



The value-added tax in a wider perspective

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The value-added tax (VAT) is a controversial tax measure. Many argue that it is anti-poor because it is regressive or in other words, it effectively taxes the poor more than the rich. In truth, the VAT is regressive and is never meant to be progressive (i.e. the rich are effectively taxed more than the poor). Any progressivity arising from special provisions such as exempting some goods is only a bonus. To address progressivity, the government can and must use other tax instruments to redistribute wealth. The VAT's saving graces, however, is that by being broad-based and having a uniform rate, it is relatively easier to administer, comply, and collect than other tax instruments. Its larger significance in times of a fiscal crisis is that it alone can generate the largest amount of revenue in the most efficient manner to prevent an economic collapse.

In the Philippine's case, however, the VAT is not as regressive as we think. Data show that the VAT is at worst mildly regressive and at best mildly progressive.

The VAT is mildly regressive in the sense that the effective VAT rate (the actual VAT paid as a percent of total expenditures) of the poor is only slightly higher than that of the rich. A National Tax Research Center study using the Family Income and Expenditure Survey (FIES) 2000 showed that the effective VAT rate of the poorest 50% of families (annual income of less than P100,000) was 5.2% while that of the richest 50% (annual income of at least P100,000) was 4.1%. The richest 3% of families (annual income of P500,000 or more) had an effective VAT rate of 3.7%.

On the other hand, the VAT is mildly progressive if we examine VAT burden across expenditure classes. A paper by UP economists using FIES 2000 (and later also using FIES 2003), revealed that 39% of VAT revenue was collected from that the richest 10% of families while only 17% of VAT revenue was collected from the poorest 50% of families.

The VAT can even be more progressive than the individual income tax. Bureau of Internal Revenue (BIR) data shows that the individual income tax suffers from rampant tax evasion and avoidance such that in 2003 alone, self-employed individuals, who are generally perceived to be richer than employed individuals, paid only about P4 billion worth of income taxes while employed individuals, whose taxes are withheld, paid a whopping P76 billion. Moreover, the Department of Finance estimates that the tax gap (the difference between collected taxes and the potential tax base) of self-employed individuals is about 70% while it is only 7% for employed individuals. It appears that the effective income tax rate of the poor and working class is much higher than the effective income tax rate of the rich who can evade and/or avoid taxes at will.

With the passage of the expanded VAT law, the VAT's progressivity will likely diminish while its regressivity will worsen. However, the expanded VAT must be understood as a critical component of the reform package (in reality a survival package): It alone can generate the biggest amount of revenue needed to stave-off a full-blown fiscal crisis and bring the country back into a respectable growth path. The VAT is anti-poor (all taxes are anti-poor) but it is far more anti-poor to allow a crisis to escalate into a great recession and plunge more people into poverty.

Having said this, many still argue that government should focus instead on reforming tax administration and not burden the people with more taxes such as the expanded VAT. While this



proposal is workable in the long-run, it is not enough in the short-run to address the urgency of the fiscal crisis. In one or two years time, a full-blown fiscal crisis would have arrived.

Of course we do not belittle government efforts in reforming tax administration. In fact, BIR tax effort in the last several months has increased significantly due to various reforms such as the use of third-party data to catch tax evaders and the use of the internet to facilitate tax-related transactions to increase efficiency. While these are laudable, humility teaches us that we cannot correct a deeply ingrained bad culture of avoidance, evasion, and corruption overnight. We need tax administration reform and new tax measures together. They complement each other and assure us of both short-run and long-run gains despite the initial sacrifices we all need to make.

The VAT and other fiscal reforms are painful solutions that we must accept as consequences of our collective past apathy to our country's plight. However, as history has shown, we have weathered much bigger crisis than the one we currently face. With sincerity, cooperation, hard work, and God's grace, the country without doubt can survive a crisis again. There is reason to hope.

(For additional information, questions, comments, or request for presentation materials on the fiscal crisis and reform, please email the author at kchua@ateneo.edu)