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

Executive Summary**

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.

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. 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.

Debts and deficits – the stylized facts

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. Both are on the uptrend.

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.

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. 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.

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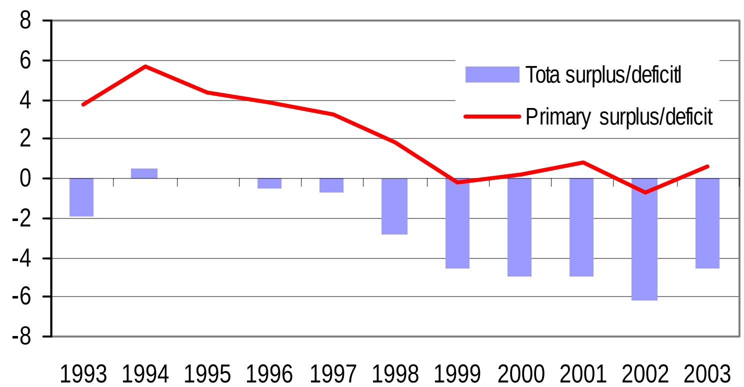
Table 1. Accounting for the increase in debt 1997-2003

	Amount billion pesos	Percent distribution
Increase in the national government debt	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

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. This assertion is evident if one views the trends in the primary surplus, that is, revenues less expenditures excluding debt service (see chart below). 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. Thus, it is evident that the current trajectory is unsustainable. Unlike 1983-1984, however, this time the problems were largely of the government's own doing.

Primary and total surpluses and deficits



It is indisputable however that this deterioration was *not* due to any sudden spike in budgetary spending. 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. Bureaucratic corruption and tax evasion could not have been the sole or major culprit in the declining revenue effort.

Hence, the problem of the ballooning government debt cannot 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.

Experience has shown that the national government will frequently step in to assume the debts of 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. Most of these are classified as "non-budgetary accounts" (See Table 1).

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. 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 figure[1] 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 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.

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 merely raises false hopes and cannot be regarded as serious.

A burden shared

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.

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[1] Reported as of February this year.

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 2). 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.

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 which is currently equivalent to some 3 percent of GDP. Doing this means compelling these corporations to get back on sound financial footing. 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). Indeed the first order of business is for the administration to turn its back on the past practice of politicized price-setting.

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. 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.[2]

Table 2. 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: For additional primary surplus						*1.9*	In addition to existing primary surplus of 0.6
For future growth						*1.0+*	for vital social spending and possible debt-reduction

* as % of GDP; **actual primary surplus

In addition to the reforms required to prevent a crisis from recurring in the future, provisions must be made for an expansion of essential budgets, such as those for physical infrastructure and education, and possibly pay down debt in the future. 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 additional revenue raising or cost cutting measures. 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

[2] 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.

further amounts are raised this may be used to retire debt. 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.[3]

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

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.

Table 3. 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	0.29	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.

[3] That is, $0.029 \times$ P4300 billion = P124.7 billion.

On this basis, we endorse the measures contained in Table 3. 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.

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. 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 on 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. Averting the oncoming crisis would be a shallow victory, however, if another crisis were to rear its head after only a few years. Hence the long term *must* be secured, and this will require permanent institutional changes, of which the following, we think, are indispensable:

1. *Downsizing the bureaucracy*. Determine after some study exactly in which agencies and functions personnel can be spared and where they will continue to be essential. Under this rubric also falls the reform of the country's revenue agencies, which, we believe, calls for investing in entirely new organizations that can take the place of the current ones, as suggested in the original bill creating IRMA.

2. *Privatization, the next wave.* Still, as part of a drive to raise revenue (albeit a non-recurring source), 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.

3. *Rationalization and reduction of tax incentives*. While this measure is not expected to be a significant revenue source in the short run – a reform of the rules would take effect only prospectively by cutting off tax incentives to future investors – closing off this leakage in the revenue system is an effort worth pursuing.

4. *Depoliticization of price-setting and regulation.* 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.* 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.[4] 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. 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.

6. *Rationalizing national-local government fiscal relations*. Once other revenue measures are in place and the reform of the revenue agencies begin to pay off in terms of increased tax efforts, withholding part of the IRA can no longer be justified, and revenue-sharing will have

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[4] 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.

to revert to the old 40 percent of revenues. This period of adjustment should last no more than three years.

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

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.

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*. 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.

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.