

COMMENT:

**REFORMING THE PHILIPPINE INCOME TAX SYSTEM:
BATTING FOR VAT***

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CHAPTER I

A. Introduction

As in most developing countries, it has been the prevailing view in the Philippines that progressivity and equity in taxation, or one that is based on the taxpayer's ability to pay, is best secured by progressive rates under an income tax system,¹ and, thus, concomitantly, the Value-Added Tax ("VAT") is commonly regarded as a regressive tax,² such that apprehension about its role in the Philippine tax system is very much prevalent. While in place as one of the taxes enforced by the State, the VAT has taken a backseat to the income tax, which remains as the more dominant tax system employed by the government.³

Having this in mind, it is useful to point out that governments around the world have increasingly shed too much reliance on steeply progressive income tax rates, and have favored a tax structure based more on consumption taxes such as the VAT.⁴

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¹ DWIGHT PERKINS ET AL., *ECONOMICS OF DEVELOPMENT* 462-63 (2001).

² Consumption Tax *available at* <http://business.mapsofindia.com/india-tax/types/consumption.html> (last visited Dec. 6, 2009).

³ BUREAU OF INTERNAL REVENUE (hereinafter BIR), 2007 ANNUAL REPORT 12 (2007).

⁴ PERKINS ET AL, *supra* note 1, at 454, *citing* MALCOLM GILLIS, *TAX REFORM IN DEVELOPING COUNTRIES* (1989).

This article will first discuss the fundamental principles of sound taxation and progressive taxation, before revisiting the genesis and history of both the income tax and the VAT, and how these taxes operate in the local setting. An analysis of the merits and demerits of both tax systems will then follow. Finally, the article will endeavor to make a case for, and/or provide a basis for, putting in place a regime of VAT in the Philippines.

B. Principles of a Sound Tax System

The pre-eminent economist and author of the “Wealth of Nations,” Adam Smith, germinated in his work “Canons of Taxation” the fundamental pre-requisites of a sound tax system, as follows:

- (i) The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is in proportion to the revenue which they respectively enjoy under the protection of the state;
- (ii) The tax which the individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person;
- (iii) Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it; and
- (iv) Every tax ought to be so contrived as to take out of the pockets as little as possible, over and above that which it brings into the public treasury of the state.⁵

The 19th century political economist, Henry George, draws upon these doctrines and, in turn says that the best tax by which public revenues can be raised is evidently that which will closest conform to the following conditions:

1. That it bear as lightly as possible upon production — so as least to check the increase of the general fund from which taxes must be paid and the community maintained;

⁵ Adam Smith and the Canons of Taxation, <http://www.economictheories.org/2008/11/adam-smith-and-canons-of-taxation.html> (last visited Dec. 6, 2009).

2. That it be easily and cheaply collected, and fall as directly as may be upon the ultimate payers — so as to take from the people as little as possible in addition to what it yields the government;
3. That it be certain — so as to give the least opportunity for tyranny or corruption on the part of officials, and the least temptation to law-breaking and evasion on the part of the tax-payers; and
4. That it bear equally — so as to give no citizen an advantage or put any at a disadvantage, as compared with others.⁶

These canons were further restated by contemporary economist, Joseph Stiglitz, who said that to be able to design a sound and desirable tax system, the following factors have to be considered:

1. Economic efficiency – which means that the tax system should not interfere with the efficient allocation of resources;
2. Administrative simplicity – meaning the expenses of administering the tax system should not be too complicated and should be inexpensive;
3. Flexibility – meaning that the tax system should be able to respond easily to changing economic conditions;
4. Political responsibility – in other words, transparency, or that the taxpayer knows what he is paying for and to what uses the proceeds are to be utilized; and
5. Fairness in the tax treatment of different individuals.⁷

C. Progressive Taxation

Prescinding from Adam Smith's canons, progressive taxation simply means that people are to be taxed "in proportion to their respective abilities"; otherwise stated - taxing individuals with higher income with higher tax rates.⁸ Joseph Stiglitz states that this system of taxation has the economic school of thought as its fountainhead, namely that of utilitarianism.⁹ This concept is based on the objective of attaining the highest combined utilities of individuals in a society.¹⁰

⁶ Outlines of Louis F. Post's Lectures, at http://www.wealthandwant.com/docs/Post_Lectures.htm, (last visited Dec. 6, 2009), citing HENRY GEORGE, PROGRESS AND POVERTY, Book VIII, Chapter III.

⁷ JOSEPH STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 457-58 (2000).

⁸ *Supra* note 5.

⁹ STIGLITZ, *supra* note 7, at 476.

¹⁰ *Id.*

To illustrate, take the case of two individuals, where one earns P300,000 a month and the other earns just P12,000 a month.¹¹ A P1,000 increase in both their incomes will result in a lower marginal utility for the individual who is already earning the higher income, while the same increase would result in a much higher marginal utility for the low income earner.¹² Hence, the progressive system of taxation can be justified under this theory by saying that a P1,000 deduction from the income of the higher income earner and giving the P1,000 instead to the low income earner would result in a higher total utility of both individuals.¹³

While Adam Smith's progressive taxation is easily justified in terms of balancing social inequality, the same, however, fails to consider the ability to pay problem, as illustrated in the example given earlier.¹⁴ As was seen from the illustrative case above, the executive still ends up suffering the brunt of taxation despite his more significant contribution to the economy.

Suffice it to state, there is in existence still a raging debate on which is the more appropriate measure of one's ability to pay. Ability to pay may be measured either by referring to one's income, consumption, wealth, or a combination thereof.¹⁵ A number of philosophers since the time of Thomas Hobbes, however, were consistently of the view that consumption is the more apt measure of one's ability to pay rather than the latter's income, and that tax obligations should be imposed based on what people take out of society, instead of what they pump into society.¹⁶

II. INCOME TAXATION IN THE PHILIPPINES

A. Tracing the Roots of Income Taxation

Precursors of the income tax - ancient practices such as tithing, offering of produce and fruits have existed as early as the dawn of civilization.¹⁷ The earliest known evidence of income taxation can be traced back to the Egyptians and Sumerians.¹⁸ During those times, taxes were still paid usually in grain, livestock, or oils.¹⁹ In ancient China, in the year 10 AD,

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* at 478.

¹⁵ PERKINS ET AL, *supra* note 1, at 462.

¹⁶ *Id.*

¹⁷ See http://en.wikipedia.org/wiki/Income_tax, (last visited Dec. 6, 2009).

¹⁸ Jennifer Rosenberg, *History of Income Tax in the U.S.*, available at <http://history1900s.about.com/od/1910s/a/incometax.htm>, (last visited Dec. 6, 2009).

¹⁹ *Id.*

Emperor Wang Mang instituted an unprecedented tax - the income tax - at the rate of 10 percent of profits, for professionals and skilled labor.²⁰

Modern income taxation, far from the ideal that its imposition be based on one's ability to pay, was borne out of war. The need to finance troops and supplies in wartime had been the driving force for many kings or rulers to impose and increase taxes.²¹ An income tax was implemented in Britain by William Pitt the Younger in his budget of December 1798 to pay for weapons and equipment in preparation for the Napoleonic wars.²²

The American experience was no different during the War of 1812, copying the British model, the United States (U.S.) government considered raising money for the war through an income tax.²³ Then again, during the American Civil War, the U.S. Congress passed the Revenue Act of 1861, imposing income taxes to raise money for the war.²⁴

The 1890s saw the U.S. Government first taking cognizance of the uneven income tax burden bearing mostly on the poor.²⁵ The U.S. Government attempted to enact a country-wide income tax with graduated rates in 1894, but failed to implement the same because of constitutional restrictions.²⁶ It was only in October of 1913, that the U.S. Government was able to enact its first permanent income tax law.²⁷

B. The Genesis of Philippine Income Taxation

Being under American occupation in the early twentieth century, the Income Tax Law of the U.S., enacted in October 1913, was made to operate in the Philippines.²⁸ After numerous amendments and revisions by both the U.S. Congress and the Philippine Legislature, the income tax law of the Philippines was put together and incorporated in Commonwealth Act No. 466 in 1939, and was, since then, referred to as the National Internal Revenue Code. Much later on and more recently, on 11 December 1997, the National Internal Revenue Code of 1997 (NIRC) was signed into law and

²⁰ *Supra* note 17.

²¹ Rosenberg, *supra* note 18.

²² *Supra* note 17.

²³ Rosenberg, *supra* note 18.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ JOSE VITUG & ERNESTO ACOSTA, TAX LAW AND JURISPRUDENCE 59 (2000).

codified all tax laws, orders, and decrees that have been separately promulgated at various times.²⁹

C. Definition, Concept, Scope and Coverage of Income Taxation in the Philippines; In General

As defined in the landmark case of *Frederick C. Fisher v. Wenceslao Trinidad, Collector of Internal Revenue*,³⁰ “income tax” is a tax on the yearly profits arising from property, professions, trades, and offices.

The NIRC imposes an income tax, based on schedular rates ranging from 5% to 32%,³¹ on the following individuals:

- a) Resident Citizens – on their compensation, business and other income derived from sources within and outside of the Philippines;³²
- b) Non-resident Citizens – on their net income derived from sources within the Philippines, in the same manner as such income would have been subjected to tax if received by resident citizens;³³
- c) Resident Aliens – on their net income derived from sources within the Philippines in the same manner as such income would have been received by non-resident citizens;³⁴
- d) Non-resident Aliens Engaged in Trade or Business – on their income from sources derived within the Philippines in the same manner as the income of resident citizens or resident aliens is taxed;³⁵ and
- e) Non-resident Aliens Not Engaged in Trade or Business – on their gross income at the special rate of 25%.³⁶

²⁹ *Id.*

³⁰ G.R. No. 17518, 43 Phil. 973, Oct. 30, 1922.

³¹ TAX CODE, § 24. The National Internal Revenue Code is Rep. Act. No. 8424 (1997).

³² § 24. *See also* VITUG & ACOSTA, *supra* note 28, at 63.

³³ § 24. *See also* VITUG & ACOSTA, *supra* note 28, at 66.

³⁴ § 24.

³⁵ § 25. *See also* VITUG & ACOSTA, *supra* note 28, at 66.

³⁶ § 25. *See also* VITUG & ACOSTA, *supra* note 28, at 67.

On the other hand, corporations, which include domestic corporations, partnerships - no matter how formed or organized, associations of persons, joint-stock companies, joint accounts (*cuentas en participacion*), and insurance companies are taxed on their income derived from sources within and outside of the Philippines at the corporate income tax rate of 30% beginning 1 January 2009.³⁷

D. The Self-Assessment System

Insofar as the administration, assessment and collection of the income tax are concerned, the Philippines, like most ASEAN countries such as Thailand, Malaysia and Singapore, practices the self-assessment system.³⁸

Under this system, individual taxpayers are required to file their returns on a calendar year basis if they do not qualify for substituted filing, which is applicable only to individual taxpayers receiving purely compensation income, regardless of amount, from only one employer in the Philippines for the calendar year, the income tax of which has been withheld correctly by the said employer.³⁹ The same is true for corporate income tax payers, who are required to file, either on a calendar or fiscal year basis, their quarterly and final/adjusted annual income tax returns.⁴⁰ Payment of the income taxes due from the taxpayers is made upon filing of their income tax returns.⁴¹

E. National Revenue from the Imposition of Income Taxes vis-à-vis Other Taxes

According to the latest published Annual Report from the Bureau of Internal Revenue (BIR), which was for the Calendar Year 2007, the revenue raised by the BIR from taxes, which include the income tax and the VAT, account for 76.49% of the Philippine Government's aggregate tax revenues.⁴² A quick glance at the said Annual Report would reveal that the Philippine Government relies heavily on the collection of income taxes compared to that of other taxes like the VAT. The said Annual Report states that among the major tax types, Taxes on Net Income and Profit were the

³⁷ Rep. Act No. 9337, § 27.

³⁸ National Tax Research Center (NTRC), *Summary Significant Features of the Income Tax Structure among ASEAN Member Countries*, XIX.4 NTRC TAX RESEARCH JOURNAL 1 (2007); *See also* TAX CODE, § 51.

³⁹ *Id.*

⁴⁰ TAX CODE, § 52.

⁴¹ TAX CODE, § 56 (A)(1).

⁴² BIR, *supra* note 3, at 10.

main and dominant source of collection which contributed 59.87% of the total internal revenue collection.⁴³ VAT collections amounted to 20.32% while Excise Taxes had a 7.71% share.⁴⁴

Statistics that have a considerable bearing on the effectiveness of the self-assessment system could be the number and percentage of tax returns filed per tax type. The BIR's 2007 Annual Report states that for the Calendar Year 2007 a total of 13,512,381 tax returns were filed.⁴⁵ Glaringly, while being the dominant source of revenue, income tax returns filed accounted only for a measly 7.53% of all the returns filed, while the VAT returns garnered a 13.42% share.⁴⁶

III. CONSUMPTION TAXES AND THE VAT

A. Origin of Consumption Taxes

Consumption taxes are imposed on the spending made on goods and services.⁴⁷ Quite obviously, the term refers to a system which uses consumption as the tax base.⁴⁸ Consumption taxes presently exist in varied forms, which usually take the form of an indirect tax, such as a sales tax or the VAT.⁴⁹

Much like income taxes, the imposition of transaction taxes can be traced back to as early as 2000 BC in Egypt, these taxes included sales taxes on individual commodities, such as cooking oil.⁵⁰ The early civilizations of Egypt, Athens, and Rome were all known to have general sales taxes, and considering the vastness of the Roman Empire, it was the Romans who were responsible for taking sales taxes to the rest of Europe, including Spain and France.

As regards the other popular form of consumption tax, which we take more interest in for purposes of this article, VAT was first devised during the 18th Century by a German economist, who envisioned a sales tax on goods that did not affect the cost of manufacture or distribution but was

⁴³ *Id.* at 12.

⁴⁴ *Id.*

⁴⁵ *Id.* at 19.

⁴⁶ *Id.*

⁴⁷ http://en.wikipedia.org/wiki/Consumption_tax, (last visited Dec. 6, 2009).

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ WILLIAM FOX, HISTORY AND ECONOMIC IMPACT 1 (2002), available at <http://cber.bus.utk.edu/staff/mnmecon338/foxipt.pdf>, (last visited Dec. 6, 2009).

collected on the final price charged to the consumer.⁵¹ Under this idea, it did not matter how many transactions the goods went through; the tax was always a fixed percentage of the final price.⁵² The large-scale use of value-added taxation began when France adopted a rudimentary form of it in 1954, and since then, the VAT was taken up in other European countries.⁵³ In fact, upon the formation of the Common Market in Europe, now known as the European Union, it was decided that one requirement of joining was the imposition of a form of VAT.⁵⁴ In 1973 the United Kingdom joined the European Union and replaced its existing Sales Tax with the VAT.⁵⁵

B. Consumption Taxes in the Philippines

After having tried, implemented and imposed various forms of consumption taxes in the Philippines, Executive Order No. 273 was issued imposing the VAT beginning on 1 January 1988.⁵⁶ Merely a few years ago, in 2005, the VAT law was revised and expanded by virtue of Republic Act No. 9337.

Subject to certain exempted transactions and zero-rated transactions,⁵⁷ the NIRC imposes the VAT on any person who, in the course of trade or business, sells barter, exchanges, leases goods or properties, renders services, and on any person who imports goods.⁵⁸

The phrase "in the course of trade or business" means the regular conduct or pursuit of a commercial or an economic activity, including transactions incidental thereto, by any person regardless of whether or not the person engaged therein is a non-stock, nonprofit private organization (irrespective of the disposition of its net income and whether or not it sells exclusively to members or their guests), or government entity.⁵⁹

As amended by Republic Act No. 9337, the NIRC levies on every sale, barter or exchange of goods or properties, and on every sale of services, including the use or lease of properties, VAT equivalent to twelve percent

⁵¹ <http://www.bbc.co.uk/dna/h2g2/A4803040>, (last visited Dec. 6, 2009).

⁵² *Id.*

⁵³ Britannica Online, <http://www.britannica.com/EBchecked/topic/519097/sales-tax/71978/History>, (last visited Dec. 6, 2009).

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ VITUG & ACOSTA, *supra* note 28, at 227.

⁵⁷ TAX CODE, §§ 108(B), 109.

⁵⁸ § 105.

⁵⁹ § 105.

(12%) of the gross selling price or gross value in money of the goods or services sold, such tax to be paid by the seller or transferor.⁶⁰

Under the VAT system, any input tax evidenced by a VAT invoice or official receipt shall be creditable against the output tax.⁶¹ If at the end of any taxable quarter the output tax exceeds the input tax, the excess shall be paid by the VAT-registered person.⁶² If the input tax exceeds the output tax, the excess shall be carried over to the succeeding quarter or quarters.⁶³ Every person liable to pay the VAT is obliged to file a quarterly return of the amount of his gross sales or receipts within twenty-five (25) days following the close of each taxable quarter prescribed for each taxpayer, provided, however, that VAT-registered persons shall pay the VAT on a monthly basis.⁶⁴

IV. Income Tax vs. Value Added Tax

Any analysis of the soundness and, therefore, desirability, of a given tax system would perforce have to be done against the canons and/or principles of a sound taxation system espoused by the aforementioned renowned economists of our time and centuries past. We, however, attempt to conduct our analysis by grouping together on one hand, the canons of administrative feasibility and political responsibility and the canons of fairness and economic efficiency upon the other, given that, as will also be shown by our discussion, these canons, among themselves, are inextricably linked.

i. Administrative Feasibility and Political Responsibility

To restate, administrative feasibility or simplicity of a given tax system only means that the expenses of administering the tax system should not be too complicated and should be inexpensive,⁶⁵ while political responsibility within that tax system simply means transparency, or that the taxpayer knows what he is paying for and to what uses the proceeds are to be utilized.⁶⁶

⁶⁰ §§ 106, 108.

⁶¹ § 110.

⁶² § 110(B).

⁶³ § 110(B).

⁶⁴ § 114(A).

⁶⁵ STIGLITZ, *supra* note 7.

⁶⁶ *Id.*

Against these canons, income taxation, at least in how it is enforced in our jurisdiction, seems to have fallen short, in large part not only by reason of the pervading culture of corruption⁶⁷ in our government but also raw human nature.

The self-assessment system is at the very heart of the conundrum. No matter how well-developed an income tax system may be, experience has shown that while the income tax could be responsible for a sizeable pie of national government revenues, a large slice of the proverbial pie is being paid by a small number of people – the urban elites, who, unfortunately, are also more vocal politically and who, over time, have developed a wide range of devices for tax avoidance and evasion.⁶⁸ It is not amiss to say that the income tax system is not only susceptible to mis-declaration and non-declaration by taxpayers, and corruption by tax officials, but experience has also shown that when faced with high income tax rates, taxpayers of every kind have the tendency to react by evading taxes through concealment of income or by altering economic behavior by supplying fewer labor services, shipping capital to tax havens abroad, hiring lawyers to find loopholes in the tax law, and worse, bribing tax assessors to accept false returns.⁶⁹

For these factors, achieving substantial income redistribution through the “progressive” income taxes has proven to be difficult, if not impossible, in most instances.⁷⁰ Where tax enforcement is weak, or where criminal penalties for evasion are next to absent, if not completely brushed aside, and where tax officials are underpaid, tax evasion and bribery is sure to be a thriving enterprise.⁷¹

Where the income tax is wanting in terms of administrative feasibility and political responsibility, the VAT enjoys a number of distinct advantages. Foremost, VAT is widely considered as having a built-in mechanism for check and balance.⁷² Otherwise stated, VAT is self-policing since underpayment of the VAT by the seller reduces the tax credit available to the buyer.⁷³ In other words, the taxpayer would not have the dilemma of whether or not to declare the correct amount of tax, as in the case of income

⁶⁷ *Intractable Problems*, BUSINESSMIRROR, Nov. 4, 2009, available at <http://www.businessmirror.com.ph/home/opinion/18172-editorial-intractable-problems.html>, (last visited Dec. 6, 2009).

⁶⁸ PERKINS ET AL, *supra* note 1, at 446.

⁶⁹ *Id.* at 463.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.* at 457.

⁷³ *Id.*

taxes, since the latter generally passes on the VAT to the next buyer, since he only pays the excess of his output VAT over his input VAT, and since, unlike income taxes, the taxpayer is not confronted with paying an annual lump sum tax, considering that the VAT is withheld per transaction, and in this sense is also considered, at times, as a painless tax.⁷⁴ Secondly, cross-checking of invoices is available to tax officers to match invoices received by buyers against those retained by sellers. This is, indeed, an invaluable tool in tax audit efforts,⁷⁵ both against the taxpayers and tax officials, themselves. Thirdly, the fact that a large part of the VAT is collected before the retail sale level is, likewise, beneficial to tax collection efforts, since in most developing countries such as ours, small scale retail firms do not keep complete tax records.⁷⁶ All these point to real and tangible administrative advantages of the VAT.⁷⁷

ii. Fairness, Progressivity, and Economic Efficiency

Progressivity and fairness of a particular tax ought to go hand in hand. In essence, according to Adam Smith, a progressive tax system means that the tax is imposed on individuals in proportion to their respective abilities, or one that is in proportion to the revenue which they respectively enjoy under the protection of the state.⁷⁸ As has been discussed above, progressivity is concerned with balancing social inequality,⁷⁹ yet a literal interpretation to the effect that those who earn more must be taxed more on their revenues is unfair and will not suffice.

Traditionally viewed hereabouts to be the most reasonable basis of taxation, income, according to those who espouse the view, reflects the individual's ability to pay.⁸⁰ As a matter of fact, and in stark contrast with advanced economies like Japan, and most European countries, the state derives the largest of its revenue from the imposition of income taxes.⁸¹

The tax on income, however, has been widely criticized by economists, and in fact, more and more countries are replacing it with other kinds of taxes, such as the VAT.⁸² These economists are of the view that

⁷⁴ *Id.* at 456.

⁷⁵ *Id.* at 457.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Supra* note 5.

⁷⁹ STIGLITZ, *supra* note 7.

⁸⁰ *Id.* at 470.

⁸¹ BIR, *supra* note 3.

⁸² PERKINS ET AL., *supra* note 1, at 448.

upper income groups have a higher propensity to consume than do lower income groups, and as such, under the VAT, end up paying more taxes.⁸³ Economists critical of the income tax system also take issue with the fact that the income tax unfairly levies even on private savings, whereas, the VAT only levies on spending.⁸⁴

Take for instance, a case where there are two brothers who are almost equal in intellect and abilities, and possess the same opportunity sets in life.⁸⁵ Let us say one of them decides after college to take up a master's degree and eventually becomes a high ranking executive in a firm, while the other, after college, decides only to become a beachcomber.⁸⁶ Let us say further that the executive is a prudent man, while the beachcomber is a big spender.⁸⁷ Towards the end of their lives, the executive, because of his savings, is able to support himself, while the beachcomber depends on government dole outs because he was not able to save.⁸⁸ In this example, obviously, the executive has the burden of paying the higher tax – he pays tax on his higher income and tax on the interest income he derives therefrom.⁸⁹ It is not difficult to see the unfairness of the situation, considering the fact that the two brothers had the same opportunity sets. In other words, the beachcomber could have made himself more useful to society, yet he did not.⁹⁰ Thus, as can easily be concluded from this example, income falls short of reflecting the individual's ability to pay.⁹¹ Corollarily, a tax on income does not appear to be all too progressive, nor does it figure in promoting economic efficiency.

It must be remembered that the most vital characteristic of every competitive economy is *pareto efficiency* – that is an economy where no one can be made better off without making someone worse off.⁹² In turn, every *pareto* efficient resource allocation can be attained through a competitive market mechanism, with appropriate redistribution.⁹³ It is, however, next to impossible to ever find a perfectly *pareto* efficient economy. An interplay of several factors create distortions that prevent this perfect economic situation. Foremost of these distortion-creating factors is taxation.

⁸³ *Id.* at 458.

⁸⁴ *Id.*

⁸⁵ *Id.* at 469.

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.* at 476.

⁹³ *Id.* at 57.

A tax is said to be non-distortionary only if there is nothing that an individual can do to alter his tax exposure. These are also called lump-sum taxes.⁹⁴ Taxes that depend on unalterable characteristics such as age or sex are lump-sum taxes.⁹⁵ Taxes on income and commodities are distortionary as they affect the behavioral decisions of individuals and cause them to devise ways to minimize their liability.⁹⁶ Distortionary taxes are inefficient economically speaking, in the sense that, if the government could replace them with lump-sum taxes, more revenue could be raised with the same effect on social welfare.⁹⁷

To attain and maintain, therefore, a proper balance between wealth creation and wealth distribution, efforts must be made to design a tax system that would minimize its warping effects on the economy, and thus encourage a genuine market economy.

It may be argued, as pure tax economists do, that a consumption tax like the VAT is superior to income taxes because it comes closest to attaining “temporal neutrality.”⁹⁸ Although it is virtually impossible to attain in reality, a tax would be considered to have attained temporal neutrality if it did not alter spending habits, change behavior patterns, or affect the natural allocation of resources.⁹⁹ Since the VAT only taxes consumption, the good or service being consumed is largely irrelevant in reference to the allocation of resources.¹⁰⁰ The tax is imposed only on the income that is, in fact, consumed while not taxing savings.¹⁰¹ A consumption tax like the VAT, therefore, eliminates any barrier to savings and encourages people to save, increase capital, and ultimately produce a more solid and robust economy.¹⁰²

Conversely, the income tax creates a barrier between the value of a person’s labor and what he actually receives, which fact produces a negative force on the economy as it causes him to work less and pursue more leisure activities than would otherwise be the case if income taxes did not exist, such that if there were no income taxes he would immediately see a real increase in purchasing power for each additional unit of time he spends

⁹⁴ *Id.* at 462.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.* at 463.

⁹⁸ *Consumption vs. Income Tax*, available at <http://www.investorguide.com/igu-article-1134-tax-basics-consumption-vs-income-tax.html>, (last visited Dec. 6, 2009).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.*

working, and thus he would be theoretically be more inclined to work.¹⁰³ This barrier, created by income taxes, also produces lesser savings (because capital is taxed), reduces investment, discourages innovation, and ultimately contributes to a lower standard of living when compared to a pure consumption tax.¹⁰⁴

While it may be true that the VAT would raise less revenue than an income tax if the two rates were the same, considering that, under the VAT, capital is not taxed, the same does not, however, hold true in the long run.¹⁰⁵ Among the effects of a consumption tax over the long haul are: (1) greater accumulation of savings, (2) more capital to invest, and (3) a fundamentally stronger economy.¹⁰⁶

V. CONCLUSION

It has been said that personal income taxes have been contributing very little to total tax revenue in many developing countries.¹⁰⁷ Coupled with structural, policy, and administrative factors, the ease with which income received by individuals can be invested abroad significantly contributes to this outcome, such that taxing this income has become an even more daunting challenge for developing countries, as was the case in a number of Latin American nations that have since stopped taxing financial income to encourage financial capital to remain in the country.¹⁰⁸

Moreover, it cannot be over emphasized that the tax on income is fast losing its popularity in advanced economies. Increasingly, these countries are beginning to realize that income is not as accurate a measure of an individual's ability to pay as it was thought it should be. Modern economists are of the view that instead of income, the more appropriate basis of taxation should be consumption, for it measures what one takes out of the economy rather than what one contributes.¹⁰⁹ This is just like asking the question: "why kill the hen that lays the golden eggs?" This point to the increased use of transaction based and transaction neutral taxes like the VAT.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ Vito Tanzi & Howell Zee, *Tax Policy for Developing Countries* (2001), available at <http://www.imf.org/external/pubs/ft/issues/issues27/index.htm>, (last visited Dec. 6, 2009).

¹⁰⁸ *Id.*

¹⁰⁹ STIGLITZ, *supra* note 7, at 474.

With respect to the “progressive” income taxation in force in the country, most people think that it is the best mechanism to implement social justice and to address social welfare problems. In fact, our present tax system is considerably skewed to favor this end. What many fail to realize is its economic impact. The same, as a system, while giving premium to wealth distribution that is geared to level social inequality, fails to take into consideration the effect that such higher taxes on large income earners will have on the overall economic efficiency in a market economy. For sure, the working behavior, productivity and enthusiasm of the high income earners are significantly dampened under this system. For why would someone work harder and earn more if the government will only to take this away from him by way of higher taxes? Clearly, a *pareto* efficient economy is not achieved in this wise.

It is true that the most efficient way to pursue social goals under a market-oriented system is to impose non-discriminatory and non-distortionary taxes. It is likewise desirable that consumption, instead of income, should be used as the basis of taxation. However, this can only work if the government is able to provide for the basic social welfare needs of its citizens. A low income earner who is made to pay taxes not significantly different from the high income earners is less likely to complain if the former need not worry about getting sick, because the government provides him with a sufficient and reliable health benefit program. He is not disadvantaged by paying a relatively higher tax if he does not have to worry about sending his kids to school, because the government sends his children to elementary and secondary schools for free; or if he does not have to worry about old age or disability, because the government has a sound retirement and disability program.

Thus, the core of the problem is the trade-off between economic efficiency and social welfare,¹¹⁰ and to achieve the fruits of a market economy, a balance, if not harmony, must be struck. Taxes, like that of our own income tax system ought not to heavily toll on the interaction of economic factors and affect behavior patterns of economic players. Aside from stepping in to check market failures, the government should take on a limited role and focus on social welfare duties that include provision of basic needs, public assistance programs, extension of low interest government credit, protection of workers, and social insurance.¹¹¹

¹¹⁰ *Id.*

¹¹¹ *Id.*

A VAT system, which ideally exempts basic commodities, offers a sound solution, at least in theory. While VAT has been adopted in most developing countries, it, however, more often than not, still suffers from being incomplete in one aspect or another, such as leaving out of the VAT net some important sectors, or providing a credit mechanism that is excessively restrictive, as when there are denials or delays in providing proper credits for VAT on inputs.¹¹² Addressing such problems and shortcomings in the VAT design and administration should be given priority.¹¹³

In closing, particularly in developing countries like the Philippines, it is acknowledged that designing, prescribing and implementing any tax system that would suit the profile of that particular state, must be challenging to begin with.¹¹⁴ Specifically in our jurisdiction, the big problem of tax evasion,¹¹⁵ complemented with the continued existence of dishonest officials and employees,¹¹⁶ who ply their trade right in the very corridors of government buildings, gives any policymaker a lot to think about. Hence, it is imperative that policymakers get their policy priorities right, and at the same time, wield the requisite political will to implement necessary reforms to meet these challenges.¹¹⁷ It is also indispensable that tax administration be strengthened to accompany the needed policy changes.¹¹⁸ Most importantly, it behooves leadership to take an unwavering stand and belief that tax policy is by no means the art of the possible rather than the pursuit of the optimal.¹¹⁹

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¹¹² Tanzi & Zee, *supra* note 107.

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ Michael Mundo, *Revenue Goals for 2006: A Taxing Climb* (2006), available at http://www.mbc.com.ph/economic_research/mbcrr/no76/default.htm, (last visited Dec. 6, 2009).

¹¹⁶ *Id.*

¹¹⁷ Tanzi & Zee, *supra* note 107.

¹¹⁸ *Id.*

¹¹⁹ *Id.*