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The real score on deficits
and the public debt***

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The deepening crisis: the real score on deficits and the public debt*

In her state of the nation address before Congress last July, President Arroyo drew attention to the government's worsening fiscal and debt problems, calling the deficit "our most urgent problem". That was an accurate statement. The looming threat represented by an uncontrolled public debt is indeed the biggest economic challenge the country will have to confront immediately and for the remainder of this decade.

But, surely, now it has been placed on the national agenda and there is no getting around it, this can only mean the issue will be seriously addressed and resolved, right?

Apparently not. Recent events and discussions give ample reason to doubt whether the President's message has been truly understood and internalized by the political elite and public alike – and hence whether the issue will be given its due importance. Though business people may wring their hands, bureaucrats may fret, and a polite audience may click their tongues, public debt and government deficits, it must be acknowledged, are of no immediate concern to the great majority of Filipinos.

This is precisely where risk and danger lurk. Because the issue is arcane and removed from people's daily experience, it commands no great constituency; that many of the proposed solutions portend only collective sacrifice and pain means the only reaction they arouse is broad opposition and deep resentment. And because the issue is crucial but esoteric, well-known but unpopular, it is almost inevitable for some politicians, media, and public intellectuals to make political capital of the situation by pandering to public ignorance instead of relieving it.

The result is an understandable cognitive dissonance: the sound-bites and headlines giving a premium to "clever" solutions with a false assurance that there is indeed no crisis, or that a crisis can be staved off with no sacrifice, no pain, and no radical readjustments in people's way of life. The quality of public debate on the issue stirs grave doubts whether the scale and consequences of "our most urgent problem" are indeed being fully appreciated.

Why it matters

The national government's total debt stood at 3.36 trillion pesos as of the end of 2003, split almost equally between foreign and domestic liabilities. This was as large as 78 percent of GDP in 2003. The outstanding debt of the public sector as a whole (the consolidated public sector debt) was running at more than 130 percent of GDP (Chart 1). Both are on the uptrend.

Creditors are on edge over whether in the near future the government should default and they will be unable to get their money back; investors on the other hand would hesitate to invest in a country that seems headed inexorably for another crisis. The growing size of the debt and the deficit are undoubtedly the biggest reasons that investment and growth

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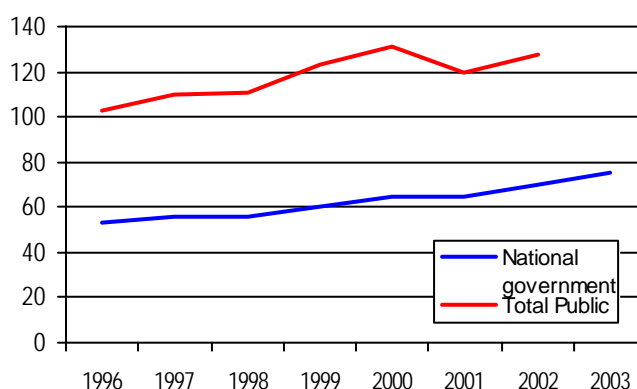
in this country have remained sluggish – fully seven years since the start of the Asian crisis.

The danger such numbers represent is obvious. The growing dependence on debt means that any sudden increase in global interest rates – which can no longer be ruled out – would cause huge difficulties in repayment, whether or not the government defaulted formally. This would result in a sharp cutback in subsequent credit, particularly from foreign lenders, and precipitate a crisis such as that Argentina or Turkey experienced. As the 1983-1984 crisis showed, the cutback in foreign lending would lead to a sharp peso depreciation, most likely aggravated by capital flight, severely contract trade as the price of imports rose, and correspondingly cause a deep recession and unemployment. The current uncertainty of the international climate, especially as it affects the country's energy supplies and military spending regarding anti-terrorism, makes it prudent to be fiscally more conservative.

A crisis would not be averted even if government sought relief by reneging only on debt held by its own citizens (this might prove tempting, since Filipinos hold most of the government's peso-denominated debt as well as a good chunk of dollar-denominated debt). Even that would also cause major difficulties and bankruptcies for the domestic banking system, which holds a large amount of government paper, and ruin millions of depositors. Such a systemic shock would entail a no less severe economic contraction, causing thousands of bankruptcies and throwing millions onto the streets.

At the moment, such scenarios are being fended off only by the fact that the country continues to earn more foreign exchange than it spends (thanks especially to overseas workers' remittances). But this could just as easily change. Any large external shock, such as a sustained increase in world oil prices, or a sharp fall-off in workers' remittances, or ironically, even rapid growth that caused the import bill to rise, would make the country increasingly vulnerable. While the economy is not yet on the brink at this time, it can probably afford at most three years to avert such a crisis – with possibly a year at most to convince financial markets it is doing something to reverse the situation.

Chart 1. Total national-government and public-sector debt
(1996-2003; as a percentage of current GDP)



Apart from what lenders and investors think, however, there is a more urgent and mundane reason for the government to focus on the deficit and the level of public debt. Unless it does so, it can make little progress on *any* of its promised programs. It is by now well known that almost 30 percent of annual spending is taken up by interest payments on past debt alone. Roughly half then goes simply to paying salaries and operating expenses. In 2003, capital outlays (which include the infrastructure budget)

made up a little more than 6 percent of the budget, with amounts being slashed almost by half even in nominal terms.¹ All of this leaves very little to go around by way of government programs, causing a wide gap between reality and its ambitious plans and promises.

Debt and deficits – stylized facts

In principle, the public debt can be understood as the accumulated difference between what government spends and what it earns. It would be a great error, however, to focus only on the *visible part* of government spending and revenue, namely the national government's budget deficit, and therefore attribute the causes of the problem entirely to that quarter. In fact, the two largest failures that have led to the present critical state of public finances are *first*, the failure of the tax structure and bureaucracy, and *second*, the inefficiency and lack of accountability on the part of public corporations. We tackle these in turn.

Between 1997 and 2003 the national government's debt rose by P2.01 trillion, from P1.35 trillion to P3.36 trillion. Of this total increase (Table 1), 43 percent was due to deficits incurred by the national government during the same period. Nineteen percent was caused by exchange-rate changes: with half of the debt being foreign-currency denominated, the peso equivalent of the debt increases every time the peso depreciates. It is significant, however, that more than one third (37 percent) of the build-up in debt is due not to accumulated deficits but is to "non-budgetary accounts" and off-book items such as assumed liabilities and lending to corporations. These we discuss further below after examining the deficit blow-out.

Table 1. Accounting for the increase in debt 1997-2003

	Amount billion pesos	Percent distribution
<i>Increase in the national government debt</i>	2009.45	100.0
Due to national government deficits	855.69	42.6
Due to exchange-rate change	377.54	18.8
Due to non-budgetary accounts	320.55	16.0
Due to assumed liabilities and lending to corporations	428.10	21.3
Increase in cash	27.54	1.4

As is well known by now, national-government deficits have grown steadily over the past years (Chart 2). From near-balanced budgets in the middle and late 1990s, deficits surpassed 5 percent of GDP by 2002 before moderating slightly to 4.6 percent in 2003. By that time, of course, a good part of the problem was the rising share of debt service in the budget; in 2003 debt service took up 27 of the total budget.

Unlike the debt crisis experienced in the late 1980s, however, the increasing debt service today has not been precipitated by suddenly higher interest rates that the government must pay on its debt. (On the contrary, both domestic and foreign interest rates have been quite benign, a situation however that may not last very much longer.) This assertion is evident if one views the trends in the primary surplus. The government has more or less run surpluses net of debt service (*primary surpluses* running to almost 6 percent of GDP in 1994), but these disappeared noticeably from 1999. By the end of 2003, the primary surplus was down to 0.6 percent of GDP. Unlike 1983-1984, this time the problems were largely of the government's own doing.

¹ Capital outlays were P93 billion in 2002 and only P50 billion in 2003.

It is indisputable however that this deterioration was *not* due to any sudden spike in budgetary spending. Total spending has averaged 19 percent (Chart 3). Net of interest payments, national-government spending (i.e., primary spending) has in fact declined significantly since 1999, and is now at its lowest level in a decade. Large chunks of the national budget are already pre-empted by salaries, maintenance and operating expenses, and the internal revenue allotment to local governments, leaving little room for infrastructure spending and other development needs.

Chart 2. **Primary and total surpluses and deficits**

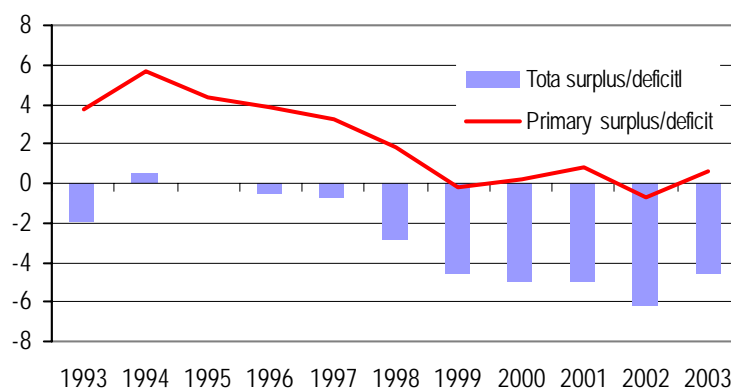
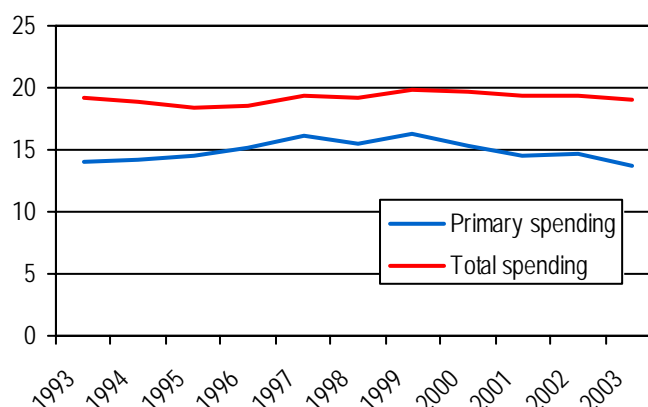


Chart 3. **Primary spending and total spending**
(1993-2003; as percentage of GDP)

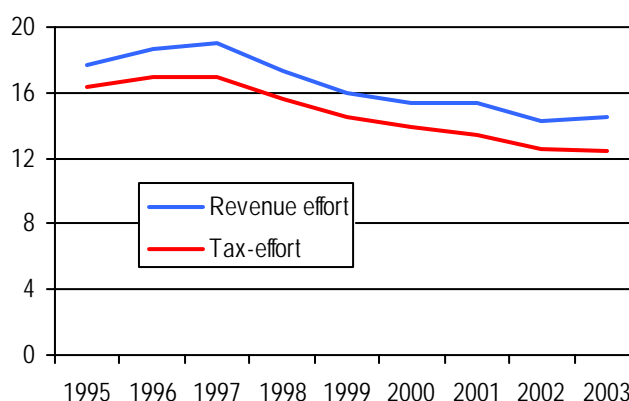


Instead what is clear is that falling revenue- and tax-efforts have been the main reason for the worsening deficit picture since 1997. The tax-effort in particular fell from a high of 17 percent of GDP in 1997 to only 12.5 percent by 2003. That this occurred even during years of continuous, though moderate, economic growth strongly suggests that serious structural flaws have crept into the revenue system. It has been strongly suggested that much of this is due to rampant tax evasion abetted by a corrupt revenue bureaucracy. There is absolutely no dispute regarding this. On the other hand, it is also known that corruption and tax evasion are not new phenomena and have been age-old features of current tax administration. Unless one is prepared to state that corruption and evasion have drastically and autonomously worsened – evidence of which has not been presented – one would still be hard-pressed to explain the fall-off in tax effort since 1997. The point is not simply to show that evasion and corruption exist – for that is conceded – but that they have worsened and that this worsening is the sole or even major culprit in declining revenue effort.

Apart from worsening revenue administration, one must also consider that economic growth has been weaker. Moreover, the economy has had to contend with an inflexible and unresponsive tax structure, mortally weakened by the legislative failure to adjust specific taxes (e.g., taxes on petroleum, beverage, and tobacco); the excessive grant of incentives and exemptions (e.g., from the BOI and for special economic zones); the failure to provide for administrative rules to plug revenue leakages (e.g., failure to ensure that final taxes on loans and deposits withheld by banks are actually remitted to the government); and an unabashed surrender to lobbying, as illustrated by the VAT exemptions given by Congress to doctors, lawyers (and law firms!), and even show-business. Finally, apart from administration, there is the problem of judicial failure in following through on tax evasion cases. Not only are large tax evaders unlikely to be charged; even those who are charged are likely to go scot-free.

In all this, therefore, there is blame enough to spread around – blame the executive for its failure to discipline the tax bureaucracy and rein in waste; blame the legislature for its failure to pass the laws that will adjust specific taxes to recover their real value and for caving in to powerful or populist lobbies; blame the judiciary for abetting tax evasion through its inaction and irresponsibility; and finally blame the taxpayers at large – better yet, the large taxpayers – for what the President has called “a culture” of tax avoidance and tax evasion.

Chart 4. **Revenue- and tax-effort**
(Revenues and taxes as percentages of GDP; 1995-2003)



The story behind non-budgetary accounts and assumed liabilities

Budget deficits have been the largest contributor to the growth of the government debt. But they are by no means the only major ones. It has already been mentioned that an equally sizeable amount (37 percent) of the debt-increase is due to “non-budgetary accounts” and assumed liabilities and lending to corporations.

Such accounts stem basically from the fact that the operations of the “government” are much larger than the activities involving regular branches and agencies. This much is already evident in the distinction between what is called “national government” debt and “public sector” debt. National- government debt at the end of 2003 was equivalent to 78 percent of GDP. Total public-sector debt, on the other hand, was more than 130 percent. The latter includes the former as well as the liabilities of government-owned or -controlled corporations, which are strictly speaking not obligations of the national government – or not yet, anyway.

In principle corporate entities like the National Power Corporation (NPC), the Public Estates Authority (PEA), GSIS, and SSS, although government-controlled, are supposed to pay their own way, borrowing on their own account whenever needed to serve their clients better, but in turn collecting fees or earning revenues to repay those liabilities.

The servicing of such debts should *not* in principle show up in the national government's budget.

Experience has shown, however, that the national government will frequently step in to assume the debts of such government corporations when these run into trouble and fail. The result: what ought to have been liabilities only of these corporations and the clients they serve become transformed into debts of the national government and of all Filipinos. The pattern is not new and has unfortunately persisted to this day. The huge debts inherited from the Marcos administration that are still a burden to today's taxpayers consist largely of the debts of ostensibly self-financing projects that turned sour and of supposedly self-sustaining institutions that bellied up and needed to be rescued. These include the bailouts of the Central Bank, the DBP, the PNB, and the old NPC (like the Bataan nuclear power plant). Most of these are classified as "non-budgetary accounts". They have long been officially recognized as government debt, and magnitude and debt service are largely known in advance. In Table 1 the servicing of these debts accounted for P320 billion or 16 percent of the rise in debt in the period 1997-2003 alone.

On the other hand, the other off-budget item we have decided to call "assumed liabilities and net lending to corporations" (ALNLC) in Table 1 is more difficult to assess. Unlike "non-budgetary accounts", a large part of which is a legacy of the past, the size of ALNLC is essentially indeterminate, since this must wait on future decisions regarding how much further government will assume the debt incurred by government corporations. Among the large new debts recently assumed by the national government have been those of the National Power Corporation and the Philippine Estates Authority. When, for example, NPC recently sought to cover its running losses by borrowing abroad, there were no takers of its bonds; the national government instead bought the NPC debt paper, then proceeded to borrow abroad on its own account then lent this on to the NPC. Thus what should have been the debts of a single corporation became the liabilities of the entire government and became included in the debt-service budget right under the noses of Congress. Over the past five years alone (1999-2003) the national government took over P44.5 billion of NPC debt. Other liabilities that may be in the pipeline for takeover and which could mysteriously make a surprise budgetary appearance include those of the SSS, GSIS, and the RSBS.

The ALNLC make up more than one-fifth of the increase in total debt thus far. But another source of indeterminacy in the ALNLC stems from the fact that a good part of them are "contingent liabilities", whose magnitudes are variable, since whether and how much of them the government must pay depends on certain "triggers" being activated. When, for example, NPC entered into purchased-power agreements with some private producers of electricity, it did so under "take-or-pay" clauses that committed the government to pay the generator a fixed amount, regardless of whether the NPC sold all the electricity or not. In other cases, the ballooning of such liabilities is inflicted by the government on itself. For example the government, for political reasons, decided to reduce power-rate charges and light-rail fares to levels below the prices it contracted to pay. Until these prices change, therefore, the difference shows up as debt service in the budget.

A relevant question then becomes how much the national government is *ultimately likely to owe* and how much it should be prepared to pay from taxes and other revenues. Is it the large figure of P3.36 trillion or the even-larger figure² of P4.13 trillion? The answer is certainly "some figure between the two". At this point, however, no one can tell exactly how much the final figure will be. Whether the debt-service payments of the national government are bigger or smaller will depend on (a) how well government-run

² Reported as of February this year.

corporations perform their operations and stay out of financial trouble; and (b) whether or not government decides to bail out failing corporations and assume their liabilities.

The problem of the ballooning government debt, therefore, cannot then be attributed solely to the “extravagance” of government budgets, or the inadequacy of its tax revenues. An equally important part of the story has been the dismal performance of government-run corporations and the equally disastrous policies of all previous administrations that have affected them. Both have played a major role in determining the size of the debt and the burden that taxpayers must bear to service it.

Even as one must agree with the note of urgency sounded by the administration on this problem, therefore, no one can justify an approach that entails *all* adjustment and pain falling only on the general taxpayer. One of the imbalances of the current system – which has been exploited by every President in the last four decades – is that the executive, acting without Congress, can decide whether and to what extent contingent and guaranteed liabilities of government corporations are to be assumed by the national government and passed on to the general public. To that extent, and because of automatic debt-appropriation, Congressional approval is reduced to a mere rubber stamp.

In this connection, the President’s proposal to limit the number of corporations is laudable and a step in the right direction. What matters immediately, however, is not the absolute number of corporations: it is whether and how much this contributes to the national debt. Hence it matters to what extent the administration itself encourages, benefits from, and ultimately condones their irresponsibility and loss-making behavior. More important than limiting the number of corporations is a hard annual limit to how much of a subsidy and guaranty they can expect from hereon. The fact that at the moment, there are no practical limits is an onus on the presidency and an abdication of responsibility on the part of Congress.

Unsustainability: the simple arithmetic

This late in the day, staving off a full-blown fiscal crisis really boils down to attaining one goal, *stopping the growth of the government debt as proportion of GDP*. In other words, maintain it indefinitely at its current level of 78 percent, or lower. In the end, any combination of measures that falls short of accomplishing this goal cannot be regarded as serious.

As a little algebra will show (see *Appendix*), whether the size of the public debt relative to GDP can be kept constant or not will depend on the following factors: (a) the existing debt-gdp ratio; (b) the growth rate of output; (c) the rate of inflation; (d) the rate of currency depreciation; (e) the government’s primary surplus or deficit, i.e., the excess of revenue over spending, excluding interest payments; (f) domestic and foreign interest rates; and (g) the extent to which the government assumes the debts of failing corporations or services contingent liabilities, i.e., the non-budget and off-book items discussed earlier.

It is intuitive that rapid economic growth should reduce the size of any level of debt in relation to GDP. Higher inflation likewise lowers the value of pre-existing obligations. On the other hand, higher domestic interest rates increase debt-servicing payments, and to the extent a portion of the debt is payable in foreign currency, higher foreign interest rates and currency depreciation would also enlarge the debt service requirements. Finally, of course, a larger primary surplus would reduce the debt-GDP ratio to the extent it allowed one not only to service the existing debt but also to pay it down.³

³ The exact relationship is $D(i - g) + A - S = 0$, where D is the existing debt, i is the average interest rate on the debt and is affected by domestic and foreign interest rates as well as currency

One may directly verify that the goal of stabilizing the government debt-GDP ratio *cannot be achieved without a radical change in observed trends*. Historically, real output growth has hovered at only 4.2 percent annually; inflation and depreciation are respectively 5 percent and 4 percent annually. The average interest rate is about 10.5 percent, while the servicing of off-budget items is currently three percent of GDP. This configuration can be sustained only if the government runs a primary surplus equal to 4.0 percent of GDP. In the current state of things, however, the actual primary surplus is only 0.6 percent of GDP, a level at which the debt would grow indefinitely.

In practice, of course, the debt *would* stop growing simply because it would become so large at a certain point that the government's creditors would refuse to lend any further – or the government itself may declare it is unable to service its debt – a default. Along the way they will have demanded increasingly higher interest rates, making it even harder to keep up payments.

This has already occurred in the case of the country's foreign borrowings, with successive credit downgrades raising the cost of borrowing. Hence, the country is already paying a high price for fiscal deficit deterioration. By reducing the risks of sovereign incapacity through credible deficit reduction, it is possible to reduce the high interest rate premium costs of financing debt. It further helps to alleviate pessimistic economic expectations arising from large fiscal deficits.

False hopes

Arriving at an adequate response to the deepening crisis must entail first presenting real alternatives to the public and to the political leadership. Conversely, it is important to dispose of schemes that tend merely to raise unrealistic hopes and distract from serious solutions. Below are discussed some apparently inspired but ultimately unworkable, inadequate, or even plainly disastrous ideas.

1. Why the country cannot “outgrow” the problem

One of the first ideas that must be disposed of is that the economy can somehow “grow” itself out of a crisis-trajectory while keeping inflation and currency depreciation at levels no worse than today's. The thread of plausibility on which this hangs is that – as a matter of simple arithmetic – higher economic growth of about 8 percent could make the existing size of debt more manageable in relation to GDP.

But this is no more than whistling in the dark. When has the economy ever demonstrated the ability to achieve, much less sustain, GDP growth of 7-8 percent annually? The answer, of course, is at no time in recent memory. Thus the idea merely begs the question. If the economy – under the same administration – was unable to grow at 8 percent when world oil prices and global interest rates were low and the country had better credit ratings, what is there to make us think it can do so in the future? It is sobering to note that the historical growth rate of the Philippine economy from the nineties to the present averages only slightly more than 4 percent even if only non-crisis years are included.

There is a finer point. Unless growth happened to be export-driven or accompanied by accelerating workers' remittances (both unlikely under present circumstances), higher growth would cause rising imports and wipe out the current-account surplus. This would knock out one of the economy's shaky props. For that would mean that, rather than inducing fellow-Filipinos to lend their dollars to the government, the government would

depreciation; g is the growth rate of nominal GDP and is equal to the rate of growth of real output plus inflation; A is the servicing of non-budgetary debt, while S is the primary surplus. All upper-case symbols are expressed as percentages of nominal GDP. Details are provided in the Appendix.

have to accept the drastically higher interest rates demanded by foreigners. Interest payments would be pushed up, and the country pushed closer to a debt crisis.

2. Why simple spending cuts will not work

Similar to the previous one is the floated idea that the government should simply “live within its means” by cutting down waste. Indeed a striking proposal has been made by some to limit the increase in the government budget to no more than 5 percent per annum in *absolute terms*. The apparent rationality of this proposal evaporates, however, once it realised that inflation alone hovers at 4-5 percent per annum, so that the proponents are really arguing that total government spending should be *frozen in real terms*. With population increasing annually at 2.3 percent, this is tantamount to a reduction of government spending in real terms per Filipino. To see the inadequacy of this proposal, it should be noted that the annual education budget has difficulty today even keeping up with new pupils. The education budget was only 2.4 percent of GDP in 2003 (Table 2), down from 2.9 percent in 2001; it has by and large risen by less than inflation, so that its real value has in fact fallen. Absent some drastic change, these trends are bound to continue. The programmed increase in the budget in 2004 is obviously less than the expected rate of inflation and certainly the rate of growth of output.

Table 2. Shrinking education budgets

	Education budget (in billions of pesos)	As a proportion of GDP (percent)	Growth of budget (percent)	CPI Inflation (percent)
2001	97.5	2.9	--	4.4
2002	104.1	2.6	6.7	6.1
2003	104.5	2.4	0.3	3.1
2004	107.5	2.3*	2.9	5.5*

Sources: NEDA, BSP, DBM; *authors' estimates

The fact is that many vital budget items such as education have *already* been *frozen* or are even *shrinking* in real terms. But simply because this has been done in the past does not mean it can – or should – continue. That budgets have been frozen is not a sign of strength – rather one of despair.

Let there be no mistake: there is every reason to look closely into the efficiency of public spending in order to eliminate waste and corruption. Raising the efficiency of government expenditure and investment implies that more results are achieved for the same amount of expenditure. But when the bulk of national-government spending is already pre-empted by debt service, the internal revenue allotment to local governments, salaries of teachers, police, and soldiers, not to mention maintenance and operations, it is difficult to find ways of reducing outlays that are sufficient to meet the demands of sustainable debt without provoking large dislocations and inviting social unrest.

3. Why reforming tax administration will not suffice

An attractive proposal is the often-repeated line that in fact “no new taxes are needed”; “all that is required is sound enforcement and tax administration”; “get rid of corruption, and you get rid of the deficit problem”. It is no surprise that this fallacy has spread and taken hold: it was the common theme propagated by both administration and opposition in the past electoral campaign, and both must now assume full responsibility for the deception they have foisted on the public.

The grain of truth in this suggestion is that – as already discussed – the efficiency of tax collection has indeed fallen off dramatically and is a major cause of the current budget deficits. It is also true that if the revenue effort were to be restored to 17-18 from the

current 12 percent, the current trajectory of moderate growth, inflation, and depreciation might stand a chance of being sustained. The crucial consideration, however, is first, whether the time exists for such reforms in administration to play out *before* the fiscal time bomb explodes. It has taken all of five-to-six years for the revenue effort to reach its present dire levels. Can it possibly recover in a shorter period? Most likely not.

Again there should be no mistake. There is every reason to support reforms in revenue administration, and indeed, many (including some of the undersigned) have proposed altogether scrapping the current BIR agency structure and replacing it with a performance-oriented agency such as the ill-fated IRMA. But even those who support this reform will admit that recovering the integrity of revenue administration is a project for the long-haul, and that indeed in the short run it may even lead to a drop in revenues as threatened incumbents and insiders attempt to hold the government revenues hostage.

Second, the limits of reforming tax-administration are in fact evident in the entirely modest nature of success even under the current BIR leadership, arguably already one of the most determined. After the administration's great hue and cry this last year over catching tax cheats and their abettors in the BIR and Customs, after the much-vaunted "lifestyle checks" and charges against bureaucrats, the tax effort in 2003 was in fact *no better than it was in 2002*. All that was achieved – and this was a success in itself – was to halt the slide in revenue effort.

These considerations suggest that the best intentions notwithstanding, reforms in revenue administration *cannot* do the entire job of staving off the crisis, nor indeed do it in time. Corruption in revenue administration was simply not solely responsible for the drop in revenues. As already pointed out, important taxes (on petroleum, tobacco, and alcoholic beverages) have simply not been adjusted for inflation; tax breaks have been generously expanded; special groups have been unduly favored; and changing economic patterns of production and consumption have meant that new sectors are under-assessed. These reasons make it evident that apart from pursuing reforms in tax administration, a substantial change in the tax structure, particularly a topping-up or updating of existing taxes, as well as new taxes must form necessary components of the fiscal-rescue.

There is truth to the idea that part of the difficulty in revenue collection is created by the complexity of the tax system. A simpler set of rules would make compliance more transparent and collection less prone to discretion and corruption. It is probably in this spirit that the idea of shifting the system over to a *gross income tax* (GIT) has been suggested. We think, however, that the promised simplification may fail to materialize, and that the proposed measure may in fact do more harm.

There are two possibilities: a gross income tax would either enforce a "one-size-fits-all" approach, or it could avoid this by tailoring tax formulas to suit different types of firms and activities. In the former case, a GIT system could positively hurt firms whose real conditions fail to conform to those assumed in the formula. Unlike typical manufacturing firms, for example, a good part of costs of consulting and other service-sector firms could consist of training and travel costs. But such firms would be unable to deduct these costs as "cost of goods sold", although these would be completely legitimate. Even firms that were starting up and promoting new products could find their marketing and advertising costs disallowed, putting them at a disadvantage against established competitors. Ultimately, one could not rule out the possibility that even firms that were actually losing money could end up paying taxes. In short, the measure would fail a test of equity by treating un-equals as if they were equal.

The proposed GIT could be designed to avoid the above difficulties. It could apply different procedures depending on the activity, e.g., use different tax schedules for manufacturing versus service firms, or use shifting definitions of what can and cannot be

classified as “cost of goods sold”, or “cost of sales”. But then this would defeat the rationale for the GIT, which is its supposed simplicity. Moreover this would leave ample room for evasion through profit-shifting on the part of firms with multiple activities, as well as provide opportunities for discretionary behavior and corruption on the part of tax collectors. In short, gross-income tax could be effective by being unfair; or it could be made fair but defeat its own purpose by being ineffective. No magic bullet here.

4. Monetizing the deficits – down a slippery slope

Should opposition to any significant tax measures prove intractable, few new revenue measures are likely to be passed. Similarly, political resistance may prevent power rates, light-rail fares, expressway tolls, and the entire slew of fees and charges from being raised. As a result, the servicing of non-budget and off-book debts may continue to be a heavy burden.

In such circumstances, a clever and sophisticated proposal may ultimately be floated for the government to stave off crisis – with the central bank’s cooperation – by simply *monetizing its deficits*. Essentially government could use high-powered money (effectively “printing” money) to pay its domestic debts as well as to buy the foreign exchange needed to service its foreign debts.

One obvious result of course would be depreciation, possibly at double-digit rates, with inflation also likely to kick in at double digits. Here again there is a grain of plausibility in the idea. Double-digit inflation and peso depreciation could make the debt somewhat more tractable, since it would amount to increasing the size of nominal GDP relative to the debt. The government basically gains to the extent that it pays off the maturing part of its old debt stock using pesos with lower purchasing power. Domestic interest rates would of course rise with inflation and depreciation, but the government would need to pay such higher rates only on its *new* borrowings, which are less than the stock of its old debt, so that it could still come out ahead.

What could prove wrong with such an approach? First, the relief it provides is obviously inherently limited, since any further new borrowing would carry higher interest rates. And though inflation would temporarily solve the problem of servicing domestic debt, it would actually make the servicing of foreign debt – which is about half the total – more difficult and costly. The peso amounts needed to service the entire stock of foreign debt would balloon owing to the large depreciation. The same would hold for non-budget liabilities, since a large part of that is also denominated in foreign currency.

Second, monetizing the deficit requires some form of capital controls. Only in this way would the government be able source its foreign-exchange needs; otherwise the mere threat of a large depreciation and run-away inflation would lead to a massive capital flight and a rapid loss of reserves. The Philippines, however, has historically been unable to implement such controls effectively – not even under the Marcos regime, so that the possibility of massive capital flight cannot be fully discounted.

The ultimate objection, however, must be that this partial solution to the government’s problems will have been obtained unjustly at the cost of a rapid loss in living standards and heightened uncertainty for large parts of the population. The true incidence of an “inflation tax” is inherently unpredictable. The better-off may be forced to accept a sharp cut in wealth to the extent that they hold government and other debt, whose interest payments are now worth less in real terms. But ordinary people are likely to feel the brunt of sharply higher prices. Inflationary expectations are likely to be fanned by price- and wage-increases, with any adjustments being unlikely to meet with anyone’s full satisfaction. The prospect of capital flight and a rapid loss in reserves is a real one. All in all the potential for significant social unrest cannot be ignored.

The Philippine economy has little to brag about in terms of performance. But the little it has achieved thus far has allowed it to attain a modicum of stability in most macroeconomic variables: restrained inflation at single digits, modest currency depreciation, low interest rates, and sustained if unspectacular, growth in real output. It is precisely these hard-won achievements, however, that an aggressive deficit-monetization would brush aside. Hence, even as the government may buy somewhat more time with such measures, the true question is whether they do not also undercut the basis for any long-run recovery.

A burden shared

The preceding section will have demonstrated one point: there is no simple, clever, or painless solution to the impending crisis; those who say otherwise are being either naïve or disingenuous, or both. But even as any adequate solution will demand sacrifice, our concern is that sacrifice should be fairly apportioned. People will demand, and government should aim for, a solution that is not only effective but also just.

Raising new taxes or just maintaining the real value of existing ones, increasing service-tariffs, or cost-cutting will always be contentious and are bound to meet resistance. If government is to foster solidarity and understanding for the national predicament, therefore, it must take special pains to render a candid accounting – not the least to some of its own leaders and representatives – of how the economy came to this impasse in the first place. More importantly, government must state what actions it intends to take to forestall a recurrence of these difficulties in the future.

The measures proposed by government must be seen to result from a judicious weighing of alternatives, a coherent program, and to have been guided by economic principles and a concern for equitable burden sharing. Confidence and credibility will hardly be served when government floats “trial balloons” on revenue and cost-cutting measures that appear arbitrary and offhand, only for these to be withdrawn subsequently.

Finally, fairness requires that if sacrifice is to be borne by the people, the government would do well to begin with and to demand more of itself. In this the acupuncturist’s maxim may serve as guide: “A thousand needles on oneself before even a single one on the patient.”

What follows is offered in the spirit of beginning a constructive public discussion of alternatives. We set down what we regard as both a workable and fair approach to resolving the government’s fiscal predicament (summarized in Table 3). No omniscience is claimed, and others are welcome to dispute the tenor and the numbers of these suggestions. Considering the nation’s predicament and the need for urgent action, however, it is but fair to ask of them one thing: do better.

Hence:

1. Limit the burden of servicing off-budget liabilities to 1.5 percent of GDP through price- and fee-adjustments, cost-cutting, and management pay-cuts in government corporations.

We have already argued that it is wrong to put the brunt of all the adjustment on the national budget. The debt has not been entirely caused by runaway budgets in the first place. A good part of it is debt taken over from government corporations, especially NPC. It stands to reason, then, that the burden imposed by those corporations must first be limited. Among others this implies that a ceiling must be set on the rate at which the national government assumes the debt of these corporations. The servicing of such assumed liabilities is currently equivalent to some 3 percent of GDP. In the next few years it would be reasonable to restrict this amount to no more than 1.5 percent of GDP. Doing this, however, means compelling these corporations to get back on sound financial footing. Among other things, serious and demonstrable efforts are required to cut out

waste, gain control over the generous pay, perks, and corruption among executives and the rank and file of such corporations. For the most part, however, the most effective immediate action will entail decisions to allow increases in the prices or fees for specific services (notably power), or a curtailment in their quantities, all of which are changes to be borne by clients or customers. Indeed the first order of business is for the administration to turn its back on the past practice of politicized price-setting. A big part of NPC losses, after all, was due to the capping of PPA charges to 40 centavos as a popular concession, even as the NPC continued to pay at least P1.20 to its IPP suppliers.

The closest attention should be devoted to the NPC, which is responsible for the biggest part of the consolidated public sector deficit and also accounts for a large part of the debt that is effectively absorbed by the national government. A crucial step in reducing the burden to taxpayers is the adjustment of power tariffs. (An increase of P1.50 per kilowatt-hour already represents a reduction of the burden equal to 1 percent of GDP.) Such a step is also indispensable in selling off the NPC's assets (now held by PSALM), which is a necessary condition for the success of the EPIRA. For even if the government should succeed in momentarily halting the rise in debt-service from government corporations, the problem of off-budget liabilities cannot be said to have been decisively solved until the privatization of NPC has been completed.

2. Raise the national government's primary surplus to control the size of the debt and to safeguard the basis for future growth.

The government needs to exert extraordinary efforts to sustain a *larger* primary surplus (that is, revenues less expenditures excluding debt service). If the aim is simply to put a stop to the growth of debt relative to GDP, then the primary surplus must rise to 2.5 percent of GDP, compared to the current 0.6 percent. This means raising additional revenues or cutting additional costs equivalent of about P81.7 billion annually.⁴ Such a target for debt-maintenance is compatible with maintaining the current moderate levels of output growth, inflation, depreciation, and interest rates.⁵ These figures of course presume that the burden of off-budget liabilities can be reduced in the manner already discussed.

Table 3. The current trajectory versus burden sharing

Scenario	Output growth %	Depreciation %	Inflation %	Off-budget*	Primary surplus*	Additional revenue requirements*	Comment
Current trajectory	4.2	4.0	5.0	3.0	0.6**		unsustainable; required primary surplus is 4%
Burden-sharing	4.2	4.0	5.0	1.5	2.5		required primary surplus for controlling debt
Target revenue be raised or costs to be cut						2.9	
Of which:						1.9	In addition to existing primary surplus of 0.6
For additional primary surplus							
For future growth						1.0+	for vital social spending and possible debt-reduction

* as % of GDP; **actual primary surplus

It cannot be the sole purpose of government, however, simply to survive its fiscal trials. If the basis for future growth is not to be compromised, then a policy of simple debt

⁴ One is required to raise an additional 1.9 percent of GDP (i.e., a target of 2.5 percent less the current 0.6 percent). Using nominal 2003 GDP of P4300 billion, 1.9 percent is P81.7 billion.

⁵ That is, real growth of 4.2 percent, inflation of 5 percent, depreciation of 4 percent, domestic and foreign interest rates of 11 percent and 6 percent, respectively. The resulting primary surplus may then be worked out using the steady-state formula in footnote 1.

maintenance cannot suffice, and the government must do more. A program that merely saved the government's fiscal hide and imposed sacrifices on its people, yet gave them nothing in return would be the height of state arrogance.

At the very least, therefore – in addition to the reforms required to prevent a crisis recurring in the future – provisions must be made for an expansion of essential budgets and possibly pay down debt in the future. Budgets devoted to physical infrastructure and to education need particularly to be increased in the face of a growing population and so as not to fall far behind in competitiveness. A prudent program would provide for an increase in the annual GDP share of these essential budget items, say by an additional 1 to 1.5 percentage points (about P43-64 billion).

If this is taken into account, government needs to raise additional revenues or cut costs by that amount. The new measures must therefore raise a total of 2.9 percent of GDP, of which 1.9 percent is to achieve the minimum primary surplus of 2.5 percent needed for debt maintenance and 1 percent is to augment budgets of vital infrastructure and education. If further amounts are raised this may be used to retire debt. Again this allows for a maintenance of at least current growth rates of output and avoiding any permanent rise in inflation, depreciation, and interest rates. In 2003 figures, this would be equivalent to raising additional revenues or cutting costs equal to a minimum of about P125 billion annually.⁶

3. Raise revenues by closing off tax-loopholes, updating existing taxes, passing new revenue measures, and reallocating spending.

It is not difficult to determine consistent, abstract orders of magnitude for macroeconomic variables that yield stability. The real challenge to the government, however, is to find measures that not merely attain macroeconomic targets, but more importantly also find a degree of social tolerance, though obviously not acceptance and support, among an already embattled and suspicious citizenry. Needless to say, it would be easier for the public to accept that painful measures are indeed necessary, if the government, its leaders, and the economic elite were first to put themselves in the line of fire.

Our own suggested criteria for evaluating proposed revenue- or cost-cutting measures are as follows: (a) implement the full intent of existing laws ahead of new taxes; (b) distribute the burden of cost-adjustment and spending cuts throughout government; (c) consider only new taxes based on strict economic justification and ease of collection, in that order.

On this basis, we endorse the measures contained in Table 4, each of which is discussed in succeeding paragraphs. Taken together, these measures, which either reduce costs or raise revenues, could conservatively help raise the primary surplus to the required 2.5 percent of GDP, in line with earlier macroeconomic discussions, and assuming the current surplus level of 0.6 percent of GDP is preserved, as well as sustain vital spending.

a. Indexing existing specific taxes on tobacco and alcohol products. The indexation of specific taxes on alcoholic beverages and tobacco (the so-called “sin products”) is a long-delayed measure that has been on the administration's agenda of priority legislation for at least the past two Congresses. This measure is not even a new tax at all, for it simply implements the intent of the comprehensive tax reform program (1997), which replaced the *ad valorem* taxes on these goods with specific excises, under the proviso that these specific peso amounts would be regularly updated. The failure to implement that proviso thus effectively means that the products in question – whose negative consumption

⁶ That is, $0.029 \times \text{P4300 billion} = \text{P124.7 billion}$.

externalities justify their being taxed extraordinarily in the first place – are currently *undertaxed* relative to the levels prevailing 1997.

Table 4. Possible immediate revenue- and cost-saving measures

Revenue measure	Additional take (bn pesos)	Contribution to revenue or cost-cutting (% of GDP)	Remarks
a. Indexation of specific taxes on tobacco and alcohol	14	0.33	a bill long pending in Congress
b. Closing off tax leaks plus additional BIR effort	12.4	0.3	half of the yield estimated by DOF (refer to Table 5)
c. P2-specific tax on petroleum	12	0.28	P2 per liter on approx. 6 mn liters (excluding fuel used for power)
d. Motor-vehicle fee increase and	2.0	0.05	a 50-percent fee increase (P1000 on ca. 2 million vehicles,
e. Eight-percent increase in excise on new vehicle registration	3.2	0.07	8 percent applied to ca. 80,000 new vehicles annually at average price of P500,000 per unit
f. Increase VAT rate from 10 to 12 percent and expand coverage	25	0.58	each percentage increase in VAT yields 0.3 percent of GDP
g. Reduce IRA to 30 percent	35.2	0.82	nominal amounts based on 2003 figures
h. Halve CDF allocations	10.7	0.25	P100 mn each from 24 Senators plus P35 mn each from 236 Representatives
i. other measures to be identified	10.3	0.24	
Subtotal (new measures)	124.8	2.90	
j.. Existing primary surplus	25.8	0.60	
Total Higher primary surplus plus new measures	150.6	3.50	
Memo:			
j. Servicing of off-budget items and assumed liabilities	65	1.50	assumed reduced from current level of 3 percent of GDP

*Reckoned on the basis of 2003 GDP of P4.3 trillion.

To prevent a similar erosion of these taxes occurring in the future, an important change in the law should allow for their automatic and periodic indexing. No special intervention by Congress should thenceforth be required, and the law should allow the indexing to be carried out following a formula and utilizing data collected purely administratively by, say, the National Statistics Office. This, it will be recalled, was the provision struck out of the original comprehensive tax reform package.

The passage or non-passage of this measure is the first signal of the government's (both the executive and the legislative) commitment to address the debt-and-deficit issue. Indeed it is fair to say that if this piece of legislation is not finally passed and signed *before the end of this year*, the entire government's credibility with respect to the entire fiscal- and debt-problem will have been irretrievably lost.

b. Plugging tax leaks. In the same spirit of taking the intent of existing laws seriously, no new legislation is needed – merely new procedures and approaches – to generate

significant revenues by a focusing on significant leakages in the implementation of certain provisions of the tax code. The Department of Finance and the National Tax Research Center in 2000 estimated that these measures could generate **almost P25 billion, or about six-tenths** of one percent of 2003 GDP.

A significant part of the problem appears to be identified with the reliance on self-declaration, particularly among banks (which are protected by the deposit-secrecy law) in the collection of the final tax on interest income on domestic deposits and the gross receipts tax. The simple application of taxes on fringe benefits and ceilings on deductions would be a fairer and more prudent way to deal with tax evasion among corporations than the proposed shift to a gross-income tax.

Table 5. Estimated yield from full implementation of existing tax laws

Type of tax/measure	Estimated yield (in P billions)	Remarks
Final tax withheld by banks on interest income	6.3	audit banks' self-declaration
Loans subject to gross-receipts tax	1.5	audit banks' self-declaration
Tax on FCDUs	1.5	audit banks' self-declaration
Tax on oil companies	1.1	audit volume of production
Collection of minimum corporate income tax	4.9	as provided by law
Tax on fringe benefits	1.3	as provided by law
Ceilings on deductions	3.7	0.59% on transport and travel; 0.41% on representation
Checking under-declaration of cigarette volumes	4.5	Use of fusion stamps or other measures
Total	24.8	approximately 0.6 percent of GDP

Source: DOF staff estimates 2001

The estimated revenues in Table 5, however, should be assessed in the light of the earlier cautious observation of how quickly administrative reforms on the revenue side can take hold. The very fact that many of these measures were not implemented in the past – notwithstanding that the law allows it – indicates they are unlikely to be realized overnight. Prudence suggests, therefore, that perhaps at most one-half of this potential yield (i.e., around **P12.4 billion**) can be counted on, and this is what is carried over into item b in Table 4. To the extent these measures in fact result in more revenue than assumed here, the proceeds may be used to augment spending on infrastructure or education.

c. Additional two-peso excise on petroleum. The tabled proposal on this matter should be supported. Though it may appear inopportune and unpopular at a moment when world petroleum prices are abnormally high, there can be little dispute that an increase in petroleum taxes is warranted at some future time for two reasons: (a) like those on “sin” products, the specific taxes on petroleum products have not been adjusted since 1997; and (b) these are justified as part of controlling environmental externalities caused by emissions from the use of fossil fuels. The additional excise would **not** be levied on fuel used for power generation (which is taken to be roughly one-fourth of petroleum consumption), yielding P12 billion assuming non-power generation-related petroleum consumption of 6 million liters annually. This excise should replace the yet-to-be-implemented executive order increasing tariffs on oil imports by 2 percent. While a step in the right direction, the tariff suffers from the fact that international commitments prevent significant tariff adjustments, a shortcoming not encountered when the tax is domestic.

d. Raising registration fees on motor vehicles. The reasoning behind increasing the registration fees, or the road users' tax, for motor vehicles partakes of the same argument as that of the petroleum tax; it is meant to further discourage an activity that is demonstrably unfriendly to the environment. An average increase of P1000 per vehicle is

proposed, although this can be differentiated into a fee structure that favors vehicles to be used for public transport and is higher for private vehicles. On the other hand, it is also proposed that some present costly impositions such as the universal drivers' drug tests should be replaced by random testing upon registration as part of the government's police functions.

e. Raise the minimum excise tax rate on new vehicles to 10 percent. At the moment, the minimum excise rate is 2 percent (for AUVs and others priced less than P600,000), while most sedans pay 2-10 percent. (More expensive models pay much as 24 percent.) There is no reason, however, why the rates may not be changed so that all motor vehicles (including AUVs) pay a minimum excise of 10 percent of their price, with most sedans then falling under a category paying 15 percent. We calculate this would amount to an increase of 8 percent in the average excise, yielding an additional P2.8 billion in revenue.

The present excise taxes based on value sought to improve upon a previous system that lost huge amounts of revenue by exempting certain categories of motor vehicles from taxes, based on physical characteristics (e.g., the perverse 10-seater rule) or some misguided industrial policy (AUVs and SUVs being exempt but not sedans). But while an improvement, even the current system is not based on truly sound economic principle. It only minimally raised the taxes on AUVs (from 0 to 2 percent), and lowered the applicable excise on sedans from a previous 15 percent to no more than 2-10 percent. It was willing to tax large-displacement luxury vehicles in the past as high as 50-100 percent, but now sets the average excise tax rate on even the most expensive vehicles at around 24 percent (e.g., the highest-end BMW, Benz, or Jaguar).

Not only does the current system give away potential revenue, it fails on efficiency, time-consistency, and equity. By effectively *lowering* taxes on private motor vehicles, the government encourages what is inherently an environment-damaging and congestion-causing activity. Second, government contradicted itself: it was willing to tax cars at 15 percent in the past but is inexplicably unwilling to do so now. (A more likely answer though is a desire to protect the industry owing to lobbying.) Finally, of course, it has been the better-off and the comfortable in society who have primarily benefited from these lower taxes. But considering how a great number of affluent people, particularly the self-employed, can cleverly avail themselves of deductions and leeway to avoid paying income taxes, an excise on a consumption good like motor vehicles may be one of the few indirect taxes that also happen to be progressive.

f. A two-percentage point increase in the VAT. A simple strengthening of the VAT system, through an expansion of its coverage and a slight increase in its rate (by two percentage points) is superior to other revenue-raising proposals that have recently been made. Relative to these other proposals, the superiority of the VAT is twofold: it is uniform and transparent in application – which reduces discretion and the scope for corruption; and it is neutral in its incidence – which minimizes the inevitable economic distortion caused by any tax.

By contrast, the proposal to abolish VAT and replace it with a general sales tax (GST) could cause serious economic distortions and inequities. Unlike a VAT, which in principle is imposed only once across all transactions, a general sales tax could be compounded or “cascade” (i.e., the tax would be imposed on a tax) if for some reason it became applied to producers as well. In principle a GST would be least distortive if it applied only to sales to final customers. Given the heterogeneous nature of production and distribution in Philippine economy, however, it is quite difficult to distinguish what is and is not a final sale, and what is and is not destined for consumption. A simple example is the countless *sari-sari* owners who purchase their supplies from grocery stores. If *sari-sari* sales are then also assessed for the GST, their customers, who tend to come from the poor, would be hit at least twice, since the grocery prices already incorporated the GST. On the other hand, a large company could avoid the GST by buying wholesale then distribute these

with professional services; here the law would have to distinguish between services performed for final consumers and those performed for firms (e.g., a contract plumber must distinguish when he works for a house and for a factory). If on the other hand the proposed law were to make allowances for all these special cases and plug all loopholes, the only argument for it – its simplicity and ease of administration – would be lost. Again, no magic bullet here.

Other proposals are inferior for similar reasons. In the case of the “tax on text”, and the “franchise tax on telecoms”, no compelling economic reason exists why these activities should be singled out for special taxation. No serious argument has been put up that these are anywhere like “sin products” or carbon emissions in being public “bads”. The only motivation for special tax treatment appears to be simply that some industries are doing well. (But guess what capitalism is all about and what corporate income taxes are for.)

As an aside, many of these objections are not new and were already appreciated years ago, when the country decided to shift to VAT from a myriad of product- and sector-specific taxes that prevailed in the past. It is somewhat unsettling (unflattering to the government’s institutional memories or its capacity to learn) when the bureaucracy regurgitates proposals that it itself already rejected in the past. The credibility of a reform agenda can only suffer when it entertains proposals that appear unfounded on sound economic principle and that appear to be uninformed or even capricious.

g. Reduction of IRA releases to 30 from 40 percent. Between 2000 and 2003, the amounts allotted to local governments averaged around 21 percent of national government spending. Allotting only 30 percent of tax collections rather than the usual 40 would allow the national government to retain some P43 billion (or more than 5 percent of total spending based on the 2003 budget), **or P35.2 billion for 2004.**

This measure is not being proposed lightly, considering the disruption it could cause some local governments. On the other hand, it is necessary under the principle of a shared burden. If infrastructure, education, and other nationally provided services have had to endure cutbacks in the past, and if senators and representatives are to be asked to halve their discretionary funds (see next proposal), then the IRA cannot remain a sacred cow and avoid that fate as well.

This measure is meant to accomplish several objectives. First, it restores meaningful control of the budget to the national government, allowing the government as a whole to rededicate significant amounts to infrastructure and reducing that portion of the budget allocated according to the “divide-by-*N*” rule. All this is based on an assessment – controversial among some – that (a) local governments have thus far generally shown little inclination to devote the funds they receive to real market-enhancing infrastructure, and (b) barring a few exceptions, they have had little incentive to raise additional revenues, instead increasing their reliance on the IRA transfer. This measure by contrast gives local governments a long-overdue incentive to raise their own in local real estate and other taxes and fees.

Putting this measure into effect is more straightforward than some might think. Following required consultations with members of both houses and the leagues of local officials, the President is empowered under the local government code to declare the existence of an “unmanageable public-sector deficit” and subsequently withhold the release of part of the IRA of the LGUs. This measure is necessarily time-bound (three

⁷ In this way the firm avoids social security contributions, their managers and workers avoid both income taxes and the GST.

years) and can be implemented only as long as such conditions exist. It is strongly suggested that this be done simultaneously with the implementation of the following measure.

h. Reducing the CDF allocations of legislators by half. In the same spirit of burden-sharing it is indispensable for Congress to make a significant sacrifice towards containing the deficit. There can be no more credible and comprehensible form for this than for senators and representatives to give up half of their discretionary funds (“pork barrel”) and allow these to be retained or realigned to meet the objective of raising a higher primary surplus and preserving vital spending. Even greater government credibility would be fostered if the remainder were also disbursed only for designated purposes, preferably for certain types of infrastructure.

The importance of a concerted implementation of such a package cannot be over-emphasized. Trust would vanish if it was perceived that that the government itself was not willing to undertake any sacrifices; solidarity would be undermined if only one sector of industry, or section of the population was made to bear the brunt of adjustments. This is why there is a need for a balanced, even-handed, and well-considered program, and why inchoate and arbitrary proposals are harmful.

i. Other measures to be identified. This list is not exhaustive, and there is obviously further room for creative suggestions from other sectors. A distinct possibility we might mention is that the demonstration of commitment to a reform package such as this may make it possible to obtain more substantial overseas development assistance (ODA) in the form of program loans. Owing to fiscal problems, we are currently unable to fully utilize ODA loans for lack of the required counterpart funds for project loans. This has resulted in borrowing at expensive market rates to pay maturing ODA loans without getting sufficient cash from new loans. New loans would reverse the current negative resource transfers with official lenders.

Facing up and phasing in

Timing these measures presents a distinct challenge to economic statesmanship on all sides. Two factors must be considered: *first*, the pace of the measures must demonstrate sufficient credibility and resolve before both foreign and domestic creditors to forestall any further slide in credit ratings or increase in interest rates. Indeed, to the extent the first few measures succeed, the country could reap an early bonus in the form of lower interest rates being demanded by its creditors. A *second* concern, on the other hand, is calibrating the phase-in of the measures in order to maintain macroeconomic stability and not to interrupt growth. Implemented in a haphazard and uncoordinated manner, the spate of tax increases and new measures could provoke an economic downturn.

To cut through uncertainty and effect a turnaround in the investment climate, the government must show decisive action early on. Specifically the following measures need to be accomplished *immediately*: (a) passage through Congress of the law adjusting the excise on alcohol and tobacco products; (b) immediate action within the executive to plug various tax leaks; (c) the President’s declaration of an “unsustainable public deficit” and, immediately following this, (d) the withholding of part of the IRA and the CDF.

Toward the end of this year, Congress needs to clear the legislation raising the VAT rate and removing exemptions. The amendment to the law on the Road Users’ Tax raising vehicle registration fees should also be passed, with the proper distinction made between public and private vehicles. Simultaneously, mandatory drugs tests for drivers should be abolished, to be replaced henceforth with random testing. To moderate their impact, however, both the amended and increased VAT and the vehicle-registration fee increase can be made to take effect only in 2005.

Legislation on the additional excise on petroleum may be enacted in early 2005 at the latest, at which time the two-percent tariff oil imports should also be withdrawn. Implementation of the two-peso hike in petroleum taxes, however, may be held off until later in the year, as soon as world oil prices have peaked. It should be emphasized that in general taxes approved need not take effect immediately. The country has gained good and valuable experiences in enacting taxes that are phased in gradually (the road users' tax is one example).

The last milestone in the short run is the completion of the sale of NPC's generation and transmission assets. By mid-2005 the executive branch should have begun the sale, with privatization being hopefully completed by late 2005 or early 2006. An improved investment climate brought on by the taming of the deficit in mid-2005 is an important element for an auspicious and advantageous sale of NPC; conversely, the NPC sale represents the definitive solution to the single biggest source of debt-surprises for the government.

Securing the medium- and long-term

If undertaken with resolve, demonstrable solidarity between both the political leadership, and a modicum of understanding from the public, the effects of these measures should result in a palpable easing of the crisis atmosphere and a gradual return of investor-confidence by late next year. It would be wrong, however, for political leaders to let their guard down. Still other measures are needed, however, to sustain the direction of a reform momentum until the end of this administration's watch and into the long term.

Averting the oncoming crisis would be a shallow victory indeed if another crisis were to rear its head after only a few years. If indeed all that was desired was to avert one crisis, it might arguably be better to undergo it, since that will at least have purged the system and possibly changed attitudes and behavior.

Hence the long term *must* be secured, and this will require permanent institutional changes, of which the following, we think, are indispensable:

1. One of these would certainly include the administration's own proposal to *downsize the bureaucracy*. The best time for such a measure, however, is not immediately but only when revenue measures are in place and the deficit has been stabilized. Current proposals moreover could do with some fine-tuning. In particular, the administration should take care not to "incentivize" a universally available retirement plan for government personnel. This could lead to several problems, including unforeseen personnel shortages in key agencies; "adverse selection" as the most qualified and mobile (e.g., nurses, doctors, and teachers) opt to retire while the deadwood remain; and an unexpected bulge in the deficit as people avail of the "silver parachutes". It would be more prudent instead to determine after some study exactly in which agencies and functions personnel can be spared and where they will continue to be essential. Early retirement should be offered as an option only in the former and not the latter case. If not enough people take the voluntary retirement option, then attrition and retooling should be focused on those same agencies where redundancy is greatest.

Under this rubric also falls the reform of the country's revenue agencies, although this is a venture fraught with its own idiosyncrasies. A method of simple attrition would obviously fail in this case, since the results of piecemeal reform and recruitment would be devoured by the predominant culture, power relations, and work ethic in such agencies. Instead wholesale replacement is called for. As a perceptive public economist once observed in this connection, "You can't move into a new airport gradually." For the same reason, we believe permanently reforming the revenue agencies must mean investing in entirely new organizations that can take the place of the current ones, as suggested in the original bill creating IRMA.

The urgent measures discussed previously imply an immediate improvement in tax effort of some 1.5 percent of GDP in the next two years, raising tax effort to around 14 percent from the current 12.5. Beyond this, more decisive improvements can be attained only by a reform and professionalization of the revenue agencies. This should allow the country over the next four (4) years to regain the peak tax effort of 16 percent of GDP attained in the past and hopefully to surpass this in the period beyond.

2. *Privatization, the next wave.* Still as part of a drive to raise revenue, the government should order a second wave of privatization involving the sale of all government holdings in the quasi-private corporate sector where there is no self-evident role for government. The presence of national-government appointees to the boards of various corporations has habitually distorted business and regulatory decisions and become a magnet for patronage. Complete privatization is long overdue for example with respect to national-government holdings in commercial banks (e.g., UCPB, DBP, and minority shares in PNB). Similarly without rationale is government involvement in inherently private-sector activities including manufacturing, real estate development, or media and entertainment. Examples are the government's shares in San Miguel Corporation, its ownership of National Steel, PNOC and its subsidiaries. Where "public television" involves three stations that broadcast basketball games, canned shows, and ads for scar removers and breast creams, the time for privatization has evidently arrived once more. Proceeds from privatization are potentially large, although they are non-recurring. In this regard, it is important for government to hold the line on reversing hard-won reforms of the past.

3. Another healthy long-term measure, though with no short-term kick, is the *rationalization and reduction of tax incentives*. These pertaining to various exemptions and privileges given to firms in sectors designated by the investment priorities plan, to exporters, and those available from various export-processing and "special economic zones" (which can include even some buildings in Makati). Estimates of the annual revenues foregone from this source reach almost P175 billion. Such magnitudes cannot be easily "recovered", however (for otherwise they would have been more than enough to cover the required increase in the primary surplus). The amounts foregone refer to incentives already given away to firms who qualified for these in the past. Hence, these cannot be simply and suddenly "withdrawn" – i.e., without risking a further relegation of the country to an investment pariah – even if the rules were changed overnight. A reform of the rules would take effect only prospectively by cutting off such incentives to future investors (of which there are few at the moment). For this reason we have not included it as a significant revenue source in the short run. Nonetheless, closing off this leakage in the revenue system is an effort worth pursuing, with the harvest that will come surely but later.

4. The medium term also demands changes in the way government deals with and utilizes government corporations. Once the immediate crisis is past, all branches of government must renounce the *politicization of prices and of the regulatory system*. A significant part of the deficit-and-debt problem has stemmed from recent or past government intervention in the rate-setting process, mainly in response to popular pressure (e.g., power rates, light-rail transit fares, highway tolls). If the experience is not to be repeated, government must establish credible regulatory bodies by appointing competent and independent regulators. Courts, on the other hand, should enhance the regulatory environment by refraining from overruling competent regulatory authorities.

5. *Spending efficiency and the tax revolt.* The other part of low revenues is a tacit but undeniable tax revolt by citizens appalled that taxes are used to support feckless, unresponsive government. To be sure, a good part of tax evasion, particularly among the wealthy and well-connected, is simple larceny that its perpetrators – frequently abetted by their political protectors – would commit under *any* government. But modern government – in principle anyway – is based on a contract, in which people agree to be taxed in exchange for protection, justice, infrastructure and services provided by the

state. Beyond simple poor enforcement, another reason for low tax collection is the assessment of ordinary people that they are simply not getting their money's worth in terms of public services.⁸ Hence the increasingly pervasive view that, in the face of the systematic rape of the treasury, evading taxes may represent a more welfare-enhancing allocation of resources. Rather than see corrupt officials waste or steal their hard-earned pesos, more and more people think it justified to waste or steal these themselves. Such a view, while individually rational, is of course unsustainable, since it flies from the fact that the people and the economy today require *more*, not less, social services and physical infrastructure.

What the tax revolt does underscore, however, is the need to refocus spending priorities to make them more rational, responsive, and untainted by corruption. Only in this way will future tax compliance be encouraged. The perverse regime under which expenditures shrink to chase dwindling revenues has institutionalized irrationality and dearth of imagination in the nation's spending priorities.

Whether the public accepts new tax measures proposed here is conditioned on their view of the quality of past spending. Unfortunately good examples are few and far between, while bad ones abound, from the feckless use of congressional pork barrel (which is why credibility demands its reduction) to the administration's use of the "road users' tax" – originally meant for civil works road maintenance – as a form of emergency employment through beautification. In the future, more instances of such clever breaches of public trust can only further fuel cynicism and weaken the credibility of the fiscal reform agenda.

6. Rationalizing national-local government fiscal relations. The condition of an "unmanageable public-sector deficit" will no longer exist once other revenue measures are in place and the reform of the revenue agencies begin to pay off in terms of increased tax efforts. This period of adjustment should last no more than three years. Beyond that period, withholding part of the IRA can no longer be justified, and revenue-sharing will have to revert to the old 40 percent of revenues.

Even before that period is reached, however, government may wish to reconsider the manner in which fiscal spending and taxing responsibilities have been divided between local and national government. Congress may wish to revise the amount and the manner in which the IRA is disbursed in order to encourage more local government effort in terms of both the responsibility for spending and raising local revenues. Part of the IRA may then be released conditional on the quality of spending or as matching grants to supplement new local revenues. A system may also be drawn up to permanently integrate the use of part of the congressional pork barrel funds into national or local priorities.

A question of leadership

From experience, political leadership in this country has only ever acted decisively when a crisis was already staring it full in the face – a skill somewhat akin to deactivating a bomb by diving on it. Thus, the economy failed to avoid the 1980s foreign debt crisis, the 1990s energy crisis, and the 1997 Asian crisis, although it can be argued that in all these cases there was ample warning of impending trouble.

If – a big small word – the Philippines does manage to avoid an economic collapse in the next two years, it will have been a first. For this to happen, however, will require unprecedented cooperation and open-mindedness among the country's political elite as well as a great deal of forbearance and capacity for sacrifice among the people. All this

⁸ As a useful counterexample one observes the high compliance with real-estate taxes among citizens in well-run localities like Marikina, notwithstanding the frequently higher tax rates prevailing.

seems a tall order, considering the divisiveness of the recent elections, the individual ambition and quite understandable need-to-shine on the part of the typical politician, and the distrust and grinding poverty already prevailing among the people.

In such circumstances, staving off a crisis becomes a classic “free-rider” problem: no one wants to be the bearer of bad news or the first to volunteer to sacrifice – the hope, of course, is that *someone else will at sometime*. In the meantime, one can bask in one’s fifteen seconds of fame by asserting that, of course, nothing is wrong and that, of course, easy, painless solutions are in sight. This is all too familiar as the “who-will-bell-the-cat?” syndrome. As in all free-rider situations, the danger is, of course, that ultimately nothing gets done, as all efforts become dissipated in finger-pointing and arguing over who should go first.

Precisely to minimize the free-rider problem, we have sought to show that only a package of measures assigning a fair burden to all stands a fair chance of success. Halving the CDF is small relative to the required revenue and cost-cutting effort. But if legislators refuse to sacrifice, local governments could argue similarly; the same goes for the public vis-à-vis their political leaders, or the legislature or judiciary relative to the President. Hence Congress, the President, local governments, business, professionals, and people at large, all effectively possess some veto power over the outcome, since by refusing to cooperate, they could scuttle the package.

All that remains now is the test to determine whether the nation’s institutions and the quality of its leadership will suffice to save its people from an impending ordeal that has been largely predicted and is perhaps entirely unnecessary. ■

Appendix

It is possible to express the relationship between the stock of debt and annual deficits in the following manner:

$$D(i - g) + A = S \quad (1)$$

where D is the current level of debt as a proportion of GDP, i and g are the nominal interest rate and the growth rate of nominal output, respectively, S is the primary surplus, and A is the level of off-budget deficits, such as those run by government corporations. If condition (1) is fulfilled, the debt should stop rising as a proportion of GDP.

This left-hand side of this equation represents the debt service, measured as a percentage of GDP, and the rate at which the national government takes over the debt of government corporations. This left-hand side must be matched by the primary surplus.

The average interest rate can be decomposed into a domestic and a foreign interest component. If α is the proportion of debt denominated in domestic currency and $(1 - \alpha)$ the foreign-currency portion, then the interest rate i is equal to:

$$\begin{aligned} i &= \alpha \underline{i}_D + (1 - \alpha)(\underline{i}_F + e) \\ &= \alpha \underline{i}_D + (1 - \alpha)\underline{i}_F + (1 - \alpha)e \end{aligned} \quad (2)$$

The interest on the foreign-currency denominated debt in peso terms depends on both the foreign interest rate plus the depreciation of the peso.

Finally, nominal GDP growth g in (1) is:

$$g = r + \pi \quad (3)$$

where r is real output growth and π is inflation. As an empirical observation, the rate of inflation is one percent higher than the rate of depreciation, which is a modified purchasing-power relationship:

$$\pi = e + 1.$$

Plugging in historical values into (2), $\alpha = 0.5$, $\underline{i}_D = 11$, and $\underline{i}_F = 6$, and $e = 4$.

$$\begin{aligned} i &= 0.5(11) + 0.5(6) + 0.5e \\ &= 8.5 + 0.5e = 8.5 + 0.5(4) = 10.5 \end{aligned} \quad (2')$$

On the other hand, again plugging in observed values of $r = 4.2$ and $\pi = 5$ into (3) gives:

$$\begin{aligned} g &= 4.2 + (e + 1) = 5.2 + e \\ &= 5.2 + 4 = 9.2 \end{aligned} \quad (3')$$

If we consider the current situation where the proportion of debt to GDP is $D = 0.78$ and $A = 0.03$, we can rewrite (1) as:

$$\begin{aligned} 0.78(10.5 - 9.2)/100 &= S - 0.03 & (4) \\ 0.78(10.5 - 9.2)/100 + 0.03 &= S \\ 0.78(1.3)/100 + 0.03 &= S \\ 0.0104 + 0.03 &= S \approx 4.0\% \text{ of GDP} \end{aligned}$$

This says the required surplus to freeze the existing debt-GDP ratio is 4 percent of GDP. On the other hand, if we reduce A to 1.5 percent but retain growth at 4.2, inflation at 5, and depreciation at 4.

$$S = 0.78(i - g) + 1.5 = 1.014 + 1.5 = 2.514$$

Allowing for a one-percentage point increase in education and infrastructure budgets adds a full percentage point to the required surplus, so that S is approximately 3.5, as stated in the text.