAT rate does not necessarily translate to higher collections since the key is still collection efficiency.

The International Monetary Fund (IMF) considers the country's current 10% VAT rate "low," but this is true only when compared to the average standard rates of Latin America (14%) and Europe (20%). It should be noted that the Philippines just falls within the standard VAT rate in Asia at 11% *(IMF, 11 August 2004)*. The Philippines has the same rate as Cambodia, Indonesia and South Korea. VAT is much lower in neighboring Thailand (7%), Singapore (5%) and Japan (5%), while Vietnam charges a VAT of between 5-10% depending on the nature of transaction.

Furthermore, compared with other countries in Asia, the Philippines has one of the lowest efficiency ratio in terms of VAT collection. "Efficiency ratio" is defined as VAT effort over the country's statutory VAT rate. While the country appears to have higher collection efficiency than Indonesia, it lags behind South Korea, Singapore and Thailand. A good case in point would be Thailand, which has a lower VAT rate than the Philippines, but registers a higher VAT effort and efficiency ratio.

Table 4.
Statutory VAT rates, VAT effort & efficiency ratio, Selected Asian Countries

COUNTRY	VAT rate	VAT effort		Efficiency ratio	
		1994	1998	1994	1998
Indonesia	10	4.80	2.96	0.48	0.30
Philippines	10	3.33	3.78	0.33	0.38
Singapore	3	1.49	1.56	0.50	0.52
Thailand	7	3.15	4.20	0.45	0.61
South Korea	10	4.04	4.30	0.40	0.43

Source: Q&A on VAT rate increase, CPBD, 09 September 2004 quoting Manasan/PIDS (2002)

4. A VAT rate hike will increase the burden on honest tax payers.

A VAT special task force created by the BIR in 2001 noted the following problems in VAT administration: **(1)** excessive claims of input VAT credit, **(2)** claims of presumptive VAT by firms not entitled to do so under the law and **(3)** the lack of industry standards against which to validate claims of input VAT.

The NTRC in September 2003 meanwhile identified the following sources of VAT leakage: **(1)** exorbitant claims/fraudulent applications of input tax credits, **(2)** under-declaration of sales and **(3)** non-issuance of official receipts or issuance of unofficial receipts.

These findings clearly point to stricter VAT regulation as the key to plugging the P65.5-billion annual tax leakage. But while several solutions have been offered, including the use of Third Party Information and the implementation of industry benchmarking (which would allow for counter-checking input claims and the use of presumptive input VAT for particular hard-to-tax industries, among others), the Arroyo government is resorting to the “quick-fix” solution of raising the VAT rate.

Aside from unduly punishing honest tax payers, an increase in VAT rate would also further widen the tax differential among VAT, non-VAT and zero-rated VAT members.

5. VAT is regressive and an increase will enhance government’s regressive tax structure.

While it may be true that VAT exempts several goods and services commonly consumed by the poor--including agricultural products in their original form, public transport and apartment units with monthly rental not exceeding P8,000—it covers a wide range of goods and services.

These include food products (processed meat, canned fish, coconut and vegetable oil, bakery products, noodles, milk, dairy products, coffee, sugar); clothing, footwear, tannery and leather products; drugs and medicine, furniture, pulp and paper; glass and glass products; cement, steel, iron, wood and most construction materials; electrical lamps and equipment; machinery and equipment both for manufacturing and agriculture; wholesale trade and retail trade; pawnshops; restaurants, cafes and other eating and drinking places; employment and recruitment agencies; motion picture production; hotels and motels, telecommunications(including landline, post-paid and pre-paid mobile phone services.)

During the committee deliberations, the DOF has consistently argued that VAT is “progressive,” noting that tax liability depends on consumption rather than income (or simply put, “the more you consume, the more taxes you pay”).

The DOF’s logic violates the basic principle of progressive taxation that a tax should be linked to “one’s ability to pay.” Clearly, VAT does not fall into this definition because the amount of VAT on a particular good is the same for everyone, however much she or he earns. This means that the more people earn, the less the proportion they will pay in VAT. Conversely, the less people earn, the more the proportion they will pay in VAT. Regressive taxes hit poor people harder than the better-off.

The government has increasingly relied on VAT to prop up its indirect tax collections. The share of VAT to total indirect taxes collected by the government stood at 28.9% in 1993, but shot up to nearly half (47.1%) in 2003. Additionally, VAT’s share to government’s total tax revenues has increased from 19.2% in 1993 to 25.1% in 2003. This indicates government’s increasing dependence on VAT.

Table 5. National Tax Revenues, by tax type
In Billion pesos, 1993-2003 (in two-year intervals)

Type	1993	1995	1997	1999	2001	2003
National Tax Revenues	230.17	311.78	412.17	431.69	489.86	538.02
1. Direct Taxes	77.27	114.06	167.85	188.17	229.00	251.03
2. Indirect Taxes	152.90	197.73	244.31	243.52	260.85	286.99
Of which VAT	44.16	58.47	88.99	91.78	106.49	135.30
Indirect to Nat'l Tax Revenues	66.4%	63.4%	59.3%	56.4%	53.2%	53.3%
VAT % to Indirect taxes	28.9%	29.6%	36.4%	37.7%	40.8%	47.1%
VAT to Nat'l Tax Revenues	19.2%	18.7%	21.6%	21.3%	21.7%	25.1%

Source of Basic Data: National Tax Research Center using BIR, BOC and BTr figures

6. Because of its regressive character, the VAT increase will hurt the poor most. The latest Family Income and Expenditures Survey (FIES 2003) indicates a movement towards a less unequal income distribution among Filipino families compared to the previous FIES undertaken in 2000. This is measured by the Gini coefficient, which stood at 0.4822 in 2000 and further slid to 0.4660 in 2003.

FIES 2003 also showed the three poorest income deciles registering negative savings or "dissavings" (where expenditures exceed income), compared to the FIES 2000 where only the two lowest income deciles experienced such. FIES 2003 also shows that the income of the richest 10% of Filipino families is 21 times the income of the poorest 10%.

The study indicates a decline in purchasing capacity which will further weaken with an increase in prices due to the VAT hike.

Table 6.
Average annual income, average annual expenditures and average savings of families at current prices, by national income decile: 2000 and 2003.

DECILE	2000			2003		
	Average Income	Average Expenditure	Average Savings	Average Income	Average Expenditure	Average Savings
PHILIPPINES	**145,121**	**118,839**	**26,282**	**148,757**	**125,277**	**23,481**
FIRST	24,506	26,463	*(1,957)*	26,424	28,699	*(2,275)*
SECOND	39,620	40,537	*(917)*	42,440	43,730	*(1,290*
THIRD	51,250	50,795	455	55,113	55,153	*(39)*
FOURTH	64,231	61,690	2,538	68,845	66,286	2,560
FIFTH	80,247	74,015	6,232	85,222	80,169	5,053
SIXTH	100,549	90,878	9,671	105,886	98,866	7,020
SEVENTH	128,203	113,094	15,109	134,103	120,731	13,371
EIGHTH	169,290	141,760	27,521	175,844	153,435	22,409
NINTH	237,029	189,464	47,565	246,192	206,228	39,964
TENTH	556,277	399,678	156,599	547,504	399,468	148,036

Source: FIES 2000, 2003

With inflation reaching 8% as of December 2004--the highest registered in six years--any further tax rate imposition, especially on indirect taxes will only hurt the poor more. **Table 7** shows the percentage distribution of family expenditures by major expenditure group. A quick scan shows that the majority of these items will most likely be affected by a VAT rate hike.

TABLE 7.
PERCENTAGE DISTRIBUTION OF TOTAL FAMILY EXPENDITURES BY MAJOR EXPENDITURE GROUP, 2000 AND 2003

EXPENDITURE GROUP	2000	2003
TOTAL FAMILY EXPENDITURES (P1,000)	1,791,132,882	2,005,045,840
(IN PERCENT)	100	100.0
FOOD	43.6	42.6
FOOD CONSUMED AT HOME	38.6	37.3
CEREALS AND CEREALS PREPARATIONS	11.9	10.9
ROOTS AND TUBERS	0.6	0.6
FRUITS AND VEGETABLES	4.4	4.3
MEAT AND MEAT PREPARATIONS*	7.0	6.7
DAIRY PRODUCTS* AND EGGS	3.0	3.2
FISH AND MARINE PRODUCTS	5.7	5.5
COFFEE, COCOA AND TEA *	1.0	1.0
NON- ALCOHOLIC BEVERAGES *	1.4	1.4
FOOD N.E.C.	3.6	3.8
FOOD REGULARLY CONSUMED OUTSIDE HOME *	5.0	5.3
ALCOHOLIC BEVERAGES	0.7	0.7
TOBACCO	1.1	1.1
FUEL, LIGHT AND WATER	6.3	6.5
TRANSPORTATION AND COMMUNICATION *	6.8	7.4
HOUSEHOLD OPERATIONS*	2.3	2.2
PERSONAL CARE AND EFFECTS *	3.6	3.9
CLOTHING, FOOTWEAR AND OTHER WEAR *	2.7	2.9
EDUCATION	4.2	4.0
RECREATION *	0.5	0.5
MEDICAL CARE *	1.9	2.2
NON- DURABLE FURNISHINGS *	0.2	0.2
DURABLE FURNITURE AND EQUIPMENT *	2.5	2.6
RENT/RENTAL VALUE OF DWELLING UNIT *	14.3	13.6
HOUSE MAINTENANCE AND MINOR REPAIRS *	0.9	0.7
TAXES PAID	2.2	2.2
MISCELLANEOUS EXPENDITURES	3.3	3.7
SPECIAL OCCASIONS OF THE FAMILY	2.4	2.5
GIFTS AND CONTRIBUTIONS TO OTHERS	0.9	1.2
OTHER EXPENDITURES	2.9	2.9

Source: National Statistics Office, 2003 Family Income and Expenditure Survey (Preliminary Results)
** Major expenditure groups likely to be affected with a VAT rate hike*

7. HB 3555 is not a product of genuine consultation.

Several irregularities marked the approval of the bill at the committee level during the Special Session called from January 5-7, 2005. The original measure, HB 1468, was merely inserted into the agenda of the Committee on Ways and Means as it was deliberating on HB 3105, which seeks to lift certain VAT exemptions on January 6. The three-day rule was violated in the distribution of official notices to committee members and affected sectors for said meeting. Consumer groups and affected industries were not sufficiently consulted.

Worse, HB 1468 was sneaked in and approved hastily during the January 7 meeting of the committee that was then tackling an entirely different agenda (i.e., HB 3104 which seeks to repeal special incentives laws). The bill would have been railroaded in plenary that same night had it not for the intervention of activist solons and the minority who scored the undemocratic process in approving such crucial tax measure.

- ***Annex 1*** *shows a sample receipt of goods consumed for a week by a typical lower-middle income class family. The receipt shows that VAT affects approximately 72% of the cost of goods bought by the household (P888.45 out of P1,231.40). This means this family will shoulder some P88.84 in VAT payments to the government for this particular transaction.*

- *For a quick scan of VAT-liable sectors, see **Annex 2**.*

8. VAT is an imposition of the International Monetary Fund.

As early as 1999, the International Monetary Fund (IMF) has been vigorously pushing the Philippine government to increase the VAT rate following the Asian financial crisis which had a negative impact on fiscal revenues. The proposal was among the IMF's recommendations in its Memorandum on Economic and Financial Policies (MEFP) to the Philippines on June 30, 1999. The proposal did not prosper.

The IMF revived the proposal only last year as Pres. Gloria Macapagal-Arroyo was about to be proclaimed to a full six-year term. It may be recalled that a Post-Program Monitoring Team was sent to the country from June 25 to July 8 to evaluate the government's fiscal position and tax proposals.

The IMF team recommended the VAT rate increase, arguing that there was international evidence indicating that raising the VAT would significantly increase tax revenues, even for a country with low collection efficiency. Based on the IMF's report, Philippine government representatives were not receptive to the idea then, saying it would only punish honest tax payers. Instead, the government proposed the lifting of VAT exemptions on certain sectors, the shift to Gross Income Taxation (GIT) and tax amnesty. The last two measures have since been rejected by IMF, while the government has made a complete turnaround from its initial position.

9. VAT collection can be increased without any rate adjustment.

In a 2004 study, the Congressional Planning and Budget Department (CPBD) recommended the use of a presumptive VAT on hard-to-tax groups using adopted industry benchmarks. It proposed a minimum net VAT of 3% for industries, hotels, restaurants, freight, etc. echoing earlier proposals by Dr. Rosario Manasan of the Philippine Institute for Development Studies (PIDS) in a 2002 study, as well as former socioeconomic planning secretary and NEDA director-general Cielito Habito in his presentation during a forum sponsored by ALERT (Alliance of Legislators Against Regressive Taxes) in August last year.

The CPBD also called on Congress to review special treatments under the VAT, including those enjoyed by Independent Power Producers and other favored sectors.

Another CPBD proposal was to spread input VAT credits over a longer period of time rather than a one-time claim. An amendment in HB 3555 (Under SECTION 4) does precisely this by equally distributing the input tax credits for capital goods (over its depreciable life) and other inputs (not to exceed 5%).

The amendment is a knee-jerk response to government's failure to earn revenues from the windfall profits of telecommunication firms. It may be recalled that the DOF initially mulled the imposition of a 5-7% franchise tax on telecommunication companies which have been registering negative VAT payments, stemming from their numerous tax exemptions and privileges. In the short-term, the amendment may result in slightly higher VAT collections from such capital-intensive firms as Globe and PLDT-Smart, but this will not necessarily solve the bigger causes of VAT leakage in the long run. **#**

For inquiries, please contact the office of Bayan Muna Rep. Teddy Casiño
• SW-616, House of Representatives • Telefax 9315911 • Tel. 9315001 loc.7315