

# The economy on a cusp\*

## The proposed VAT amendments and their larger significance

(Condensed\*\*)

Debates on the revision of the value-added tax (VAT) are about to reach the penultimate stage. Once house and senate have passed their respective versions of the bill, congress – through a bicameral conference committee sometimes referred to as the “third chamber” – must then agree on the final form of the law. After all the media-posturing, the politicking, and horse-trading have subsided, politicians of both chambers are still left to confront the nation’s true interests – and their own consciences. It is vital that they finally pass a law that is right in form and adequate to the economy’s needs.

The shape of the VAT law that is ultimately passed will dictate whether or not the country remains on a fiscal sickbed. Contrary to government pronouncements, the Philippine economy is *not yet* out of fiscal trouble. Notwithstanding all that has occurred, the country, in our view, still needs to raise the rough equivalent of one percent of GDP in additional revenues (around P54 billion in 2005) simply to avert a massive loss of confidence in Philippine sovereign debt that could cause borrowing costs to rise by 300 basis points (i.e., three percentage points) and cost the nation an additional P5 billion in just one episode.<sup>1</sup> That burden would multiply as the country continued to borrow and its ratings continued to decline. More profound than this, however, are the social, economic and financial costs to the nation if one considers – as one should – the macroeconomic instability and uncertainty that are bound to follow upon a debt-payments crisis. (Among other things, recent favourable trends in the exchange-rate and the stock market could very quickly reverse.)

Beyond merely placating its creditors, however, the government must seriously respond to the people’s need for development and expand the budgets of vital social services and infrastructure: to do this it actually needs to raise the equivalent of *another percentage point* of GDP in revenue at the very least.

As a proportion of GDP, government spending net of debt service (primary spending) has fallen more or less continuously from 16 percent in 1999 to less than 13 percent in 2004. By the end of this year it will have shrunk by the equivalent of 2.7 percentage points of GDP (1.09 and 1.61 percent in 2004 and 2005, respectively).

Social services spending has mirrored this decline: as a proportion of GDP, spending on education dropped from 3.4 percent in 1999 to only 2.7 in 2004, while health spending fell from less than half a percent to less than a quarter of a percent of GDP. Similarly, spending on infrastructure is now barely one percent of GDP.

More alarming is the fact that the 2005 budget even projects a *contraction* of primary spending by 2.8 percent in absolute (nominal) terms. The decrease in real terms, of course, is much larger. The cuts would bring primary spending down to only 11.9 percent of GDP.

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<sup>1</sup> That is, an increase of  $0.03 \times \$3 \text{ billion} = \$90 \text{ million}$  or approximately P4.9 billion at a P54.5/\$1 exchange rate.

If the nation's politicians would only care to look, the magnitude of the task would be clear enough. The legislature's target should be to raise roughly P108 billion<sup>2</sup> in revenue or in reallocated spending in 2005. Roughly half of this is the minimum needed to stave off a fiscal crisis; the other half is required to restore vital social services to even halfway-decent levels.

### The score so far

*How do actual accomplishments measure up?* Thus far congress has really passed *only one* significant revenue measure: the updating of tobacco and alcoholic beverage excises, or the so-called "sin taxes". By most estimates this measure will raise at most P6.7 billion this year, with perhaps succeeding three-percent increments in the next two years. Unfortunately even this gives mixed signals. The measure could have raised as much as P14 billion if only congress had not surrendered on the one crucial issue of re-classifying products to reflect their current prices rather than those that prevailed in 1997. This fact confirms the suspicion that certain interests remain sacrosanct.

The only other significant fiscal "reform" legislated thus far occurred unintentionally when the senate passed the house version of the budget without revision. That budget contained the original 40-percent cut in pork-barrel funds<sup>3</sup> submitted by the executive, slicing off approximately P8.5 billion from the budget. By making it possible to run a smaller deficit than otherwise, the cuts should be lauded for lowering the debt-trajectory. It is naïve, however, to think the savings will recur in future budgets.

Still, relative to the goal of P54 billion in added revenue simply to avert a crisis – not to mention the P108 billion for both stabilisation *and* even a minimal recovery of social spending – these achievements are paltry, indeed.<sup>4</sup> The current tenor of developments bodes ill even for the administration's own programme of legislative revenue measures (Table 1). Of eight revenue measures the Arroyo administration originally proposed, only *two* have been passed (of which one even has a dubious revenue impact) while *four* have been abandoned.

Table 1.  
**The administration's original legislative revenue programme**  
(projected yield in billions of pesos)

	Yield	Status
Sin product indexation	9.1	Passed in diluted form; yield P6.7 bn
Rationalization of fiscal incentives	5.0	Pending (partly covered by VAT proposal)
Raising the VAT	30.0	Pending
Tax on telecommunications	9.1	Abandoned
Excise tax on petroleum products	28.0	Abandoned/postponed?/replaced by VAT inclusion?
Adoption of gross income tax	16.8	Abandoned
<b>Total</b>	<b>97.0</b>	
<i>Memo:</i>		
General tax amnesty	25.00	Abandoned; one-off increase
Lateral attrition law	---	Passed (of unknown revenue impact)

**Source:** *Philippine medium term development plan 2004-2010*, Chapter 7, pp. 97-98.

To be sure, some of these proposals did not even deserve to see the light of day: tax amnesties are well-known failures, and gross-income taxation is highly suspect in terms of horizontal equity and its economic impact.<sup>5</sup> Be that as it may, what is clear is that the administration's programme is now

<sup>2</sup> That is, two percent of an estimated nominal GDP of P5375 billion for 2005.

<sup>3</sup> Forty percent of P21.3 billion. Before the cuts each senator expected to receive P200 million in annual pork barrel while each of 236 house representatives (including party list representatives) was to get P70 million (P4.8 billion plus P16.5 billion for a total of P21.3 billion in such funds).

<sup>4</sup> The foregoing refers only to measures coming from congress. An important action by the executive was the partial adjustment of the National Power Corporation's rates in September 2004, which has helped to limit that part of rising public debt and growing debt service that is due to off-budget items.

<sup>5</sup> The table presented is in fact only the latest in a changing list of "priorities", which were apparently not well thought out. The administration initially even proposed scrapping the VAT and replacing it with a general sales

tattered and mangled. For this the Arroyo administration itself must assume some responsibility for its precipitate pronouncements and lacklustre leadership; but the legislature's obduracy and its vulnerability to lobbying by powerful vested interests are also partly to blame. If towards the end of 2004 the administration envisioned P97-122 billion from its programme, it can now expect *less than* P42 billion even under its own assumptions.<sup>6</sup> As stated above and argued in detail below, however, this amount is barely sufficient to fill the minimal requirements of stabilising the debt, much less responding to people's needs.

What becomes even clearer, however, is the pivotal role the VAT measure now plays in the equation. The VAT amendment is now the only significant revenue measure that is still active and pending; it has become, like it or not, the centrepiece of the Arroyo administration's fiscal reform programme. Without a credible law that increases the VAT rate now (and expands its coverage later) the government's fiscal reform programme has no leg to stand on.

### **VAT's supposed regressiveness**

This brings us then to the main point: *just how good are the VAT-related proposals currently on the table?* Two criteria must be applied: the first is whether the revenue raised is adequate to the task. For this is certainly the entire point of the effort. Second, however, one must ask whether and how any social inequity and economic distortion can be avoided or mitigated without sacrificing this principal task.

The original idea – a proposal we originally supported as part of a burden-sharing package – was simply to increase the VAT rate from the current 10 percent to 12 percent. If nothing else is done, this is estimated to yield an additional amount of P30-35 billion,<sup>7</sup> a figure broadly in line with the government's own projections when it assumes a 70 percent VAT-collection efficiency. We continue to hold that *as a bare minimum, an increase in the VAT rate from 10 to 12 is an inevitable and basic component of any adequate formula to address the fiscal crisis.* Nor would a 12-percent rate, if adopted, be internationally out of line.

Finance department computations suggest that, when combined with the removal of a number of unwarranted VAT exemptions, such as those on medical and legal services, cooperatives, and various fuels, petroleum products, the higher VAT rate could result in revenues approaching P63 billion, assuming 70-percent efficiency in collection<sup>8</sup>. In terms of the stipulated benchmark, such a measure may be adequate to fulfil the demands of debt stabilisation, but it would only begin to alleviate the pressing requirements for social and infrastructure spending (recall the benchmark of P108 billion).

The simple proposal to raise the VAT rate from 10 to 12 percent has since been mangled, however. The principal objection lodged against it is not that it fails to raise significant revenue – for it obviously does – but that it is inequitable. Such a casual observation, often allowed to pass unanswered, has since led a number of politicians to tinker with the simple VAT law and to propose any or all of the following: from the house come proposals exempting or privileging certain manufactured goods consumed by the poor (e.g., instant noodles, canned sardines), as well as instituting multi-tiered VAT rates, with zero or lower rates on certain goods presumably consumed by the poor. From the senate, more significantly, comes the general proposal of opposing *any* increase in the VAT rate in favour of simply broadening its coverage.

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tax – in obvious contradiction of its current position. These and other ill-advised proposals were discussed in an earlier paper, "The deepening crisis: the real score on deficits and the public debt" (August 2004).

<sup>6</sup> That is, P41.7 bn (= P30 bn VAT + P5 bn fiscal incentives + P6.7 bn sin taxes)

<sup>7</sup> Since every percentage-point increase in VAT yields revenues of about 0.3 percent of GDP, a projected nominal GDP of P5375 bn in 2005 implies additional revenue of approximately P32.2 bn (= 0.06 × 5375).

<sup>8</sup> Using an unrealistic assumption of 100 percent efficiency, the DOF projects additional revenues of P90 billion instead.

To the extent it is used as a rationale, in the first place, the myth must be dispelled that the VAT in general – including any additional amount to be imposed – is paid *only minimally* by the affluent, and that most of the revenue would be collected from the middle classes and the poor. Media has repeated the assertion, for example, that only two percent of the VAT is paid by “the rich”, 44 percent by the “very poor”, and 54 percent by the “middle classes”. Such claims do not seem to jibe with the facts.

Expenditure (i.e., consumption) rather than income is the proper basis for measuring progressiveness, since not paying taxes on income saved at most postpones but does not avoid tax payment. Using household expenditures as a tax base shows that the VAT is in fact *mildly progressive*.<sup>9</sup> There are two factors at work here. First, because consumption like income is highly concentrated, any consumption tax is more likely to fall on the rich (column 3 and last two rows of Table 2).

Second, goods consumed by the rich are more liable to be subject to VAT than those consumed by the poor. In the Philippines, the exemption of a number of goods consumed largely by the poor (e.g., agricultural products, unprocessed food, and kerosene) has meant that the proportion of a household’s consumption subject to VAT increases as the household becomes richer (Table 2, third column). This despite the fact that some items pre-eminently consumed by the rich – such as air travel and jewelry – are unjustifiably VAT exempt, a matter discussed further below.

Table 2.  
**VAT paid by expenditure percentiles**

Percentile	Share (%) of total spending	Percentile spending liable to VAT (%)	Share (%) in total VAT due
Poorest 1%	0.1	44.2	0.1
1-10%	1.9	45.9	1.4
10-25%	5.2	48.4	4.1
25-50%	13.2	53.0	11.5
50-75%	22.1	58.4	21.2
75-90%	22.3	61.9	22.7
90-99%	25.0	63.8	26.3
<b>Richest 1%</b>	<b>10.1</b>	<b>75.8</b>	<b>12.6</b>

*Sources:* FIES 2000, Fletcher [2005] and own computations<sup>10</sup>

The net result of both factors is that almost 40 percent of the VAT is due from the richest 10 percent of the population, while only 17.1 percent is due from the poorest *half*. As a proportion of spending, the effective VAT rises from 4.4 percent of spending for the poorest decile to 7.6 percent for the richest one percent.<sup>11</sup> In this sense the existing VAT is actually progressive and probably more so than some forms of income tax, which are progressive in principle but barely collected in practice.

Even as an indirect tax, the VAT is less regressive than other indirect taxes (e.g., the “sin” taxes). Indeed, as demonstrated above, the VAT is actually mildly progressive. Still, of course, it cannot rival

<sup>9</sup> Take the tax paid by a household as a proportion of its economic or financial means (whether measured by income, spending, or wealth). If this proportion is higher for richer households than for poorer ones, the tax is said to be “progressive”; where it is invariant, the tax is “proportional”; and where it is higher for poorer than for richer households, the tax is said to be “regressive”.

<sup>10</sup> If  $s_i = E_i/E$  is the proportion of the  $i$ th percentile’s spending  $E_i$  to total expenditure  $E$ , as reported in column 2 of Table 2 and  $k_i = VAT_i/E_i$  is the proportion of its spending  $E_i$  subject to VAT in column 3, then the share of the  $i$ th percentile in total VAT due is  $s_i k_i / \sum_j s_j k_j$  as given in column 4. This is because  $VAT_i = s_i k_i E$  and  $\sum VAT_j = E \sum_j s_j k_j$ .

<sup>11</sup> In Table 2, the VAT paid as a proportion of household spending by percentile can be obtained by multiplying the third column by standard VAT rate of 10 percent. Hence, for example, for the poorest 1 percent, 44.2 percent of whose consumption is under VAT, the proportion of VAT paid to household income is 0.0442 (= 10 percent  $\times$  44.2 percent).

the potential progressiveness of a direct tax. Difficulties in the collection of income and wealth taxes in the Philippines are legion and well known, however, so that large changes in direct-tax collection are unlikely to be forthcoming soon. So this brings up a general point about tax collection in the Philippines that turns textbook prescriptions on their heads: an effectively collected indirect tax can be more progressive in practice than a poorly collected direct tax. From this viewpoint, the VAT does not come out looking too bad.

Those parts of VAT that make it progressive would undoubtedly be further enhanced if unconscionable exemptions of some goods consumed by the rich were withdrawn. These can and ought to be done. The removal of exemptions favouring affluent consumption is certain to enhance progressiveness and should be vigorously pursued. But even if redistributive equity were not served, they should still be removed simply because doing so would raise more revenue and reduce economic distortions. (As an aside, it is an alarming aspect of some current proposals that even as they remove some exemptions, they retain other unjustifiable ones, including such a luxury as air travel.)

Still it should be remembered that *it is not the main purpose of a consumption tax to be progressive* but rather, in being uniform, to raise revenue in the simple and less distortive manner for the economy. A consumption tax would fulfil its function of simple and minimally distortive revenue generation, *even if* it were simply proportional, or perhaps even mildly regressive. The particular virtue of a single rate is that it makes compliance easy to monitor and hence collection more effective. The application of a uniform rate also means that no particular types of consumption or of stages of production activities are privileged.

### **Mangling a simple proposal**

By contrast, current proposals appear to have lost sight of the original purpose of a value-added tax and seek instead to address everyone's pet-issue in a single measure – as if the government had no other tools at its disposal to address the various social problems being raised.

The economist Jan Tinbergen originated the well-known adage in macroeconomic planning that one cannot have more goals than the number of instruments available. For the same reason, no single measure can be expected at a single stroke to effectively raise revenue in an unbiased manner and also alleviate poverty, redistribute income, provide safety nets, help small businesses, and define industrial priorities to boot. Yet it is precisely this gargantuan task some legislators would have VAT achieve. In truth, however, to hold out the illusion that the VAT measure can and should do all these is to perpetrate a sham upon the public. Behind it all can only lurk either ignorance, tokenism, vested interests – or all these.

As an example, apart from the obvious demand that the VAT should raise sizeable revenues, the measure is now also expected to serve as an anti-poverty programme, in addition to being its own safety net! On this argument, proposals have been made to exempt instant noodles and canned sardines from the VAT or, in the senate version, to increase the presumptive VAT input credits (Table 3, item 6) on such things as sardines, mackerel, cooking oil, and refined sugar.

The folly and tokenism behind such proposals become apparent once one considers the following: *First*, not all who are poor consume only instant noodles and canned sardines. What about those, for instance, who eat wheat not as noodles but as cheap baked products? This is the problem in poverty-alleviation called inadequate scope. *Second*, not all instant noodles and canned sardines are consumed only by the poor (the "leaky-bucket" problem). Should premium Japanese instant noodles and premium canned sardines (imported and local ones) also be VAT-exempt? Who is to say which is which? *Third*, another leaky-bucket problem, not all who consume instant noodles and canned sardines are poor. Does a rich person addicted to instant noodles, whether cheap or expensive, deserve an exemption? *Finally* a lower VAT rate or a higher VAT exemption on specific goods is hardly the only way to help the poor, and likely not the best, either. A reallocation of spending towards better social priorities would probably do more good. More importantly, ad hoc rate-discounts and exemptions detract from the main function of a consumption tax, which is to raise revenue. Overburdening the VAT revision with such impossible subsidiary goals only risks its failure in its principal task. In particular, a multi-tier system (such as the 4-6-8-12 proposal from the house)

that seeks to achieve these “pro-poor” objectives unnecessarily complicates the collection of the tax as well as encourages evasion.

Worst of all, however, any further addition to the list of exemptions runs the risk of capture by vested interests. It should be remembered that virtually no tax – not even a consumption tax like the VAT – is ever paid entirely by consumers alone. Producers must also typically bear part of the burden to the extent that the higher price caused by a tax compels them to raise prices, lowers demand, and leads to lower profits.<sup>12</sup> Hence it will always be in the interest of producers to lobby vigorously to exempt themselves from the VAT, or to be spared any increase. Under the guise of providing protection to the unfortunate and poor, for instance, VAT exemptions in the past have been used to give privileges to some fortunate non-poor sectors of the economy, including big publishing outfits, housing developers, lawyers and law firms, and doctors (not to mention entertainers and sports personalities in the past).

It is well and good that the removal of some of these is being sought, although in the next section we shall warn against careless tinkering. It is disturbing however not only that many exemptions will remain, but that *new ones* – whose justifications on economic and equity grounds are questionable – are being inserted (Table 3).

Table 3.  
**New exemptions and other  
revenue-losing measures considered**

	Remarks
<i>Zero-rating</i>	
1. Services for persons doing business outside RP	
2. Sales to persons engaged in international shipping or international air transport	
<i>Higher exemptions</i>	
3. Sale of real properties not greater than P1.5 million	raises existing ceiling from P1 million
4. Lease of residential units rentals up to P10,000 monthly	raises existing ceiling from P8,000
5. Entities with gross annual sales of P750,000 or less	raises existing ceiling from P550,000
6. Higher presumptive input tax in processing of sardines, mackerel, milk, refined sugar, cooking oil	
<i>Reduction of non-VAT taxes</i>	
7. Raising the corporate income tax from 32 to 35 percent and lowering it to 30 percent beginning 2009	
8. Deleted 3-percent tax on quarterly gross receipts of international air carriers doing business in RP	
9. Deleted 3-percent tax on quarterly gross receipts of international shipping carriers doing business in RP	
10. Exempting electric utilities (e.g., Meralco) from paying the franchise tax equal to 2-percent on gross receipts	
11. Waiving amusement taxes on cabarets, night- or day-clubs	currently taxed at 18%
<i>Reduction of petroleum products excises</i>	
12. Lower tax on naphtha to P4.35	from P4.80/litre
13. Zero tax on kerosene	from P0.60/litre
14. Zero tax on diesel fuel	from P1.63/litre
15. Zero tax on bunker fuel	From P0.30/litre

<sup>12</sup> The tax burden will be heavier on producers the more sensitive their customers are to any price increases.

These brazen attempts at log-rolling not only sabotage the government's plans at a critical time when it is pressed to earn more revenue, they also profoundly undermine faith in the seriousness and objectivity of the entire legislative process. The inclusion of non-VAT-related items is particularly deplorable, first, since they unnecessarily give up revenue already earned by the government; but secondly, they risk placing the process in a legal limbo, for the farther the senate bill deviates from and improvises upon the bills already passed by the house, the greater is the likelihood that constitutional questions will be raised and that the emanating law will be challenged in the courts, creating a logjam on the issue that the economy can ill afford.<sup>13</sup>

### **Eliminating exemptions: some difficult issues**

While the principle of broadening the base of the VAT by removing exemptions cannot be denied, a good deal of apprehension and uncertainty has attended the proposal to subject two major items to the VAT system, namely, *petroleum products* and *electricity generation*. There is good reason to be circumspect regarding these products and services, first, since these are almost universally used commodities; hence large increases in their prices could have potentially far-reaching effects in the economy. Second, however, these commodities are already the subject of specific taxes and other impositions, which themselves need to be re-examined.

Our position is as follows: there is a case for including power and petroleum in the VAT system, but it may be tempered by other considerations – a transitory circumstance in one, a political one in the other. In the immediate term, there may be good reasons to hold off on the inclusion of these sectors. For petroleum, government may want to wait for an opportune time when the price of petroleum is on the downtrend. For power, government may wish to calibrate the VAT against the eventual phase-out of the universal electricity charge. In the event, that two important candidates for exemption-delisting are problematic suggests at the least that a more careful study ought to be done and that a precipitate decision is unwise. In turn, a postponement of a decision on these matters only underscores the importance of raising the VAT rate now on items currently covered.

Beyond these, new proposals to exempt certain industries from VAT or to grant them lower rates will generally impair either revenue collection or redistributive equity. In this case it is poised to do both, losing revenue and serving the rich; therefore it should be viewed with extreme suspicion. *Caveat civis!* The guideline to observe at this time should be the following: if one is unable to reduce the scope of exemptions, one should at least not add to them.

The plea then is to keep things simple: the VAT is bound to bite into consumers' pockets – if it did not do so, it would not be a consumption tax. But it does so for a larger purpose – to stave off a crisis and contribute funds for social development and infrastructure. Congress should just let the tax do its job of raising revenue as simply, uniformly, and universally as possible. This means raising rates and reducing, not increasing exemptions. In the meantime there is no shortage of *other means* to alleviate any ill effects the tax may occasion. Helping the poor, helping small businesses, even helping big airlines may be priorities that congress deems important. Income and wealth taxes, implemented effectively, can redistribute income; well-targeted social subsidies and programmes can alleviate poverty. And government has certainly found other effective ways to help people like Mr. Lucio Tan both in the past and more recently. For now, therefore, they should do well to leave the spirit and structure of VAT alone.

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<sup>13</sup> The constitutionality of the senate proposing amendments significantly different from that originating from the house has always been open to challenge. It is little noted that in the case dealing with the expanded VAT law under president Ramos, a dissenting vote was cast by the current chief justice H. Davide, who wrote regarding the respective authorities of the house and the senate over revenue measures: "Indisputably then only the House can cause the beginning or initiate the passage of any appropriation, revenue, or tariff bill, any bill increasing the public debt, any bill of local application, or any private bill. The Senate can only 'propose or concur with amendments'."

### The chimera: expanded coverage in lieu of a higher rate?

In this entire debate, the most seductive suggestion has come from those who contend that it is a real option *not* to increase the current VAT rate, if only the coverage of VAT were expanded and exemptions removed. As already argued above, any expansion of the scope of the current VAT should be generally supported. What is wrong and misleading, however, is to think – given the magnitude of the fiscal problem – that an increase in the rate can be avoided. Adequacy demands that the VAT rate be raised *and* that exemptions be withdrawn.

Proponents of the broadening-only idea contend that just casting the VAT net more widely would yield an additional P24 billion which, in addition to the removal of exemptions worth P27.6 billion would yield as much as P51.6 billion, i.e.,  $(27.64 + 24.12 = 51.6)$ . Table 4 details the additional Senate proposals. It is evident, however that *virtually all* of this expected additional revenue (94 percent) is supposed to come from a single item: the “spreading out” of the crediting of the VAT on capital equipment.

Considering the saliency of this proposal in the argument over the necessity of a higher rate, it is worth dissecting. Under the current system, companies that invest are allowed to immediately credit the VAT they paid on their capital-equipment purchases. It may then occur that a firm’s input-VAT credits may exceed its VAT due on sales so that it remits nothing to the government in the current year. Suppose for example that a company would normally remit P100,000 as its VAT payments for the year; it could happen however that in this very year, it purchased a piece of equipment worth P1 million, a price inclusive of a VAT of 10 percent, or P100,000. Current practice then allows the firm to offset this VAT on capital equipment against the VAT remittance it would have made, so that the firm does not remit any VAT at all this year.

Table 4.

#### Senate proposals for additional withdrawals of VAT exemptions

VAT exemptions to be withdrawn from:	Yield P bn
Nonfood agriculture products	0.74
Services by agricultural contract growers	2.95
Personal & household effects and professional instruments	negl.
Water and air transport of passengers	1.54
Spread out the crediting of input-VAT on capital equipment	22.58
<b>Total</b>	<b>24.12</b>

Source: Department of Finance, March 2005.

The senate proposes to prohibit this practice. Hence a business would no longer be allowed to credit – as it normally could – the entire VAT it has paid on its investment purchases (e.g., machines, construction) in the same year these are made. Rather it must credit these only in instalments over a five-year period. Hence, the company in the example above would be prevented from claiming P100,000 as a VAT credit immediately in the current year; rather it could claim only P20,000 in additional VAT credits annually over the next five years. In purely nominal terms, of course, the sum of all credits is the same over five years. Effectively, however, any company making an investment would be forced pay VAT on its purchases up front without immediate offset. This amounts to extending a loan to the government equal to the opportunity cost of the funds tied up in its impounded VAT credits. The size of this compulsory loan increases with the investment being made and the prevailing interest rate. For interest rates between 15 and 25 percent, for example, a business could forego an additional 23 to 33 centavos for every peso of creditable VAT compared with the present rules.<sup>14</sup> The upshot of this is to penalise investment by effectively taxing it. Between two otherwise identical firms, one of which makes an investment while the other does not, the latter by not investing can avoid tying up its funds unnecessarily in a forced loan to the government.

<sup>14</sup> The implicit loss to a business for every peso of creditable VAT is  $1 - [0.2 \sum_t (1 + r)^{-t}]$ ,  $t = 0, 1, \dots, 4$ . The amount will obviously depend on how high the interest rate is.

In their zeal to show that revenue can be earned *without* a higher VAT rate, proponents of this shrewd measure have accomplished the seemingly impossible: they have managed to employ a consumption tax to *tax investment* instead – all this in a bid to rescue a somewhat desperate notion. Yet even then it fails to deliver honestly, since the estimates of potential gain to the government are probably overstated. First, the initial rise in revenues from this measure will not be an annually recurring one. The government’s gain consists merely in getting some revenue up front rather than later; it gains liquidity in the present but this is not sustained into the future.<sup>15</sup> Second, given the disincentive to investment that the measure represents, one should wonder whether the estimated take is likely to be as large as its proponents make it out to be. Such a measure is more than likely to reduce the appetite to invest, and therefore at least partly reduce the base from which it intends to collect.

The most important objection to this proposal, however, is that it threatens to knock out one of the major props to long-term confidence in the economy. The “consumption-led” character of recent growth has been a cause for concern, and the government itself has pointed to a need to shift the sources of growth towards spending that has a greater impact for the long term. By imposing a hidden investment tax – which is what the measure amounts to – the government can only interrupt the momentum of nascent capital spending in many sectors and imperil the sustainability of the very growth it is so ready to proclaim.

In the end, therefore, one must again confront the hard fact that there is no magic bullet, no painless potion that will allow the country to evade a higher VAT. The alternatives are either worse (a sudden slip towards crisis, or a slow squeeze on social spending) or – as this measure turns out to be – largely illusory.

To reiterate, therefore, our proposed approach to the issue of VAT amendment is to “keep things simple” and may be summarised as follows:

- (a) first and foremost, increase the VAT rate to 12 percent from the existing 10 percent;
- (b) support the principle but postpone the inclusion of petroleum products and electricity generation under the VAT system;
- (c) accept all other proposals to reduce the number of exemptions to the VAT;
- (d) reject all other proposals to lengthen the list of VAT-exempt, zero-rated, or VAT-privileged goods; in particular reject any attempt to experiment with a multi-tier rate system;
- (e) resist proposals to implicate or “trade-off” with VAT any other revenue-losing measures, particularly those involving downward adjustments of excise taxes, franchise taxes, or income taxes

## **Conclusion**

In the experience of countries that have recently confronted fiscal and financial crises – Argentina, Turkey, and Brazil – the difference between deliverance and collapse often revolved around no more than two percent or so of GDP. Historians of such events may find it curious that the steps needed to avert tragedy were, upon hindsight, relatively minor when set off against the severe crises that those societies subsequently had to endure. But situations are not unknown – bank runs<sup>16</sup> are a related phenomenon – when even small changes suffice to decide between vastly different outcomes.

Increasing the chances of a favourable outcome involves not only the current question of passing a credible VAT amendment. Beyond this, it involves moving away from the overworked and short-

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<sup>15</sup> Under the current system the firm in the example would pay nothing in the first year and P100,000 in the next four years. Under the proposed rules, on the other hand, the same firm would pay P80,000 spread out over five years. It is a mistake to compare only the first year and say that the government stands to gain P100,000 annually, since obviously that gain from the scheme is not sustained in the succeeding years.

<sup>16</sup> See, for example, P. Diamond and D. Dybvig [1983]

sighted device of simply compressing spending to meet a fiscal exigency. What is required, arithmetically, is a significant and permanent rise in the revenue effort in the order of at least 2.0-2.5 percent of GDP, an amount that would permit a palpable increase in spending on human-development and infrastructure priorities. Given the widespread cynicism about government, however, such resources will be forthcoming only if the political leadership, particularly the chief executive, can articulate a coherent and reliable plan regarding where exactly such new resources shall be directed. In particular, the eventual inclusion of fossil fuels and electricity generation in the VAT system, the adjustments of various excises, as well as other future revenue measures, can win a significant constituency as long as there is a well-articulated vision of where the money is supposed to go and the political leadership credibly commits itself to it. For this purpose – though again textbook-writers may chafe – the earmarking of funds should not be ruled out. Ultimately, public cynicism and the tax revolt can be overcome only if people are reassured – mainly through their experience – that government can gather and dispose over the people's resources intelligently, equitably, and honestly. It is the role of leadership to find the imagination, the good will, and powers of persuasion to make that happen.

And so, the risks remain, yet the possible rewards are also significant. The question therefore is thrown once more to the country's political elite: Can they deliver?

Good Friday, 2005