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The economy on a cusp: The proposed VAT amendments and their larger significance*

*E. de Dios, B. Diokno, E. Esguerra, R. Fabella, Ma. Bautista, F. Medalla, S. Monsod, E. Pernia, R. Reside, Jr., G. Sicat and E.Tan

School of Economics, University of the Philippines

The economy on a cusp*

The proposed VAT amendments and their larger significance

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 placate financial markets and pave the way for the refinancing of maturing debts (thereby avoiding a future default).[1]

Failure to pass an adequate VAT law would be most inopportune, particularly when the national government is expected once more to tap international credit markets in September this year for the amount of some $3 billion. Indeed the mild treatment Philippine government debt paper received was due to the fact that markets had *already* factored in the passage of a satisfactory VAT law. Without such a law, on the other hand, if a credit-downgrade or massive loss of confidence in Philippine sovereign debt should occur, borrowing costs could rise by 300 basis points (i.e., three percentage points) and cost the nation an additional P5 billion in just one episode.[2] 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 overcoming the "Moody's blues" and 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.

Government spending net of debt service (i.e., primary spending) grew in nominal terms only by 1.4 percent in 2003 and 3.9 percent in 2004. These increases failed to keep pace even with the rate of inflation. As a proportion of GDP, primary spending has fallen more or less continuously from 16 percent in 1999 to less than 13 percent in 2004 (Table 1). 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.

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[1] Analyses of most fiscal crises show that most defaults happen when countries fail to refinance maturing debts.

[2] That is, an increase of $0.03 \times \$3$ billion = $90 million or approximately P4.9 billion at a P54.5/$1 exchange rate.

Table 1
Selected items of government spending
(as percentages of nominal GDP)

	1999	2000	2001	2002	2003	2004
Primary spending[1]	16.25	15.04	14.76	14.95	13.96	12.86
Education	3.39	3.23	3.05	3.03	2.99	2.69
Health	0.44	0.38	0.31	0.33	0.25	0.23
Infrastructure outlays	1.85	1.94	1.77	1.51	1.41	1.06
Memorandum:						
Personal services	7.24	7.01	6.82	6.77	6.42	6.16

[1]Expenditures less interest payments
Source: Department of Budget and Management

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. While there are those who would argue that spending compression cuts fat – about which there can be no argument – what is even more obvious is that expenditure cuts are hitting not just fat but bone and muscle as well. The result is the present state of affairs where, among other things, the secretary of education must grovel before private charity simply to rebuild schoolhouses in Quezon levelled by last year's storms and landslides; and where, rather than have supervised school lunches, scores of young children must die of food poisoning from ill-prepared street food. In the meantime, the government has also cancelled hundreds of millions of pesos in foreign official grants for want of counterpart funds.

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[3] 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. Furthermore, it retains the inherent inflexibility of a specific tax system whose adjustment is hostage to the whims of congress. It was this very feature that contributed largely to the fiscal crisis in the first place, as tax revenues on big items such as alcohol, tobacco, and petroleum failed to keep pace with the changes in economic activity because they were invariant to changes in the prices of these goods.

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[4] 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. Be that as it may, however, this is at least still "burden-sharing" – no matter how grudging and unintended – and people should be grateful enough not to look a gift-horse in the mouth.

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[3] That is, two percent of an estimated nominal GDP of P5375 billion for 2005.

[4] 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)

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.[5] The current tenor of developments bodes ill even for the administration's own programme of legislative revenue measures (Table 2). 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 2.
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
Total	**97.0**	
Memo:		
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.[6] Be that as it may, what is clear is that the administration's programme is now 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.[7] 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 given no action on the IRA. 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

[5] 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.

[6] 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 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).

[7] That is, P41.7 bn (= P30 bn VAT + P5 bn fiscal incentives + P6.7 bn sin taxes)

is estimated to yield an additional amount of P30-35 billion,[8] a figure broadly in line with the government's own projections when it assumes a 70 percent VAT-collection efficiency (first row in Table 3). 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: while it is true that a 10-percent VAT appears to be a rule of thumb for the region (e.g., for Thailand, Vietnam, Indonesia), none of of these other countries faces a fiscal crisis of the magnitude the Philippines does. On the other hand 15 percent is the level of China's VAT, as well as the average for fiscally troubled Latin America.

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 (Table 3), assuming 70-percent efficiency in collection[9]. 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). Moreover, with respect to the removal of some major exemptions, particularly those on petroleum, there could be difficulties with timing, as we discuss further below.

Table 3.

Yield from raising VAT rate to 12 percent and repealing selected VAT exemptions

(70% collection efficiency assumed; yield in billion pesos)

	Yield
Increase of VAT to 12 %	**35.12**
Repeal of VAT exemptions	**27.64**
Particulars of which:	
Coal and natural gas	0.34
Petroleum products	8.62
Raw materials for petroleum products	11.77
Vessels of more than 5000 tonnes	0.002
Cooperatives	4.87
Books	0.23
Medical services	1.37
Legal services	0.44
Total	**62.76**

Source: Department of Finance estimates (4 March 2005)

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.

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.

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[8] 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).

[9] Using an unrealistic assumption of 100 percent efficiency, the DOF projects additional revenues of P90 billion instead.

Of course, since richer households can save more, VAT paid reckoned as a proportion of *household income*, may fall as income rises; by this measure it is moderately regressive. The National Tax Research Center (NTRC) estimates the effective VAT rate is 5.2 percent for people who earn P20,000 or less, while those making P500,000 or more pay 3.66 percent of their income as VAT. Nonetheless economic theory posits expenditure (i.e., consumption) rather than income as the proper basis for measuring progressiveness, since not paying taxes on income saved at most postpones but does not avoid tax payment. (This is all the more true, since interest income from savings is also subject to a tax of 20 percent.)

Using household expenditures as a tax base, therefore, it is not surprising that the VAT is in fact *mildly progressive*.[10] 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. To illustrate using figures for 2000, the richest 10 percent of the population accounted for *35 percent of all spending in the country* (column 2 and last two rows of Table 4). This, of course, merely confirms a well known fact, namely, that incomes and wealth are unequally distributed, but it also suggests that it is the rich who are more likely to pay the VAT than the poor.

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. Again Table 4 (third column) shows that somewhat less than half of consumption in the poorest half of the population is subject to VAT, but that this figure rises to 64 percent for the next-richest nine percent and to more than 75 percent for the very richest one percent of the population. (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 4.

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
Richest 1%	10.1	75.8	12.6

Sources: FIES 2000, Fletcher [2005] and own computations[11]

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.[12] In this sense the existing VAT is actually progressive and probably more so than

[10] 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".

[11] 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 4 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 $s_i k_i / \sum_j s_{ji} k_j$ as given in column 4. This is because $VAT_i = s_i k_i E$ and $\sum VAT_j = E \sum_j s_{ji} k_j$.

[12] In Table 4, 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

some forms of income tax, which are progressive in principle but barely collected in practice. The bulk of personal income taxes, for example, is paid by many non-rich wage- and salary-earners who are captured by the withholding tax system; meanwhile many rich non-wage earners slip through the cracks.

Even as an indirect tax, the VAT is clearly less regressive than other indirect taxes (e.g., the "sin" taxes). Still, of course, it cannot rival 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. There was no compelling economic or social reason, for example, that a resort to law suits and to botox injections and liposuctions should have been exempted from a consumption tax in the first place. 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 5, 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

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of whose consumption is under VAT, the proportion of VAT paid to household income is 0.0442 (= 10 percent × 44.2 percent).

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.[13] 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 ill-conceived exemptions will remain, that *new ones* are being inserted.

(a) Except for the first item, none of these proposals in Table 5 is unequivocally justified on economic or equity grounds. One of the most controversial of these new exemptions is the proposal under HB 3705 in favour of international air transport and shipping operators (Table 5, items 2, 8, and 9). A BIR ruling currently allows such operators to impose no VAT on international passengers and cargo (in lieu of which there is a travel tax), and they are charged no VAT on their inputs either. The proposal, if accepted, would not only exempt these operators from VAT but also allow them to (a) *refund* any VAT paid on their inputs, (including imports or lease of aircraft or ships, imports of petroleum, and aircraft and shipping parts and supplies) or (b) *credit this* against their income-taxes and other duties (zero-rating). In addition, the three-percent tax on quarterly gross receipts from such carriers will no longer be charged. The question, of course, is why?

There *is* a valid economic reason for exempting international carriers from VAT in principle. It is the same reason one VAT-exempts exporters who must sell their products abroad, namely to put them on equal footing with the foreign competition. To the extent that these operators serve foreign passengers and handle foreign-related cargo, they are exporters and should not charge a VAT on foreigners. On the other hand, it would also be unfair to national carriers to subject their inputs to VAT if they did not have an output VAT against which to credit it. Thus far, the current system.

But the proposal goes too far. First, it maintains the VAT-free status of these operators. Second, it rescinds an already-existing gross-receipts tax. Third and more significantly, however, it *zero-rates* their inputs. That is, they are not merely exempt from paying VAT (as they already are under the existing system), now they may instead pay the VAT on their inputs then credit this amount against income- and other taxes. This is especially beneficial to carriers doing *both* domestic and international business, since then the VAT input-credits might be set off against taxes on profits arising from both sides of the business.

It is a sad commentary on this entire discussion that the proper distinction among consumption, intermediate inputs, and export of services has been lost. For example, a personal trip taken by

[13] The tax burden will be heavier on producers the more sensitive their customers are to any price increases.

Filipinos to Boracay or to Hong Kong is (luxury) consumption and should be taxed. On the other hand, a foreigner's trip to Boracay is exports and should be exempt. This confusion is what comes from taking the industry rather than the transaction as the unit of analysis.[14]

Table 5.
New exemptions and other revenue-losing measures considered

	Remarks
Zero-rating	
1. Services for persons doing business outside RP	
2. Sales to persons engaged in international shipping or international air transport	
Higher exemptions	
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	
Reduction of non-VAT taxes	
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%
Reduction of petroleum products excises	
12. Lower tax on naptha 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

A simpler and superior system would have been simply to subject both national and foreign carriers to a VAT when selling to Filipinos, exempting sales to foreigners, and allowing VAT credits on foreign sales. This would remove both the disadvantage to national carriers when selling to foreigners, whether at home or abroad. It would also give away no more revenue than is absolutely required by the demands of competitiveness. At the very least, however, given the complex issues involved, this matter should have undergone further study and discussion, rather than being merely smuggled in given the rush to pass the VAT amendments.

(b) The justification for the remainder of the proposals is even more tenuous. We have already discussed the folly of favouring selected goods supposedly consumed by the poor (item 6). These are as likely to benefit the non-poor (including their producers) as the poor in whose behalf they have supposedly been proposed.

The rationale for adjusting the ceilings on VAT-exempt sales, "low-cost" housing, and "low-rent" housing, for example, (items 3, 4, 5) might be described as sheer inertia. Although these were justified in the past as being "pro-poor", the incidence or impact of these pre-existing exemptions has never

[14] On the other hand, it should not matter that a business trip is subject to VAT, since it can be credited by the travelling businessman against the output VAT of his firm.

been investigated to begin with. What has been the distribution of housing sales in the relevant ranges, say, P50,000-P1o0,0000, versus P1 million-1.5 million? How many poor and non-poor people fall under each category? How have these patterns changed since 1995? Have any studies been conducted that justify raising these ceilings? Finally, how much of this is really the result of special pleading on the part of real-estate contractors and housing developers with strong backers in congress?

(c) Even more incomprehensible is the decision by congress to co-mingle proposals *unrelated to VAT* with discussions of the VAT measure. Hence among others there are proposals to scrap *already existing* gross receipts taxes on international carriers (Table 5, items 8 and 9) as well as the franchise taxes on electric utilities like Meralco (item 10). Of course the most outrageous measure – risible were it not so brazen – is the inclusion of a proposal to scrap the amusement tax on cabarets and night-clubs (item 11). What the urgent motivation for such a measure and its relationship to VAT could be is anyone's guess.

Almost as frivolous and ill-conceived is the proposal first to raise then to lower the corporate-income tax rate (item 7). Again this is no more than tokenism and pandering. As it is, the country's corporate income tax rates are on the high side in a context where the rest of the world's are on a downtrend. They are also among the most plagued by tax evasion. Raising rates merely further penalises those who are already complying and allows evaders simply to get away with more. Moreover, the time-bound promise to first raise and then lower taxes can only be feckless or downright harmful: feckless because it assumes it can credibly bind the policies of any future administration; and harmful to the extent that the uncertainty it creates could induce a postponement of investment decisions. Such proposals are unworthy of the legislature and should not be taken seriously.

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.[15]

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.

Petroleum products

The current set-up exempts final and raw petroleum products from VAT, instead imposing various levels of specific taxes on them, ranging from P4.35 per litre of unleaded gasoline to P1.63 per litre for diesel to 60 centavos and 30 centavos per litre of kerosene and fuel oil, respectively. In the case of unleaded gasoline, the specific tax is as much as 19 percent of the value of the product, although even

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[15] 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'."

P4.35 (about 8 US cents) per litre is still less than what other countries impose on similar products (e.g., about 10 and 15 US cents and for Thailand and Malaysia, respectively).

Estimates of the revenues to be earned from including petroleum products and their inputs in the VAT system vary from P20 billion to P29 billion, depending on what one assumes about collection efficiency.[16] There are, however, sound reasons apart from generating revenue for subsuming petroleum and its raw materials to VAT, which incidentally is common practice elsewhere in the world. For one, unlike the present system of excises, the VAT would give users of petroleum products (notably electricity generators) some relief in the form of tax credits. By the same token, the crediting of VAT inputs creates a paper trail that facilitates monitoring and efficient collection. Finally, unlike a system of specific taxes, an *ad valorem* tax like VAT makes the revenue system more buoyant, i.e., rising or falling with the product's value as a matter of course. As with the "sin taxes", the failure to update specific taxes on petroleum is one of the major reasons that revenue effort has fallen off.

In principle, the specific excises themselves need updating; these have not been adjusted since 1996. Indeed we have gone on record as supporting an increase in the current excise on gasoline (excepting fuel used by electricity generators) by P2 per litre, a move we estimated could generate P12 billion. This option need not be given up. As a matter of principle, *both* should be in place, i.e., a VAT on petroleum products for uniform treatment, and an excise tax to reflect the additional cost to society imposed by the use of fossil fuels, as is also the case with tobacco and alcohol products.[17]

In practice, however, the current specific taxes on final petroleum products were functioning *in lieu* of VAT. For this reason and as a transitional measure while world oil prices remain high, it should suffice for the moment simply to capture the entire petroleum sector in the VAT net *without cutting the excise on petroleum*. One roughly makes up for the other: just as an initially bloated excise tax used to fulfil the consumption-tax functions of a VAT, so too can inclusion in the VAT system replace the updating of an outdated excise.

The complication posed by current proposals from the senate is that they *remove* the excises on bunker, diesel, and kerosene even as they subsume these products to the VAT. Hence against the prospective gain from including these products in the VAT system, one must set off the losses from the removal of the excises. One must be careful not to double count the VAT revenues, since the amounts that will actually be credited as input-VAT are highly uncertain. It is not difficult to construct plausible scenarios in which the additional revenues, after netting out excise-tax losses and input-VAT, are negative or minuscule.[18]

Timing moreover is essential. If gasoline is included in VAT, it is not unlikely that, contrary to the senate's proposal, the excise on gasoline, just like that on diesel, will also be reduced. Doing this at a time when petroleum prices are high and rising increases the political cost and makes revenue-slippage even more likely. A wiser course would be to affirm the principle but to postpone the actual inclusion of the entire petroleum product sector until a time that the economy will have adjusted to higher world oil prices.

Electricity generation

Like petroleum products, power-generation has thus far also been VAT-free. There are no special reasons on equity or efficiency grounds why it should be. The complication presented by the taxation

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[16] With 70-percent collection efficiency, the DOF estimates revenues of P20.4 bn (= 8.6 from petroleum products + 11.8 raw materials used in such products). A 100-percent collection efficiency is estimated to yield P29 bn (= 12.3 from petroleum products + 16.8 from raw materials).

[17] In an ideal tax system, there would be three classes of goods and services: (a) those not subject to VAT (e.g., exports); (b) those subject only to VAT (most other goods); and (c) those subject to a VAT plus an excise tax (i.e., those whose consumption with creates demonstrable harm to the community, and which therefore society wishes especially to discourage. Fossil fuels, tobacco, and alcohol – and night clubs? – fall under this latter category.

[18] The expected gross gain from including petroleum products in the VAT system is around P25 bn. On the other hand, the proposal to reduce or remove excise taxes loses P13 bn, leaving a tentative gain of P12 bn. But this does not factor in input-VAT credits. Assuming only half gets input-credited, this leaves almost nothing in terms of additional revenue.

of this commodity is largely one of timing and circumstance. The entire power sector is currently undergoing a major transformation under the electrical power industry restructuring act. An essential element is the imposition of a universal charge (UC) on all power generated which, under the Electric Power Industry Reform Act (EPIRA), is expected to be in place by next year. There are various valid purposes this impost will serve[19], but its principal component will go toward amortising the huge residual debt ("stranded costs") remaining after the privatisation of that national tragedy that is the National Power Corporation (NPC). This passing-on of the burden of NPC's mistakes to the electricity users will mean that for a significant period of time, electricity will be priced *artificially higher* than it should be.

The big difference between petroleum and electricity, therefore, is that unlike the former, whose pre-tax domestic price is broadly in line with world prices, electricity is already artificially expensive even before it is taxed. For this reason, there can be a genuine debate about whether power ought to be folded into the VAT system as long as the universal charge will be levied. To impose both a universal charge *and* the VAT in this case would unduly discourage power consumption and impose an additional burden when there is no economic or social reason for doing so.

Nor is this conclusion altered by the simple-minded attempt of the house to prevent a pass-through of the proposed VAT on power to consumers. Apart from being deplorable economics – it turns a consumption tax into a tax on producers – this stratagem is in any case unlikely to prosper legally[20] and smacks frankly of a crude show to please the gallery.

The choice then is clear: if the VAT is to be imposed, the UC must be given up; if the UC stays, then VAT-inclusion must be foregone, or at least phased in only as the UC diminishes. The equivalence between the two imposts becomes even clearer if one considers that the purpose of collecting the UC hardly differs from that of raising the VAT, which is to reduce the government's indebtedness (which in turn includes the indebtedness of NPC). As a corollary, in the larger picture of raising revenues to stabilise the debt, the proceeds from a possible VAT on power cannot be regarded as an undiluted gain; they must be set off against a possible loss of the proceeds from the universal charge.

Clearly then the case for including power and petroleum in the VAT system exists, 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

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[19]An important one is "missionary electrification", i.e., providing power to areas that are inaccessible and therefore unprofitable to the private sector.

[20] The contracts of independent power producers guarantee a complete pass through of any taxes.

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.

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 exemptions in Table 2 worth P27.6 billion would yield as much as P51.6 billion,. i.e., the first line in Table 2 replaced by the last line in Table 6 gives (27.64 + 24.12 = 51.6). Table 6 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.

Table 6.
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
Total	**24.12**

Source: Department of Finance, March 2005.

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.

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.[21] The upshot of this is to penalise investment by effectively taxing it. In their zeal to

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

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 one-time revenue boost comes from the fact that companies will not be allowed to credit their input-VAT all at once and must therefore in the meantime remit a larger amount to government. Eventually however they will be allowed to use those credits, albeit gradually, so that the government stands to earn a smaller amount in all succeeding periods. 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. [22] 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

Fiscal crisis revisited

It is appropriate, at this point, to step back and look at the big picture. In late August last year, we co-wrote a paper[23] that raised the warning that the economy could confront a financial crisis a few years down the road if the government failed to take bold steps to fix the fiscal mess. Using historical trends, the "UP-11" paper estimated that the government needed to raise additional revenues equivalent to 2.9 percent of GDP. That amount explicitly provided for an added one-percent of GDP

[22] 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.

[23] "The deepening crisis: the real score on fiscal deficits and the public debt", University of the Philippines School of Economics Discussion Paper (August 2004).

earmarked for social services and infrastructure. The increment needed to avert a crisis was thus put at 1.9 percent of GDP[24], which as needed to obtain a primary surplus (i.e., budget surplus excluding interest payments) equivalent to 2.5 percent of GDP needed to stabilise public debt.

The course taken by revenues, primary spending and balances since then is given in Table 7. On the face of it, the economy made progress in approaching its goal of sustainability: between 2003 and 2004 the primary surplus in fact rose from 0.6 to 1.5 percent of GDP (Table 7, line 3). Moreover, if the approved budget for 2005 is implemented, this trend is bound to continue so that by the end of this year, particularly if one includes the revised "sin" taxes and the passage of a serious VAT bill, the country stands to "over-achieve" its fiscal sustainability targets for 2005 and possibly attain a primary surplus *in excess of 3.5 percent* (Table 7, Column A). Indeed even without the VAT, a primary surplus of almost 3 percent might be attainable (Column B).

Table 7
Fiscal crisis redux
(items reported as percent of current GDP)

	2003	*2004*	*Scenarios*			
			A	B	C	D
1. Primary spending	13.95	12.86	11.26[a]	11.26[a]	13.95	13.86
2. Revenue	14.58	14.41	15.07[b]	14.21	15.07	16.21
3. Primary surplus	0.63	1.55	**3.73**	**2.95**	**1.12**	**2.35**
Broken down as follows:						
4. Previous primary balance	--	0.63	1.55	1.55	1.55	1.55
5. *Plus*: cut (or: rise) in primary spending		1.09	1.61	1.61	(1.1)	(1.0)
6. *Plus*: new revenues		--	0.86[b]	0.12[b]	0.86[b]	2.0
7. *Less*: regular revenue slippage		(0.17)	(0.2)[c]	(0.2)[c]	(0.2)[c]	(0.2)[c]

a = based on approved 2005 budget
b = sin taxes equal to 0.12 and and VAT 0.74 percent respectively of 2005 GDP
c = revenue effort assumed to slip annually by 0.2 percent without new measures

Column A: assume primary-spending cuts in 2005 budget and passage of VAT and sin taxes
Column B: assume primary-spending cuts in 2005 budget without VAT
Column C: restore 2003 levels of primary spending and pass VAT and sin taxes
Column D: restore 2003 levels of primary spending with recommended 2-percent additional revenue

Some could choose to interpret these data in reassuring terms to say that the crisis is over; indeed, others might utilise them to argue that no new revenues – not even the VAT amendment – are really needed. But all such inferences would be self-deceiving, since as already noted in the beginning, this "feat" is founded on a single old stratagem: *spending compression*. Spending compression is effectively mortgaging the future. This fact makes it artificial and unsustainable. For it is unreasonable – indeed anti-people and anti-development – to believe that such low levels of government provision of public goods can be indefinitely maintained. One only needs to look in on the physical and intellectual state of basic public education to see how, by this means, Filipino children are daily being robbed of their future. Nor do we need to mention the deplorable state of primary health, the penal system, and transport infrastructure in this country. At the other extreme, one might also wonder how long congress can reconcile itself with a reduced-pork budget. Spending compression in the late 1980s begot the crippling power crisis!

[24] That is, an addition to primary surplus of 1.9 percent, plus the existing primary surplus of 0.6 percent.

An indication of how tenuous the fiscal situation remains may be seen from the following thought-experiment: suppose levels of primary spending were only to be restored to those of 2003 (ca. 14 percent of GDP). Then the primary surplus would shrink to no more than 1.1 percent of GDP (Column C), a figure well below the 2.5-percent benchmark for fiscal sustainability. At which point the wolves would again be baying at the country's door. This simple *Gedankenexperiment* also demonstrates that the revenue efforts thus far – even with a VAT revision passed –are barely enough to provide the needed cushion for sustainability. Things would, of course, be even worse if no VAT revision was passed (primary surplus shrinking to about four-tenths of a percent of GDP). Such precarious numbers are almost certain *not* to impress financial markets, for they are bound to see that the only consequence of such self-injurious actions in the long run is either crippled development or political unrest, or both.

Our preferred scenario would have been to front-load the raising of additional revenues of as much as two percent of GDP, while *simultaneously raising primary spending* by one percent of GDP. As a result (shown as Column D) revenue effort would rise to 16.2 percent and primary spending to 13.9 percent, yielding a primary surplus of about 2.3 percent. On the one hand, the credible rise in revenue effort would serve to reassure the international finance community; on the other hand, the people's present and future needs would not be unduly sacrificed.

Current developments do not however point to this preferred scenario. Instead what is immediately shaping up – assuming crucially that the VAT amendment passes – is that deep spending cuts may serve to stabilise financial expectations – for the moment, anyway. The threat of a crisis will have been postponed for a year, though that will still leave the government to deal with people's frustrations over the inadequacy of public-goods provision. Then the situation would still be serious – but not hopeless.

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[25] are a related phenomenon – when even small changes suffice to decide between vastly different outcomes.

At bottom is always the issue whether an adequate deal can be brokered that will be regarded as fair and acceptable by important parts of the population. But when political institutions have typically delivered only biased and flawed results in normal times, they cannot be expected to command trust and support when they demand sacrifices of the populace in a crisis. Much of this unfortunately applies to the Philippines as well. The question is, first, whether the country's political elite can look beyond their smaller concerns and realize the gravity of the situation and second, whether this leadership can craft a package that the rest of the country can accept. The latter entails that the proposals must be viewed as fairly apportioning the burden. On both counts, in the Philippines, the record thus far has been mixed.

Yet the stakes have never been more tantalizing. For the economy now genuinely seems to be on a cusp, an odd moment during which things could just as easily turn for the worse as get better. Ironically the financial markets are almost aching to favour the Philippines; this fact that can be partly seen in the peso's recent strength, as well as in the relatively mild treatment the country received from ratings agencies. What is required to complete the job, however, is a convincing fiscal turnaround, an indispensable component of which in turn is a credible VAT measure. The Philippines could then become one of the few sovereign borrowers in the world that offered attractive premiums without the concomitant risk of default.

[25] See, for example, P. Diamond and D. Dybvig [1983]

The high cost of the last bond issue has not dispelled the impression that the country's offerings have junk-bond status. We might then cash in on one case of positive history: the country's reputation of never having reneged on its debt (not even during the debt crisis of the mid-1980s). From that point on, any or all of the following would be plausible: (a) avoidance of a further downgrade and instead an improvement to ASEAN standards of the terms at which government borrowed abroad; (b) a new stage when the government might simply borrow in local currency, purchasing foreign exchange it needed from current account surpluses and foreign portfolios moving into holding domestic paper. It is not far-fetched to imagine the side of the cusp where the economy starts to become burdened by an over-strong currency, bid up by foreign inflows. That situation would present problems of its own which need not be confronted now.

On the other hand, that scenario could just as easily vanish if the government failed to seize the moment and to act decisively. The economy could just as likely slide down the cusp's other half if no credible revenue measure was passed – more specifically if the much-awaited VAT amendment carried no increase in rates, or was seriously impaired by major exemptions, or entailed such innovations that its effective implementation was placed in doubt. Then the scenario would revert to a gradual or rapid deterioration in credit standing, increasing debt, further spending contraction, all of which would bring this country that much closer to a real payments collapse.

Increasing the chances of a favourable scenario involves not only the current question of passing a credible VAT amendment. Beyond this, it involves moving away from the overworked and short-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. Here remains a splendid opportunity for presidential leadership.

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

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