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FINANCING THE PUBLIC SECTOR IN THE PHILIPPINES IN THE 1970'S

By

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Financing the Public Sector in the Philippines in the 1970's

Introduction

Any attempt to look ahead into the prospects and problems of the Philippine Economy in the next decade with regard to financing the public sector must take the following, among others, into consideration:

- (1) the existing plans of the Government both national and local and discernible trends thereof,
- (2) the existing tax structure and the expected trend of modifications thereof,
- (3) the present stage of development of the economy, and
- (4) the prevailing ideological attitudes such as, for instance, the vehemence of economic nationalism.

Each of these factors will be discussed at some length below but before we do so it would be helpful to review the patterns of public expenditure and revenue in the last two decades in order to place the decade of the '70's in proper perspective.

Patterns of Public Expenditure

Briefly, the growth of Philippine Public expenditure may be described thus: From a level of more than ₱ 700M in 1951, expenditure from all funds combined rose to more than ₱ 1,400M in FY 1960 or double its amount in just a decade. From FY 1961 to FY 1969, it doubled again

needed infrastructure projects and social development projects which have been generally accepted as preconditions to continued economic development.

It is reasonable, therefore, to assume that the clamor for rapid economic development will continue in the 1970's, not only because many of our leaders say so, but also because most of our people want to accelerate economic growth as a facilitating condition to the achievement of other social objectives such as higher living standards for everybody and the redistribution of income and wealth to reduce apparent inequalities in the long run, inequalities which have been identified by many as a source of social unrest. This point was raised in several lectures of this series. You may recall the eloquent plea of Mr. Manuel Arejola who was a discussant of Father Carroll's paper "Source of Social Unrest". Likewise, you may recall the warnings of Father de la Costa who identified the wide disparity in income and wealth between the masses of people and the few wealthy families as a social problem which has to be faced in the 1970's.

Dr. Sicat made the point that redistribution can wait as long as the economy is forging ahead fast enough, alluding to the hopefully short-run phenomenon observed during the process of growth when the disparity tends

Financing of the Public Sector in the 1970's

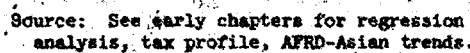
Therefore, taking the two general categories of fiscal operations together, it seems that there is a tendency for public expenditure to rise much faster than public revenue, especially up until 1968.

You may recall that since 1959 to 1968 there were no significant tax measures increasing tax revenue, only a series of measures granting tax privileges in one form or another which, in effect, eroded the tax base, for instance, the Basic Industries, the NACIDA law, Shipping Industry Subsidy, Gold Industry Subsidy, to mention just a few. And before the decade of the '60's there was the "New and Necessary Industries Act" which exempted so called "new and necessary" industries from virtually all taxes. It was only in 1968 that the trend of eroding the already narrow tax base, which in general prevailed in the last two decades, was finally reversed.

In spite of the tax modifications in 1968 and the Omnibus Tax Law of 1969, one of the persistent problems that the Philippine economy will face in the 1970's is the financing of its public sector. To a larger extent, the attainment of many of our social objectives will depend upon our resolve to face up to this problem.

Given the avowed desire of the Filipino people for accelerated

An Ideal Type: Tax Structure Change During Development



...to hope, however, that the
...with the problem of
...I think that the
...of the E-R gap will enable us to judge Philip-
...performance in recent decades a little less harshly, knowing that
there are structural changes going on in the process of economic development
which lead to the emergence of this gap.

For one thing, the percentage of government expenditure to in-
come as measured in the vertical axis tends to rise quite rapidly when a "tra-
ditional society" tries to break away from the old, which rise in percentage
from slightly above 5% will continue to as much as 25% to 30% of income
as a society approaches "modernity". Moreover, the structural changes
inherent in a growing economy cause the tax structure to change also. For
instance, so-called traditional direct taxes, such as land taxes and poll taxes
will decline as a ratio, while so-called modern direct taxes (net income
taxes on individual and business) will increase from virtually nothing to a po-
sition of predominance as a society approaches modernity. The so-called
internal indirect taxes, such as sales and specific taxes, will rise from a
low share rather smoothly upward as the economy becomes more monetized.
So-called taxes on foreign trade - i.e., only import duties in the Philippines,

since we do not impose export taxes, will rise at first and then tend to diminish as a proportion of income after the breakaway stage. Special arrangements with the United States which was our principal trading partner, as in the Bell Trade Act and then the Laurel Langley Agreement, tended to postpone the utilization of this type of tax to a much later date in our economic development; that is why the Philippines may still be experiencing a rise in the proportion of taxes on foreign trade for some years to come, especially if taxes on selected exports can be imposed. But there is little doubt that this type of tax will tend to decline in importance as the economy progresses towards modernity. There are economic as well as social reasons for not relying too much on import duties.

The above changes of the tax structure over development time have to be considered in tax reform planning in the Philippines, but more of this will be said later.

Economic Nationalism

Economic nationalism, defined as a system of national economic policies which recognize the nation state as the relevant social unit organized to pursue national interest /as identified through the political process/ is on

the upsurge in many countries in Southeast Asia². This concept of economic nationalism helps in explaining many of the economic policies which have developed in the Philippines since the grant of independence in 1946. Many of these policies would not make much sense without the concept of economic nationalism as a rationale. For instance, the policies during the period of import controls may be viewed as an attempt to wrest greater control and regulation over trade relationship with the rest of the world by establishing import substituting industries in the domestic economy. Several laws which require a larger share of nationals in the ownership, management, and control over productive assets in the Philippines are manifestations of the same economic nationalism. More recently, legislation to increase the share of Filipinos in the prestigious functions and materially rewarding jobs is another manifestation unless, of course, there are obvious non-nepotistic, monopolistic and other discriminatory practices. On strictly economic grounds, these policies seldom makes sense.

Another basic element of economic nationalism today is the

²See Frank H. Golay et al, Economic Nationalism in Southeast Asian countries, (Ithaca, New York, Cambridge University Press, 1969.)

extension of regulation and control to internal economic processes in order to mobilize resources for economic development³. [It is this element of economic nationalism which practically insures the increase of the share of the public sectors in the '70's and as a concomitant development magnifies the problem of financing the public sector without too much inflationary pressure on prices.]

Some observers would attribute the current increases in prices to the relatively greater amount of public expenditures in recent months, especially prior to November. Others would take these increase in prices as indicating the low-ceiling for deficit financed public spending (usually financed through borrowings from the Central Bank or other financial institution here and abroad). This apparent low-ceiling for deficit financed government spending should inhibit the Government from utilizing this avenue of financing the public sector, especially if the resources to be diverted for government's use can be locally procured⁴.

³Ibid

⁴If the problem were merely that of finance, the government could very well print the money but the real economic problem is the diversion of domestic resources which have alternative uses so taxes have to be imposed to reduce effective demand of the private sector at the same time that effective demand is increased through government expenditure from tax funds.

This link between the increase of the size of the government sector and economic nationalism is not readily apparent, so much so that many economic nationalists find themselves in the ambivalent position of sometimes advocating the extension of government regulation and control over natural resources to favor nationals at the same time, fighting off the government on alleged encroachments on their private preserves. Many of them would favor relatively ambitious infrastructure programs to be undertaken by the government, but at the same time many of them would be against increased taxation that would provide the resources and the wherewithal to implement such a program.

At this juncture, it would be useful to point out the difficult situation, which is practically a dilemma, in which the government usually finds itself. [On the one hand, it is expected to provide the infrastructure facilities on which economic development can be based; on the other, it is inhibited by other constraints.] It can not readily divert the resources from the domestic economy because of strong resistance to additional taxation from the masses of the people as well as from some of their leaders. In a democratic society which favors free enterprise, the problem is considerably aggravated because there is an ideological bias against state enterprise, and even incremental change in the size of the public sector may be

labeled as "creeping socialism". Moreover, any tax measure under our political system must emanate from the halls of parliament, and approved by the duly elected representatives of the people. But often times, many of these elected representatives themselves also represent vested interests, social classes, and on the whole, the political, social and economic elite which would be the first target of any increase in taxation or social reform. It would be the height of altruism for many of them not to resist, no matter how subtly, or unconsciously even, any attempt to increase the tax liability of the members of their own group.

It is only through a strong political leadership of the presidency → U.S. Mar. L. that such tax or social reform measures can be passed over and above the understandable resistance of legislative members who will surely be adversely affected by these measures.

Redistribution Is Important Too!

It is the thesis of this paper that taxation is one of the evolutionary methods of social reform which is by far less chaotic in result than revolution. Viewed in a certain light many of those who have much to lose in a revolution will probably consent to redistributive taxation as a form of buying time. It is imperative, however, that the masses of the

people be convinced that the government is doing something to change the existing distribution significantly because, as Henry Simons' would put it, extreme inequalities in income and wealth is "distinctly evil or unlovely"⁵. And as many of our leaders have recognized, at least in their public pronouncement - extreme disparity in income and wealth is an irritant that could endanger the entire society unless positive measures are adopted to change the situation at a fast enough rate to satisfy the increasingly deafening clamor for social justice by many sectors of our society.

On this point, I go much further than most economists would go, on the judgement that social justice is just as important as economic development as a social objective.

The Congruence of Solutions

The preceding sections, on the need for some moderately redistributive taxes at this time, are not mere digressions. They are intended to ^{apt, well-chosen} juxtapose the felicitous congruence of the solutions of two admittedly difficult problems: (1) the irrespressible clamor for social justice and, there-

⁵Henry Simons, Personal Income Taxation, Chicago: University of Chicago, 1938. Pp. 18-19.

WOW!!!
Here are openings in the English Dept.

fore, the need for some redistribution of income and wealth; and (2) the financing, without too much inflationary pressure on prices, of the expected gap between projected public expenditure and public revenue in the 1970's which is characteristic of many developing economies at this particular stage of their development.

There appears to be, at the beginning of this new decade and at the beginning of a second mandate for the incumbent administration, a rare opportunity for solving these two problems simultaneously, if not fully, at least partially.

Alternative Methods to Finance the Public Sector

Briefly, let us go through the list of alternative methods of financing the expected E-R gap. Some of us who have heard of compensatory fiscal policy associated with the name of Lord Keynes will probably favor deficit financed government spending. But upon closer examination, the high level of unemployment which is another pressing problem of the economy now and in the 1970's (Dr. Mercedes Concepcion has warned us and the economic-policy-makers in particular, to please consider demographic factors in our policy planning/ is of a different kind. It is not the unemployment due to lack of effective demand, or what has been labeled as

Lack of Demand

← "Keynesian Unemployment" wherein a substantial number of the labor force cannot get jobs at the prevailing wage rate because of lack of demand to utilize existing capital plant. The unemployment that the Philippines is experiencing today is of a different variety, although the outward manifestation of workers unable to get a job at the prevailing wage rate are the same.

Lack of Capital

This type of unemployment has been sometimes labelled in the literature as "Marxian unemployment" to use a term I hope devoid of ideological connotations of Marxian socialism.

While the symptoms are outwardly the same, the diseases are significantly different and, therefore, the prescriptions for their cure. In the latter, case, unemployment is not due to lack of effective demand, but to the lack of capital with which to equip the idle laborers. In any modern society, unfortunately, capital equipment no matter how modest is needed before a laborer can effectively be employed in the process of production. The capital need not be sophisticated, it can be a simple spade only but certainly not his bare hands. Again, the inexorable physical as well as economic laws state that something cannot be created from nothing. Domestic capital can come out only from savings; capital formation must come out from what has been previously produced and then saved, i.e., not consumed or eaten.

2) Deficit spending has only a limited role to play in the unemployment situation that faces the Philippines in the '70's. In so far as the economy becomes more monetized as the economy progresses through development time, the government can provide a part of the additional money by deficits in the budget. I submit that this is one of the most equitable way of introducing new money to the expanding economy. To a limited extent, some infrastructure projects can also partly be financed through

3) issue of government securities, i.e., the creation of public debt, just like the standard practice of financing capital assets in the private sector.

But there is always the danger that heavy pressure on prices will mount before the increased output expected from these government projects reaches the market. This is so because many of the government projects such as irrigation systems have a relatively long gestation period. At any rate the equally important objective of price stability defined as only moderately rising prices imposes a low ceiling to the use of deficit financing in the context of a developing economy.

Fiscal Policy and Capital Formation

It is in the process of capital formation that fiscal policy can

play a very important role as many economists⁶ have instructed us. It is painful for me to admit that it seems that the Filipino people, or at least their leaders, have chosen by design or ignorance, not to use fiscal policy for this purpose. What contribution conscious fiscal policy had, if any, in augmenting capital formation in the Philippines since its independence, is meager indeed.

4) This has to be the conclusion based on the available statistics, the pronouncements of our political leaders to the contrary notwithstanding. In the Philippines we have hardly begun to use fiscal policy as an instrument to augment total savings by inducing the people, through taxation, to save a larger proportion of their income. In effect, fiscal policy can substitute public saving for private saving and, even more important, for private consumption of the kind which is definitely of lower social priority.

This new role of fiscal policy is as yet hardly recognized by many of our leaders. Understandably, therefore, the masses of our people oftentimes will resist the very policies which upon deeper analyses are

⁶See Walter Heller, "Fiscal Policies for Underdeveloped Countries", Reprinted in R. Bird and O. Oldman Readings on Taxation in Developing Countries, Rev. ed. (Baltimore: John Hopkins Press, 1967, Pp. 5-32.

intended for and will redound to their own long-run welfare.

In other words, increased taxation coupled with a well designed infrastructure program by the government will be able to induce increased savings in the community and increased investments of the type that private investors will not readily undertake for technical and financial reasons, but are just as important to the society. In fact, the private investors themselves clamor for the same investments to be undertaken by the government. As the prefix "infra" denotes, these investments are figuratively below or beneath the structure of ordinary investments which are expected from the private sector. For technical reasons such obviously useful investments in roads and highways, irrigation systems, power facilities, portworks and harbors, usually have to be undertaken by the government, if they are to be undertaken at all. Similarly, social development expenditures in education, public health and welfare, are in a sense also investments in human beings to enhance their productiveness, among other social objectives.

5) Foreign Grants-in-Aid and Reparations

Foreign grants-in-aid from the United States of America have been declining over the years. And it is not very likely to increase

in the decade of the '70's. Grants-in-aid from other sources are sporadic and are not likely to make a significant contribution to financing the needs of the public sector. Of course, any amount which is not encumbered with too many strings will contribute something, especially in such areas as basic research, institution building and the like. This will help, but the amount of grants-in-aid is not going to be substantial unless there is a major shift of foreign aid policy in the United States and elsewhere.

Reparation payments from Japan have been and will be useful in providing imported capital equipment and materials as well as limited technical assistance, but again the overall amount still remaining to be paid is too small (averaging P 25M annually) in comparison to the projected gross financial gap which averages more than P 700M annually in the next four (4) fiscal years. The financial gaps will probably be greater for the remainder of the decade after 1974 unless substantial tax reform is undertaken immediately, in addition to what has been achieved in 1968 and 1969.

Foreign Loans and Investments

Of course, another possible source of financing is foreign loans and investments. In fact, the private sector will continue to look towards

this source, the climate of economic nationalism permitting. The public sector, however, cannot expect very much from this source except perhaps from some of the international financing institution such as the IERD and the IMF. Consultations are going on at present to form some sort of a consortium of financiers to help provide the financing needs of the Philippine Government. Realistically enough, the projected amounts from this source in the next four years averages around P 200M annually. Some persons will even question the feasibility of raising these relatively modest amounts.

The above analysis of the alternative sources of financing the public sector leads us to the inevitable conclusion that the preponderant portion of the projected financial gap has to be covered by additional tax revenue or from domestic borrowing. Most of us are aware of the limited possibilities of the latter, considering the state of development of the market for Philippine government securities here and abroad. This leaves us taxation as the only possible source of financing a substantial portion of the projected E-R gap in the next decade, which leads us to the need for tax reform planning.

Tax Reform Planning

✓ The additional tax revenue to finance the public sector in the

1970's can be generated with minimum adverse effects on incentives. It is not true that taxation as such will reduce incentives to work, produce, save and invest.

In fact, practically all the studies in this area⁷ indicate that contrary to the popular notion that taxes tend to discourage work effort, on balance, taxation probably will increase work effort. Of course, there are taxes that could discourage work effort under certain assumptions as to the shape of the marginal rate of substitution curves between income and leisure. But on the whole, moderately progressive income taxes would still, on balance, have the effect of increasing work effort rather than diminishing it. In other words, the results of surveys and other statistical analyses indicate that the income effect which is favorable to work effort would probably outweigh the substitution effect which is adverse to work effort.

The point to be made is that it is relatively easy to design a tax structure, with some imagination, of course, that would not dis-

⁷G. F. Break, T. E. Sanders, J. D. Butters, L. L. Bolinger, L. A. Thompson, M. Levy, and C. A. Hall have done researches in this area.

Courage work effort on balance. Similarly, it is possible to design a tax structure change that would not be adverse to saving and investment on the whole, while generating the much needed resources to finance the public sector through taxation.

In order to achieve this tax structure change there should be systematic planning of tax reform. And before that can be done, extensive studies have to be made regarding the direction of the reactions of taxable units to different types of taxes that would raise a given amount of revenue. Our own Joint Legislative-Executive Tax Commission and its technical staff have been given the responsibility of making the necessary studies and formulating recommendations for changing the tax structure. The Commission and its staff under the able direction of Mr. Angel Yuingco, one of the discussants, have been doing just that during the past decade. It is possible to state categorically that we know a lot more than ten years ago about the incidence of most of the taxes that we impose at present, and we have some idea about the reactions of economic units to others recently imposed or still to be imposed.

Instead of making ad hoc studies of the tax structure as in the past First and Second Tax Commissions, the Philippines has chosen

to establish a permanent body to undertake studies towards tax reform.

The Philippines is among the first to do so in this part of the world.

Let us hope that the efforts of the past decade will result in a modified tax structure that will adequately serve our society. The Commission and the technical staff, as well as the tax structure itself will be put to a difficult test in the 1970's.

Concluding Remarks

Before closing let me anticipate a few questions that inevitably are asked of anybody advocating increased taxation in the Philippines or anywhere else.

How certain are we that the additional tax revenue will not be wasted? To be sure some of it will, but there are strong indications that the leaders of the country are sincerely trying to reorganize the government structure to make it more adapted to the needs of a developing economy. We heard Dr. Abelardo Samonte, Executive Director of the National Reorganization Commission, gave the basic outlines of the prospective change in the government structure. This endeavor is not limited to government officials alone. Many persons from the business sector, academic institutions, and civic groups participated in different reorgani-

zation panels which framed the recommendations to the National Commission for government revamp, I am confident that substantial changes will be made in the near future to make the government a little bit more efficient, and to direct more of its effort towards economic development.

While earmarking of tax funds normally would be against basic principles of budgeting, it seems that earmarking serves two purpose at this time. (1) It seems that the people and their representatives in Congress are more willing to be taxed, if the funds are reserved for a specific purpose such as education and science, to mention two recent examples. (2) earmarking imposes discipline on the executive since the funds can be used only for the specified purposes. There have been several surveys that showed that the Filipino people are willing to pay additional for certain purposes⁸.

The ability of our administrators will also be put into question. The public image of the principal tax revenue collecting agencies, namely: The Bureau of Internal Revenue and the Bureau of Customs is

⁸For instance, the JLETC conducted two tax consciousness surveys which brought out this surprising finding which is contrary to popular notions.

not the best, to indulge in an understatement early in the year. But there is an increasing resolve on the part of the top executives to improve the performances in these two very important government agencies as witnessed by the recent administrative reforms which were passed in 1968 and 1969.

Our discussant from the Bureau of Internal Revenue can correct me on this, but I believe that our tax collectors are no more corruptable than others in Southeast Asia, their poor public image notwithstanding. ^{how true is this?} Thank God, the Philippines do not have a monopoly of graft and corruption. Without condoning whatever malpractices that actually happen, I am told that what happens in the Philippines would seem like peanuts when compared to what does happen elsewhere sometimes.

On matters of strategy in regard to the timing of tax reform, I am sometimes tempted to suggest that instead of having an Omnibus Tax bill, or some massive package of tax reform proposals, it might be more expedient to do it piecemeal in order not to consolidated resistance to the proposed reform. In other words, to divide and conquer. The loggers this time, the sugar bloc next. The landlords at another time, the businessmen probably later. It is important, however, that there is a grand design somewhere so the Philippines will end up with the structure it wants as

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time goes on and in response to the changing needs of a developing society.

More seriously, I will close by alluding to the significance of the tax breakthroughs in the past two years. For virtually a decade no significant tax measures were passed to add to the revenue of the government. Instead, the already narrow tax base was eroded willy-nilly by tax exemptions in one form or another so that the revenue collected became grossly inadequate to finance the desired government services, especially for building up the economic and social infrastructure of Philippine society.

The contribution of the new import substituting industries which were set up in the period of controls, and even the so-called new and necessary industries, as well as the basic industries must be considered in relation to its opportunity cost in terms of government services which had to be

foregone because of the loss of potential tax revenue. I hope that in the

1970's the Philippine legislators will be more selective in granting tax holidays to almost everyone who can lay claim that he also needs encouragement to become a producer - an industrialist! a capitalist.

The tax reforms of 1968 and 1969 reverse a trend which resulted in the erosion of the tax base. In the 1970's there is an imperative need to widen the tax base not only to finance the public sector but also to begin to make our tax structure more equitable, and thereby, begin

to achieve another social objective - redistribution of income and wealth.

In advocating that we should pursue this last objectives, I am aware of the possible conflict between the goal of accelerating economic growth and the goal of redistribution. It is because I am aware of the danger of the widening disparity that comes with economic development that I strongly advocate a conscious effort to counter this natural, but not inevitable tendency, lest we lose by default to other systems of government for failing to act now. Perhaps, it will be to the lasting credit of some of our leaders that we have at last started to tackle the difficult problem of tax reform, that we have at last begun to use fiscal policy to achieve some of the most fundamental of our social objectives.

In a sense, the monuments of one's greatness should not be limited to the thousands of miles of highways and the hundreds of bridges built, to the school houses constructed and to the achievement of self-sufficiency in rice or to the reorganization of the government for development. It should include the strengthening of social institutions and the removal of some of the sources of unrest. It should even include the reform of the tax revenue structure so that it can better meet the chal-

Challenges to the Philippine society in the 1970's.

Now that we have discussed at least in its broad dimensions the problems and prospects of financing the public sector in the next decade, I hope, that we as citizens will be less unwilling to pay our taxes.

AMEN

AKjr:ldm
23.01.70

Office of the Director, Bureau of the Census

Washington, D.C. 20543

Dear Sir:

I am writing to you regarding the information that you have provided to the Bureau of the Census.

Sincerely,
Director