

**BRIEFER ON VAT REFORM LAW**  
**(AS OF NOVEMBER 2, 2005)**

**1. WHY IS VAT REFORM NECESSARY?**

The current Philippine fiscal condition requires that immediate attention be given to fiscal reform:

- In 2004, debt service (principal and interest payments) was equivalent to 86.1% of government revenues
- Interest payment alone was equivalent to 37.4% of government revenues
- On the other hand, infrastructure and other capital expenditures were only 10.87% of government expenditures for the same year

In order to address this fiscal condition, the Government is proposing a fiscal reform program that intends to generate additional revenue equivalent to 2.5% of the projected gross domestic product (GDP) for 2005, with the end in view of accelerating the balancing of the National Government budget possibly by 2008. Reforming the value-added tax system is a vital component of this fiscal reform program.

**2. WHAT ARE THE SALIENT FEATURES OF THE VAT REFORM LAW?**

- 10% VAT rate is retained; however, the President shall increase the VAT rate to 12% starting January 1, 2006 if (a) VAT collection-to-GDP ratio for 2005 exceeds 2.8% or (b) the National Government deficit-to-GDP ratio for 2005 exceeds 1.5%
  - For 2004, VAT-to-GDP ratio was 2.9%. On the other hand, the National Government deficit-to-GDP ratio was 3.9%.
- the following goods and services are now subject to VAT:
  - i. coal, natural gas and other indigenous fuels
  - ii. petroleum products and their raw materials
  - iii. power
  - iv. electric cooperatives
  - v. domestic transport of passengers by air and sea
  - vi. medical services
  - vii. legal services
  - viii. cotton & cotton seeds; non-food agricultural products
  - ix. works of art, literary works, musical composition
- the following goods and services are VAT zero-rated:
  - i. transport of passenger or cargo by air or sea to a foreign country
  - ii. services rendered to aircrafts and vessels engaged in international transport
  - iii. sale of goods, supplies and fuel to aircrafts and vessels engaged in international transport
- other VAT reform measures
  - i. 5-year spread out crediting of input VAT on capital equipment
  - ii. cap on input VAT crediting at not more than 70% of output VAT for the same quarter
  - iii. removal of 1.5% presumptive input VAT on public works contractors

- iv. uniform 5% VAT withholding on government purchases of goods, services and public works contracts
- mitigating measures:
  - i. reduction of excise tax on kerosene, diesel and bunker fuel oil
  - ii. removal of franchise tax on power distribution utilities
  - iii. removal of franchise tax on domestic airlines and common carriers tax on domestic shipping
  - iv. increases presumptive input VAT of agro-processors from 1.5% to 4%
  - v. increase marginal threshold from P550,000 to P1.5 million per annum; rental threshold from P8,000/mo to P10,000/mo; and real property threshold from P1 million to P2.5 million
- non-VAT reform measures:
  - i. increases corporate income tax rate to 35% up to end of 2008; the rate will be automatically reduced to 30% by 2009
  - ii. increases gross receipts tax from 5% to 7% on royalties, rentals of property, real or personal, profits from exchange and all other items treated as gross income, of banks and non-bank financial intermediaries
  - iii. removal of PAGCOR income tax exemption
- incremental revenue earmarking
  - i. 50% of local government units' share in incremental VAT collections was earmarked for the following purposes:
    1. public elementary and secondary education, to finance construction of school buildings, school furniture and in-service training of teachers
    2. health premiums of enrolled indigents
    3. environmental conservation;
    4. agricultural modernization to finance construction of farm-to-market roads and irrigation facilities

### 3. WHAT IS THE REVENUE IMPACT OF THE VAT REFORM BILL?

- Projected Additional Revenue from the VAT Bill at 70% collection efficiency:

Particulars	2006 Assumes VAT at 12%
<b>TOTAL</b>	<b>81.41</b>
<b>Increase of VAT to 12%</b>	<b>35.12</b>
<b>Repeal of VAT Exemptions</b>	<b>38.54</b>
-Petroleum, Coal & Nat. Gas	29.95
-Power and electric coops.	6.19
-Medical and legal services	1.81
<b>Other VAT Reform Measures</b>	<b>23.29</b>
-5-yr crediting of input VAT on capital goods	18.97
-70% input VAT cap	8.33
<b>Mitigating Measures</b>	<b>-21.50</b>
-Excise tax reduction	-13.55
<b>Non-VAT Reform Measures</b>	<b>6.12</b>
-Corporate income tax increase	5.59

- For 2005, the estimated incremental revenue is P5.5B representing collections from the months of October and November 2005.
- Additional mitigating measure per EO 440 reverting back the tariff on petroleum from 5% to 3%.
- The VAT reform package makes up a significant portion of the additional revenues from fiscal reform measures. The share of the incremental VAT in the expected revenues from the approved and proposed fiscal measures of the government for 2005 is shown below:

<b>Fiscal Reform Measures</b>	<b>2005 Projected Incremental Revenue at 70% Collection Efficiency (in ₱ billion)</b>
<b>Sin Taxes</b>	<b>10.50</b>
<b>Lateral Attrition</b>	<b>7.00</b>
<b>VAT Reform</b>	<b>5.50</b>
<b>Rationalization of Fiscal Incentives*</b>	<b>11.20</b>
<b>TOTAL</b>	<b>39.15</b>

\*Pending legislation

#### 4. HOW WILL THE INCREMENTAL VAT COLLECTION BE USED?

The new VAT law addresses the delivery of basic services by earmarking the equivalent of 20% of the incremental VAT collection for the following purposes:

	<b>20% of incremental VAT collection*</b>
Public Elementary and Secondary Education	6%
Health Insurance premiums	4%
Environmental Conservation	6%
Agricultural Modernization	4%
<b>TOTAL</b>	<b>20%</b>

\*These amounts will be available to the LGUs after three years in accordance with the Local Government Code

In concrete terms, such amounts are roughly equivalent to the following:

<b>Sector</b>	<b>2006</b>
	<b>Physical Units</b>
Public Elementary and Secondary Education	521 single-storey bldgs w/ 5 classrooms
Health Insurance premiums	3.1M indigents to be newly covered
Environmental Conservation	9,190 ha for reforestation
Agricultural Modernization	1,012 kms of farm-to-market roads

\* For illustration purposes only.

An additional P15 million was earmarked for Public Information and Education Program that will explain clearly to businesses the administrative requirements under the VAT.

Also, starting 2006, 30% of the incremental VAT collection for the year will be used for capital expenditures. This amount will be increased by 5% yearly until it reaches 50% in 2010.

	2006	2007	2008	2009	2010
Portion of incremental VAT collection that will go to investments in social services and government capital expenditure	30%	35%	40%	45%	50%

## 5. IS VAT ANTI-POOR?

- No, the VAT system recognizes the needs of the poor and exempts basic commodities and socially sensitive products from VAT. Among these VAT exempt commodities are:
  - a. agricultural and marine products in their original state such as vegetables, meat, fish, fruits, eggs and rice. These goods remain exempt from VAT even if they had undergone simple processes of preparation or preservation for the market (such as freezing, drying, salting, broiling, roasting, smoking or stripping);
  - b. educational services rendered by both public and private educational institutions;
  - c. books, newspapers and magazines;
  - d. lease of residential houses not exceeding P10,000 monthly;
  - e. sale of low-cost house and lot not exceeding P2.5 million;
  - f. sales of persons and establishments earning **not** more than P1.5 million annually, which could include sari-sari stores, carinderias and street vendors.
- To further minimize the effect of VAT on sardines, milk, noodles, sugar and cooking oil, the VAT system allows manufacturers of these products to credit against their output VAT a presumptive input VAT equivalent to 4 % of the value of their purchases of primary agricultural products used in the production of these goods.
- Based on Department of Agriculture figures, the impact of R-VAT on retail prices of basic agricultural food products that are VAT exempt shall be less 1%. The table below shows the impact of R-VAT on a per commodity basis:

Commodity	Price per kilo	Price with impact of R-VAT (P/kilo)	Percentage Increase
Rice	P 20.76	P 20.77	0.05%
Corn	10.60	10.603	0.03%
Milk fish	83.01	83.05	0.04%
Tilapia	67.93	68.04	0.016%
Cabbage	24.01	24.01	0.00%
Eggplant	43.37	43.40	0.05%
Chicken	97.33	97.41	0.09%
Pork	141.67	141.94	0.19%

\* Price estimate at 10% VAT

\* Prices quoted above may vary depending on location and other factors.

- To cushion the impact of imposing VAT on petroleum products, the VAT bill put in place a reduction of excise tax on kerosene, diesel and bunker fuel oil so that what would otherwise result to a 10% increase in pump prices of these products would be minimized.

Further, EO 440 reduced the tariff rates on petroleum products from 5% to 3%. Below is a table showing the increase in the VAT on these products:

Petroleum Product	Pump Price* 11/1//05 (in Peso/liter)	Mitigation		New Pump Price	10% VAT	Final Pump Price	Price Increase (in Peso/liter)	% Increase
		Excise	Tariff					
Unleaded	35.45	0.00	(0.52)	34.93	3.49	38.42	2.37	6.6%
Regular	33.97	(0.45)	(0.46)	33.06	3.31	36.37	1.80	5.2%
Diesel	32.35	(1.63)	(0.57)	30.15	3.02	33.17	0.22	0.7%
Kerosene	32.91	(0.60)	(0.57)	31.74	3.17	34.91	1.40	4.2%
Bunker	21.38	(0.30)	(0.35)	20.73	2.07	22.80	0.82	3.7%
LPG (P/cyl)	458.00	0.00	(10.03)	447.97	44.80	492.77	22.77	4.8%

- Based on October 1-20, 2005 MOPS/Contract Price. Pump prices may vary based on location, company and other factors.

- \* With Rollback of P0.60/liter on all products, except for LPG with a rollback of P11.00/kg or P11.00 per cylinder.

- To temper the effects of imposing VAT on power, the VAT bill eliminated the franchise tax on power distribution utilities so that the increase in power rates is less than 10%. The table below shows the initial estimated impact of VAT on power rates in selected areas.

Distribution Utility	Existing Ave. Resd'l. Rate (no VAT) (Peso/kwh)	Estimated Ave. Resd'l. Rate With VAT (Peso/kwh)	% increase
MERALCO (NCR)	6.6366	7.1547	7.8%
VECO (Cebu)	6.2173	6.5167	4.8%
CEPALCO (Cagayan de Oro)	5.3046	5.5519	4.7%
Davao Light (Davao)	4.8402	4.986	3.0%

- DOE figures as of October 28, 2005

- Estimate for Meralco is based on weighted average rates of residential customers 50-1,000 kwh); VECO estimate assumes a 70% zero-rated generation for NPC; Davao Light estimate assumes a 75% zero-rated generation for NPC; CEPALCO estimate assumes a 60% zero-rated generation for NPC.

If the Department of Energy proposed scheme is approved by ERC, it is estimated that there will be no power rate increase for a Meralco residential customers, for example, who consume not more than 200 kwh per month (lifeline customers). Power rates for residential customers who consume more than 200 kwh but not more than 999 kwh per month shall increase by P0.73/kwh. Power rates for residential customers who consume 1,000 kwh or more per month and commercial and industrial customers will increase by P0.85/kwh. This sample computation was based on Meralco's April 2005 billing. Final impact of VAT to end-users will differ monthly depending on the power generation mix used to supply electricity.

- Since VAT is a consumption tax, its burden is heavier on those who consume more VATable goods and services.
  - Most of the goods consumed by lower income families are VAT exempt.
  - Based on the spending profiles of Filipino families across income classes, those families spending not more than P60,000 annually spend only 0.2% of their expenditures on taxes (VAT, excise and other taxes). This is largely because of their purchases of VAT-exempt goods (such as foodstuffs consumed at home, which constitute more than 60% of their purchases).
  - On the other extreme, those families spending upwards of P250,000 annually spend at least 4.10% of their expenditures on taxes, largely because they consume more VATable goods and services.
- The VAT law intended that the burden of taxation be shared among individual and corporate taxpayers. Due to this burden sharing approach, the corporate income tax rate was increased to 35%, and limitations on input VAT crediting (the 70% cap on input VAT crediting and 5-year crediting of input VAT on capital goods) among others were put in place.

#### **6. WILL THE IMPOSITION OF 10% VAT ON PETROLEUM AND ELECTRIC POWER INCREASE THE PRICES OF CONSUMER GOODS ALREADY SUBJECT TO VAT (e.g., canned goods)?**

No, imposing VAT on petroleum products and electric power will have no effect on the prices of consumer goods that are currently subject to VAT such as canned goods. In a radio interview, Francisco Buencamino, head of PAMP (Philippine Association of Meat Processors), a federation of food canning companies, said that – in addition to the zero effect of VAT on their products – lively competition among industry players will prevent prices from rising.

#### **7. WHY DO WE NEED TO LIFT THE VAT EXEMPTIONS OF CERTAIN GOODS AND SERVICES?**

*Generally:* Reducing the number of VAT-exempt goods and services increases the efficiency of the VAT system. This translates to higher tax collection and less tax leakage.

*Rationale for lifting particular exemptions:*

- sale and importation of coal, natural gas and petroleum products
- sale and importation of raw materials for petroleum products
  - in most countries, petroleum products are not among the standard VAT exemptions; the Philippines is one of the few countries that exempt petroleum from VAT
- services rendered in the exercise of medical and legal profession
  - to achieve fairness in VAT treatment across sectors; other service sectors are subject to VAT
  - these professionals are subject only to income tax and a minimal professional fee paid to local government units

- this should not affect the poorer segment of society who rely on government doctors and lawyers for medical and legal services; also those doctors and lawyers in the provinces who do not earn more than P1.5 million annually would be exempt from VAT
- d. importation of passenger and/or cargo vessels of more than 5,000 tons
- part of the effort to harmonize fiscal incentives under a uniform incentive package

## 8. HOW MUCH VAT CAN BE GENERATED FROM LIFTING THESE EXEMPTIONS?

The table below shows the projected incremental revenue from lifting of VAT exemptions, assuming 70% VAT collection efficiency:

PARTICULARS	2006 (in Peso Billion) <small>*Assumes VAT rate at 12%</small>
Raw materials for petroleum products	16.32
Petroleum products	12.61
Natural gas and other indigenous fuels	0.68
Coal	0.34
Power	5.33
Electric cooperatives	0.86
Medical services	1.37
Legal services	0.44
Domestic transport of passengers by air and sea	0.51
Non-food agricultural products	0.08
<b>Total</b>	<b>38.54</b>

## 9. WHY SHOULD THE VAT BE INCREASED FROM 10% TO 12%?

- This is part of a bigger effort to address the country's budget deficit. We need to increase our tax collection to sustain the government's delivery of basic services. While we can conceptually reduce government expenditures, we can only reduce it by so much because the public relies on government for these basic services, which includes education and medical services.
- If we increase the VAT rate from 10% to 12% in 2006, we can raise as much as **P35.12 billion** more. On the other hand, if this measure is coupled with the repeal of the VAT exemptions mentioned above and other provisions of the VAT bill, we can raise **P81.41 billion** assuming a 70% collection efficiency.
- Raising these additional revenues is expected to translate to the strengthening of the Peso-Dollar exchange rate and better interest rates arising from improved investor perception of the Philippines.

- We have to acknowledge that some revenue is lost due to inefficiency in the collection system and corruption in the collecting institutions. The Department of Finance, the Bureau of Customs and the Bureau of Internal Revenue are developing ways to address the tax leakages. The Department launched a few months ago the Operation RATE (Run After Tax Evaders) to catch tax evaders and recently Operation RATS (Run After the Smugglers) to catch smugglers. There is also RIPS (Revenue Integrity Protection Service) that files charges against corrupt officials and employees in the Department and its attached agencies like the BIR and BOC. The institutionalization of an efficient tax collection system is one of the goals of the DOF, and DOF will relentlessly pursue these initiatives to plug the tax leakage. However, these efforts and the enforcement of remedial measures may take some time before it reaches full revenue potential. For example, the investigation, prosecution and dismissal of undesirable government employees are circumscribed by the procedural and substantive due process requirements of the Constitution and our laws. At present however, there is a need to manage the budget deficit. The VAT reform measures are designed to address this urgent need.

## **10. WHO CAN CONSUMERS AND TAXPAYERS CALL FOR QUESTIONS ABOUT PRICE INCREASES DUE TO VAT OR GENERAL QUERIES ON VAT?**

### ***DOE***

Consumer Welfare and Promotions Office Hotline No. 840-2267

Complaints should be directed to

Retail Marketing Division, Oil Industry Management Bureau

For LPG, call 840-2130

For Liquid Fuels, call 840-5669

### ***DTI***

To report abnormal or drastic increase in prices of goods attributed to VAT, call 751-3330

### ***DA***

For queries and complaints, call 920-9178, 920-2216 or 371-2050

### ***BIR***

Queries on VAT and other BIR-related concerns, call 981-8888

Please log on to [www.vatreform.gov.ph](http://www.vatreform.gov.ph) for additional information on the Reformed VAT Law.