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Philippine Public Finance in Recent History

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Abstract

This paper reviews public finance policy covering the fiscal deficit, public expenditure, and taxation over a period of two decades until the opening of 2000. The first section reviews national government budgetary operations through the net fiscal stance of the budget. Initially, the fiscal deficit level was high and quite volatile. Through stringent efforts to reduce that fiscal deficit, macroeconomic instability was brought under greater control, with less volatility. This effort took the better part of the first decade and a half, even though this was not clearly evident from just looking at national budgetary operations. But in the recent aftermath of the Asian financial crisis, the fiscal deficit has risen again.

The next two sections discuss the evolution of public expenditure and of tax mobilization efforts, emphasizing changes in structural patterns for both the allocation of expenditure and the sources of fiscal revenues. The paper highlights the evolution of real per capita public expenditure as well as efforts to improve the revenue base to reduce the deficit through resource mobilization, tax reform and efforts to raise non-tax sources of revenues.

The last section briefly takes up the fiscal implications of the operations of public enterprises, both financial and non-financial. When public enterprise operations sustain persistent losses, the magnitude and severity of financial cash shortages add volatility to macroeconomic management. The budget becomes hostage to their losses and financial liabilities. The problems that they brought to the rest of the economy had very important repercussions on the performance of the fiscal sector.

This is one of several papers on fiscal and development issues on the Philippine economy being undertaken by the main author.

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Episodes of macroeconomic turbulence were part of the two decades of Philippine fiscal history that is analyzed in this paper. The turbulence was partly induced by external shocks that mostly took place during the preceding decade. But domestic adjustments to those shocks resulted in a trajectory of development policy that particularly accounted for the uniqueness of that experience.¹

The first section discusses the national government budgetary operations. Initially, the fiscal deficit level was high and quite volatile. Then, through stringent efforts to reduce that fiscal deficit, macroeconomic instability was brought under greater control, with less volatility. The deficit became less threatening. But this took the better part of the first decade and a half, even though this was not clearly evident from just looking at fiscal operations. In the aftermath of the recent Asian financial crisis, which still carries on a lagged impact, the fiscal deficit has risen again.

The next two sections discuss the evolution of public expenditure and of tax mobilization efforts, emphasizing changes in structural patterns for both the allocation of expenditure and the sources of fiscal revenues. The paper highlights the evolution of real per capita public expenditure as well as efforts to improve the revenue base to reduce the deficit through resource mobilization, tax reform and efforts to raise non-tax sources of revenues.

The last section briefly takes up the fiscal implications of the operations of public enterprises, both financial and non-financial. This part of government fiscal operations often does not appear in the front burner of public finance measures. But when public enterprise operations sustain persistent losses, the magnitude and severity of financial cash shortages add volatility to macroeconomic management because of the threat of new requirements. In this way, the budget becomes a hostage of their losses and financial liabilities. Until these operations became tightly monitored, their activities were not initially adequately reviewed together especially since they are not entered as line budget items. But eventually, the problems that they brought to the rest of the economy had very important repercussions on the performance of the fiscal sector.

1. National Budget Balance: Operational Deficits and Fiscal Stabilization

As the 1980s opened, the growth of the Gross Domestic Product (GDP) was 5.5 percent per year. The national government fiscal deficit was 1.4 percent of GDP. This was the prelude to national economic turbulence in the decade. In 1983 to 1985, an economic crisis hit the country and caused a drastic fall of output, high inflation, reduction of external credit flows. The crisis caused the adoption of severe measures designed to contain demand through fiscal compression. Following a minor financial crisis in 1981-1982, the economy took a major tumble at the end of 1983 that continued for two years.

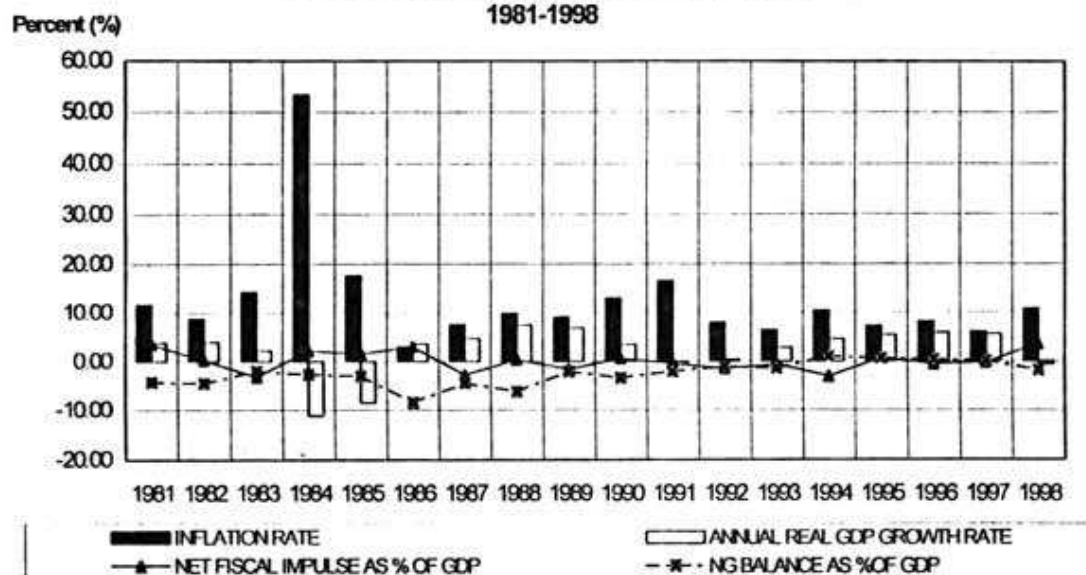
¹ These shocks could be enumerated. First, the energy shock of the 1970s (during the preceding decade) caused a serious external payments problem that extended beyond that decade because of the country's energy dependence. Then, the institution of floating exchange rates in world currencies brought an era of uncertainty in exchange rate anchors for weak currencies like the peso. The extra abundance of petrodollars made easy financing of trade deficits in world financial markets. But this was cuffed by the sudden interest rate shocks of the 1980s (the so-called Volcker shocks) that opened the way to the crisis in international debt of countries already caught in high debt resulting from the energy shocks. Eventually, the Philippines got heavily drawn into this trap.

Figure 1 shows the magnitudes from 1980 to 1998 the fiscal deficit that was measured as percent of GDP. Against these data are also shown the annual rate of inflation and the real growth rate of GDP. A fourth measure shown is the "net fiscal impulse", to be discussed later (see below).

Impending problems were evident in 1981 with a rising fiscal deficit, a growing gap in the balance of payments, and a high inflation rate. There was market nervousness around this period because of the domestic credit scam that caused problems in the financial system. And then, somewhat later, in the midst of increasing external debt, the Mexican debt problem of 1982 arose causing world market uneasiness. The possibility of contagion then was very real. But domestic political events in 1983 precipitated an economic crisis already in the making. A serious external debt overhang turned into crisis and led to an economic depression. The loss of credit lines, high scarcity of imported raw materials, high interest rates, and, of course, a rapid fall of government revenues all conspired to produce the tailspin of the economy.

During the crisis of 1983-1985, inflation was a problem. This led to measures of tightening credit and a major fiscal deficit compression. At its peak in 1984, the annual inflation rate reached 55 percent. Aggregate demand was achieved through a combination of tight monetary policy and an accommodating

Figure 1. Fiscal and Macroeconomic Indicators, 1981-1998



fiscal policy. The contraction of aggregate demand was achieved through a combination of tight monetary and fiscal policy. The introduction of high interest rates for central bank bills that were offered to the financial markets mopped up private savings at the same time that the government also reduced expenditure drastically. This cut into aggregate demand deeply. As a result, the annual rate of inflation stabilized at less than 10 percent per year and stayed below that upper range through the late 1980s and for most of the 1990s. The fiscal deficit level was held to less than 3 percent of GDP for the second half of the 1980s. During 1981 to 1982 and in 1986, the deficit on national government fiscal operations reached almost 5% of GDP.

The government fiscal deficit was at a level below 5 percent of the GDP from their high level of 8.5 percent of GDP in 1986. For most of the years that followed, in fact, the deficit was in the range of 2 percent of GDP (for 9 years) and below 3 percent of GDP (for 4 years). By the second half of the 1990s, the average fiscal deficit was closing towards balance.

This record indicated a fiscal stance that was essentially conservative. This, of course, had the stamp of a fiscal strategies developed in the context of a program with the International Monetary Fund over the years. In comparison, many developing countries are often perennially beset with internal economic instability that is directly attributed to fiscal deficits. The annual inflation rate had gone over the low two-digit range (near 10 percent), with the exception of 1983 and 1984 when the inflation rate broke loose and in the early 1990s when it rose close to 15 percent.

The national government fiscal balance was, however, complicated by the operations of government enterprises. Those activities were not fully reflected in the budgetary allocations as they concerned the operations of agencies not being allocated funds for their operations because they had autonomous financial operations. These were, however, agencies that acted as restraining influences on the price movements because their primary tasks were to extend consumer subsidies. Further complicating the national budgetary operations were the financial institutions. These complications are analyzed fully later in the context of the consolidated public sector deficit (see below, section IV).

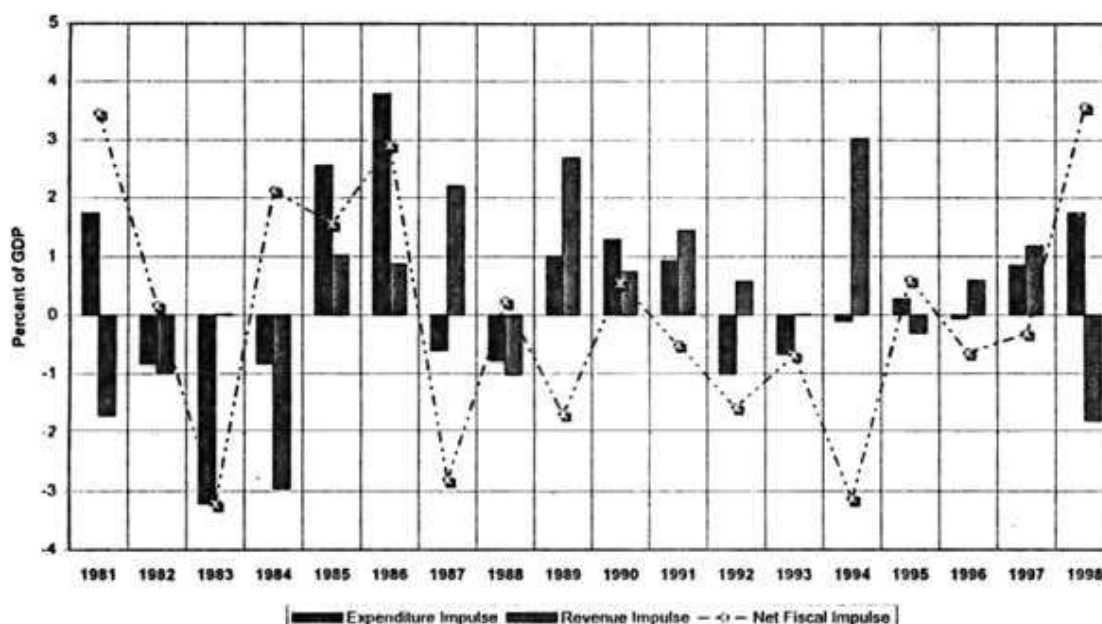
Fiscal stabilization and net fiscal impulse.

The net fiscal impulse summarizes the overall influence of budgetary operations on output. The fiscal impact of public expenditure is to cause output to rise. Taxation restrains that output from rising because purchasing power is taken away from the general public. An expansionary outcome on output results when the expenditure activities exceed the tax effects. The model is premised on the concept of potential output that is greater in magnitude than current actual output. It is premised on the existence of unemployed resources that can be further employed to achieve a higher level of output, an assumption that is realistic as applied to the country.

To derive estimates of potential output, a trend model of the economy was fitted to national income data. From the derived structural equation, a potential output series was calculated per year. The model is explained in the Annex.

The net fiscal impulse is the difference between the change in expenditure and the change in taxation, set against, respectively, the expected average level of expenditure and of taxation evaluated at the level of potential output. Fig. 2 shows the decomposition of the net fiscal impulse into its components. Intuitively, public expenditure would expand output and taxation contract it. But the net fiscal impulse is essentially defined from the year to year changes of the levels of expenditure and of taxation (i.e., by the size of the fiscal deficit). If tax proceeds are falling, then the tax impulse is expansionary because output is being taxed less. An expanding expenditure program also means an expansionary public expenditure impact. This is the reason why the net impacts of both expenditure and of taxation could be either positive or negative, as shown in Figure 2, depending on whether the expenditure impulse exceeds or falls short of the tax impulse, respectively.

Figure 2.
Decomposition of Net Fiscal Impulse



A strong swing back into a fiscal contraction during the change in government resulted from efforts to stabilize the economy. The fiscal compression in 1986 was severe. However, it produced a strong impact on containing inflation by almost 15 percentage points – from 18 percent in the previous year to 3 percent. Even though improved expectations were immediately the outcome of the euphoria resulting from a change in government (after the fall of Marcos), the costs in terms of the reduced resources for the public sector by the fiscal contraction were large.

Fiscal stabilization was achieved at great cost. For instance, during 1983 to 1984 and the 1990s, the net fiscal impulse was mainly contractionary. This was not the case for 1998, however, when the government initiated a different fiscal stance. The strong fiscal measures were a component of the fiscal discipline under the agreed program of fiscal stabilization with the IMF. Fiscal tightening reduced demand severely. The net fiscal impulse indicates the outcome on output direction through its time profile as a percent of GDP.

The most apparent new development is the return of the fiscal deficit by 1998. The resurgence of the deficit is partly due to the relaxed fiscal stance arising from the response to the Asian financial crisis, which provided a higher tolerance limit for the level of the fiscal deficit to provide an anti-cyclical fiscal posture. But the failure to realize expected revenues as targeted (after adjusting for diminished expectations) and the slowness of the government in pushing the privatization program thereby depriving it of additional extra revenues from temporary sources led to larger fiscal deficits. The increased fiscal demand arising from recent developments affecting peace and order in Mindanao that has compounded the future fiscal problem. Therefore, looking down the road in 2000, there are likely to be a new wave of difficult fiscal adjustments and a reversal of the gains made in recent years.

The primary fiscal balance.

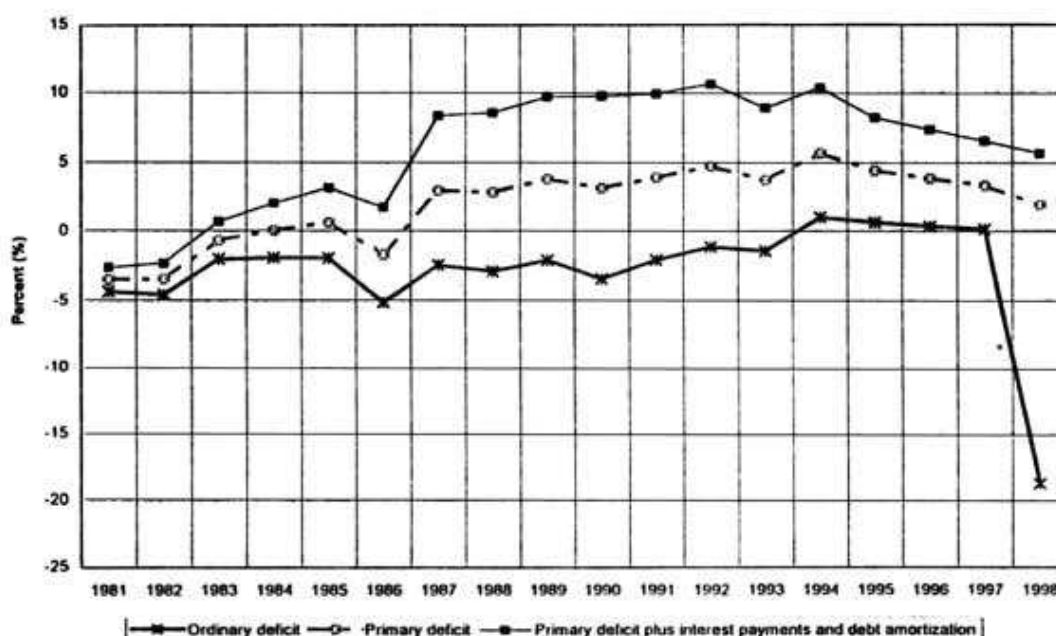
The principal direct evidence about a narrowing fiscal deficit comes from an assessment of the primary fiscal balance. The primary fiscal balance is equivalent to the ordinary, or conventional, fiscal balance minus expenditure for interest payments and debt amortization. It therefore shows how government

expenditure and revenue resources match when expenditure to service the existing debt is taken into account. If this is in complete balance, it means that no new debt is incurred. And when it is in surplus, it means that the debt service has reduced part of the debt.

The path of the primary fiscal balance (see Fig.3), shows that from being in a large deficit territory, the primary balance began to narrow down significantly after the low points of the economic crisis in 1986. Throughout the period after 1986, the primary deficit became progressively smaller. By 1987, the government achieved a primary fiscal surplus. The primary fiscal deficit of -3.45 percent of GDP in 1981 turned to a surplus of 3.28 percent of GDP in 1997. With the exception of one other year (1986), the primary balance remained a surplus for the rest of the period under study.

The major exception to this pattern was in 1993. The primary balance -- although still positive -- began to decline, indicating that new debt was being incurred and that the debt service was again rising. Even more problematic, however, was the aftermath of the response to the Asian crisis when the fiscal deficit rose strongly.

Figure 3. Ordinary vs. Primary Deficit, as a % of GDP



II. Public Expenditure

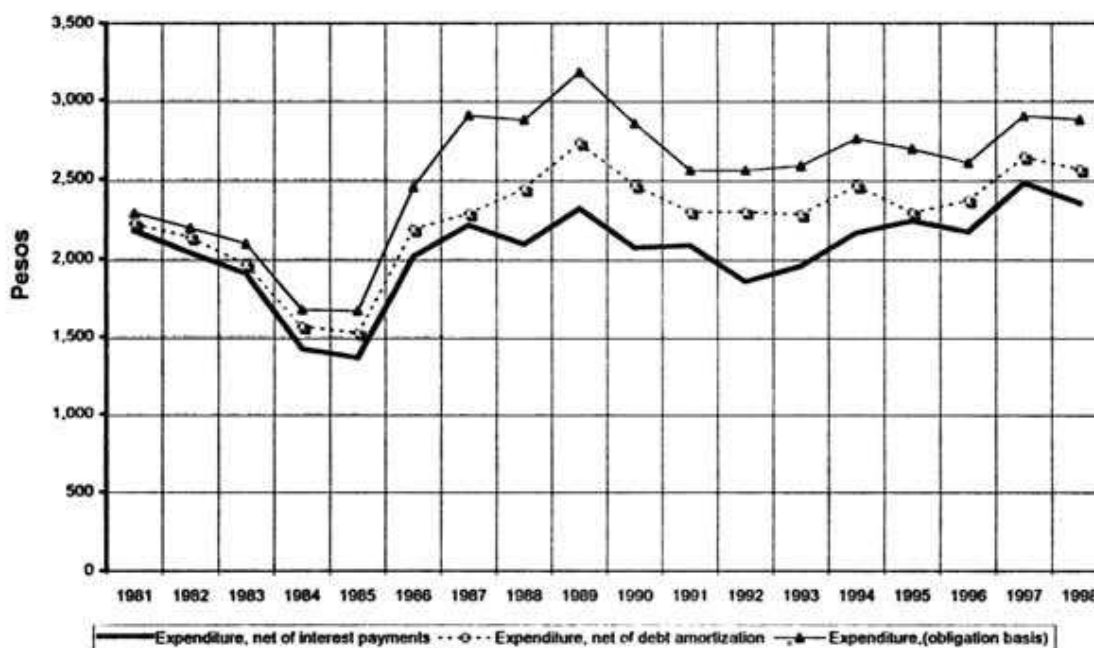
Per capita Real Public Expenditure.

Real public expenditure per head in constant 1985 pesos began at a relatively high level as the 1980s opened. Per capita government expenditure fell from 1981 to 1985. After the full impact of the crisis of 1983 to 1985, real GDP fell by more than 10 per cent of the level of 1981. The per capita fall in spending was most significant for 1984 to 1985. Then, real per capita expenditure slowly grew unevenly over time after this. After 1985, real per capita public expenditure experienced a gradually rising trend.²

² The GDP deflator was used to derive the real level of government expenditure. It would be misleading to apply sectoral deflators on the components of expenditure, as much of the corresponding services rendered

Fig. 4 shows real government expenditure per capita during 1981 to 1998. This is shown in three definitions: total real expenditure per capita; real expenditure minus all debt amortization; and real expenditure net of interest payments. By presenting these numbers in one chart, the per capita cost of servicing the debt appears side by side with the net expenditure on goods and services.

Figure 4. Real Per Capita Expenditure Trends
(In 1985 Prices)



Thus, the time profile of real per capita public expenditure net of debt servicing shows net expenditure after deducting the cost of servicing existing debts. The interest payments burden per head rose sharply from 1987. The fall in this number was achieved with the help of the Brady bonds debt reduction between 1989 and 1994, discussed elsewhere below.

Per capita public expenditure on economic services fell by 20 percent in real terms from 1981 to 1985, at the same time that total real spending per capita fell almost 7.2 percent. Additional expenditure in the social sectors, covering education and health expenditure, was made. In part, this is seen from the per capita growth of government spending from 1986. Another rising portion of spending consisted of increases in central government transfers to local government units as a result of devolution reforms that took place. One result of devolution is that some expenditure on educational, health and other social services were also moved to the local government and the extent of any successful absorption of this transfer in responsibility would need to be evaluated by an analysis of new information at the local government level.

Most of the increases in social sector expenditure went to education. Per capita expenditure on the health sector remained the same. The catch-all "other social services", which included support of social services including housing, land reform, and transfers to local governments, also rose in percentage share.

by the government within those sectors involve a basket of services composed of government projects, personnel services, and consumption of materials requirements.

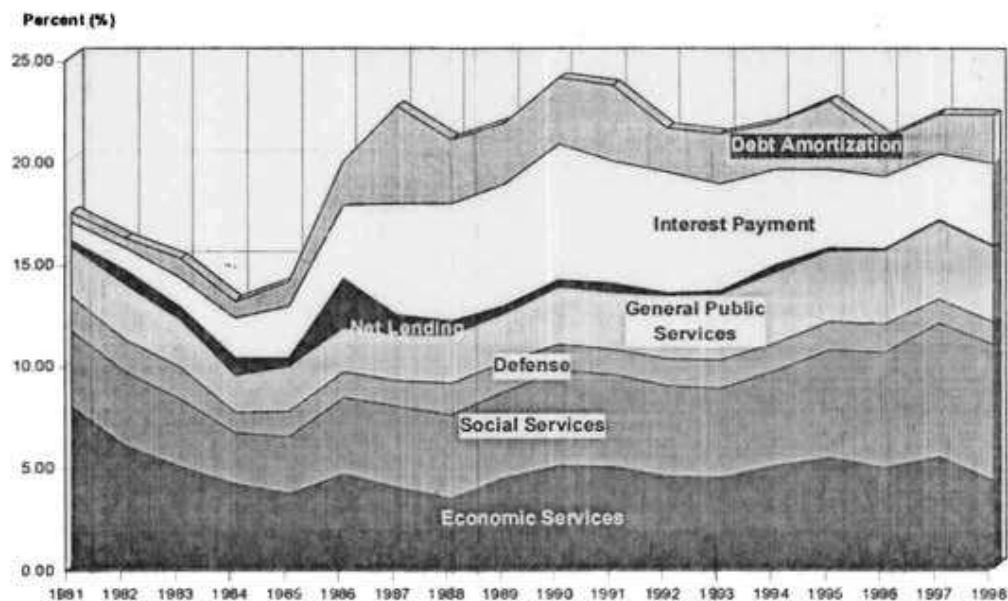
Sectoral Allocation

Public expenditure underwent structural changes in composition (see Fig. 5). In 1981, the share of economic services to total expenditure was 45 percent. This share fell consistently in the next few years as a result of budgetary constraints and reallocations. In 1981-1985, the share of expenditure for economic services fell to 34.4 percent of total. The infrastructure agencies that deliver most of these services (power and energy, water resources and flood control, and public works and communications agencies) contributed 28.4 percent of total in 1981. But for the period 1992 to 1997, economic services accounted for 22.5 percent of total government expenditure. The same infrastructure agencies claimed only 10.8 percent of total public expenditure. These reduced shares represent a severe real cut in developmental expenditure.

Expenditure for social services (education, health and other social services expenditure) remained steady in terms of share to total expenditure during the entire period of 1981 to 1997. A major increase in percent share to total expenditure began to rise during the late 1990s, however. For 1981-1985, average social expenditures amounted to 20.7 percent of total expenditure. And the same expenditures claimed around 23.6 percent of total expenditure by 1997.

Expenditure for interest payments and debt amortization were a major component of spending, as the mandatory obligations to service the public debt took precedence over discretionary claims. Interest payments as a category of spending was below 5 percent of total spending in 1981. But by 1984, interest

Figure 5. Expenditures, as % of GDP



payments accounted for 15 percent of the total budget. The allotments for interest payments to service the debt more than doubled between 1981-1985 from 10.86% of total spending to 24.83%. In 1988, interest payments as a percent of total expenditure reached a peak of 27.34 percent of total spending, a peak that would be nearly repeated in 1992.

The interest burden of the debt was heavy especially during the period following the economic crisis as the country became highly indebted. From 1986 to 1992, the interest payments ranged from 17.8

percent to the peak level of 27 percent, as percent of total expenditure. Some kind of interest payment relief was essential to improve the allocation of budget resources towards more important expenditure needs.

The servicing of a high external public debt posed the greatest problem of crowding out allocations for other types of public expenditure. Such exposure made the budget vulnerable to exchange rate fluctuations since a major part of the servicing of the debt was in foreign currency. The consequence was that debt servicing squeezed out the peso resources that were needed to match foreign-assisted projects from development finance institutions, among other potential expenditure allocations. The problem of peso funding of externally supported development projects intensified. The failure to generate sufficient peso funds for these projects is due to the lack of flexibility in the use of budgetary resources. As a result, some cases of foreign-assisted loan projects with international donor and bilateral donor institutions had to be canceled, to make way for a rationalization of the use of the remaining peso funds.

In general, mandatory expenditures such as interest payments on existing debt reduce the available resources for expenditure on development services and on other discretionary public programs. The need to raise a positive cash flow relief into the budgeting system required a rearrangement of expenditure patterns. If debt rescheduling was practical, this would have been a useful route to reduce the debt burden. But this implied a long process of negotiations with creditors and it raised the possibility of long delays and uncertainty in outcome. Debt repudiation was too radical and self-immolating for the country an alternative and that option carried worst potential consequences.

Reduction of the external public debt came about with the help of Brady bonds that helped to retire some commercial debt for highly indebted middle income countries. This facility enabled existing commercial debt that was available at a discount in the commercial debt market to be swapped with Brady bonds. In this way, Philippine external debt was effectively reduced by \$4.6 billion (or about 12 percent of the \$38 billion debt outstanding at the time). This had the effect of freeing a significant amount of government revenue resources related to the servicing obligations for the public external debt to help finance public expenditure by the early 1990s. Of course, this also reduced the primary fiscal deficit.

The reduction of the external public debt burden incrementally allowed an increase in allocation of resources for other expenditure needs. The need to reduce the debt burden, which was partly met by the debt reduction program, could have been alleviated by a stronger output growth performance. But this was not to be, because improved growth, aside from positive factors about the investment environment, was hampered by the long period that it took to undergo the program of liberalization of trade and industry. The effort was amply rewarded by the early 1990s with an upsurge in export performance and an improvement of the fiscal picture³. But from a fiscal viewpoint, it is the reduction of the fiscal burden that provided a direct benefit, for it enabled the government to reallocate a little amount of freed resources for other expenditure.

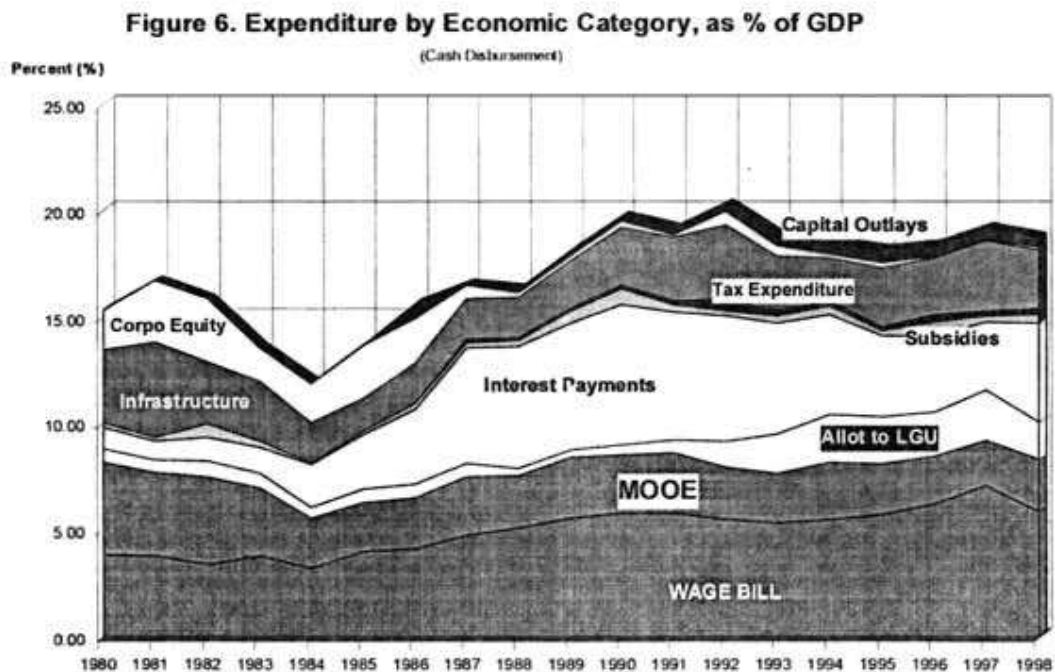
A clear beneficiary of the reallocation of budgetary expenditure resources was the social sector, as already indicated. The surge of public expenditure went to social services beginning in 1995. Social services made a gain of two percentage points in total share in 1995 (compared to the base year of 1994). By 1997, the share of social services was 29.45 percent of total expenditure.

³ The debt service burden also eased from a balance of payments viewpoint. Improved export earnings, especially in the 1990s, became a major factor in the evolution of trade performance as the industrial sector became more proficient in the exports of semi-conductor and other electronics exports.

Budget Flexibility: The Wage Bill and Other Mandated Expenditures.

An aspect of fiscal management is budget flexibility. Taking account of the functional use of the peso of public expenditure, what flexibility was available so that the expenditure could fund actual programs of services identified as important in the governmental scheme of priorities? Fig. 6 shows various categories of claims on the budget by functional classification (in contrast to sectoral distribution, as shown in Fig. 5). The comparison used below is with current operating expenditures rather than total expenditure, to emphasize the more urgent competition for funds in the current period. Of the resources allotted to spending for the year, how much was really discretionary in character?

The government wage bill absorbed around 35 percent of total operational expenses. This ratio hovered around this percentage over the years. In 1986, it claimed 37 percent of operational costs but in more recent years, this had gone down to as low as just little over 33 percent of total current expenditure.



Other mandated expenditures impinged on the budget. Of this, as already commented upon, interest payments claimed a high percentage of the current expenditure. During the difficult years of the debt crisis, interest payments accounted for up to 40 percent of current operating expenditures (in 1988 in particular), although this claimed an average of 38 percent of the operating budget from 1987 to 1991. The fiscal problems of the Aquino administration were therefore prodigious on this count alone, for there was hardly little left for other expenditure.

After 1992 when the local autonomy law came into effect, a new mandated claim on the budget posed a large continuing budgetary claim. The discretion of the central budgetary authority was transferred to the local government as part of fiscal devolution according to a fixed formula. This principally meant that a large amount of tax resources had to be passed on to finance the expenditure program of local

governments. This would not pose a major problem if the national government did not have to meet other major allocations of governmental resources for the national expenditure program. The expenditure for interest payments was relatively reduced as a percent of total current expenditures (by 1996, this was down to 22 percent of total current operating expenditure) because the size of the external debt had become less significant to the fiscal coffers. But the climb in the financial requirements of LGUs took away what could have been an increase in fiscal flexibility. Together with the claims of fiscal subsidies and tax expenditures (automatically appropriated revenues by specified agencies), little fiscal flexibility remained.

A big squeeze resulted in the context of diminishing the discretionary expenses related to the purchase of supplies and the maintenance of public facilities after the mandated claims are taken into account in the budget. The major mandated expenditures are the cost of personnel services, or the government wage bill, interest payments, the share of LGUs as a result of fiscal devolution, and the cost of subsidies and tax expenditures (which is about one-fourth as large as the required allotments to LGUs). All told, these expenditure accounted for close to 90 percent of current expenditure, even though in some years, all told, these mandated expenses totaled at their lowest level, around 82 percent of current expenditure, a very high figure.

During this period, the budget that was allotted to expenditures for maintenance and operations (MOOE) ranged from 12 percent to 24 percent of total current expenditure during 1986 to 1997. In some years, the claim of maintenance and operations was on the low side of this range. It was no wonder that, to sustain these expenditures, the total budgetary expenditures (including capital expenditures) would require a deficit. In fact, from these calculations, the current operating budget ended up in some deficit, during some of these years.

The highly constrained problem of budgetary flexibility could be interpreted, from one perspective, as an extreme case of a heavily committed budget for which little flexibility in planning fiscal expenditure was a continuing problem. From another angle, the problem is one of lack of tax and other revenue resources. For, after all, if government revenues exceeded all these mandated expenditures with a good margin, the problem of lack of budgetary flexibility would diminish.

III. Public Resource Mobilization: Tax and Other Sources of Revenues

The effective constraint to the level of expenditure is government revenues. An improvement in tax revenues has the effect of permanently lifting the level of spending, even when there is a fiscal deficit.

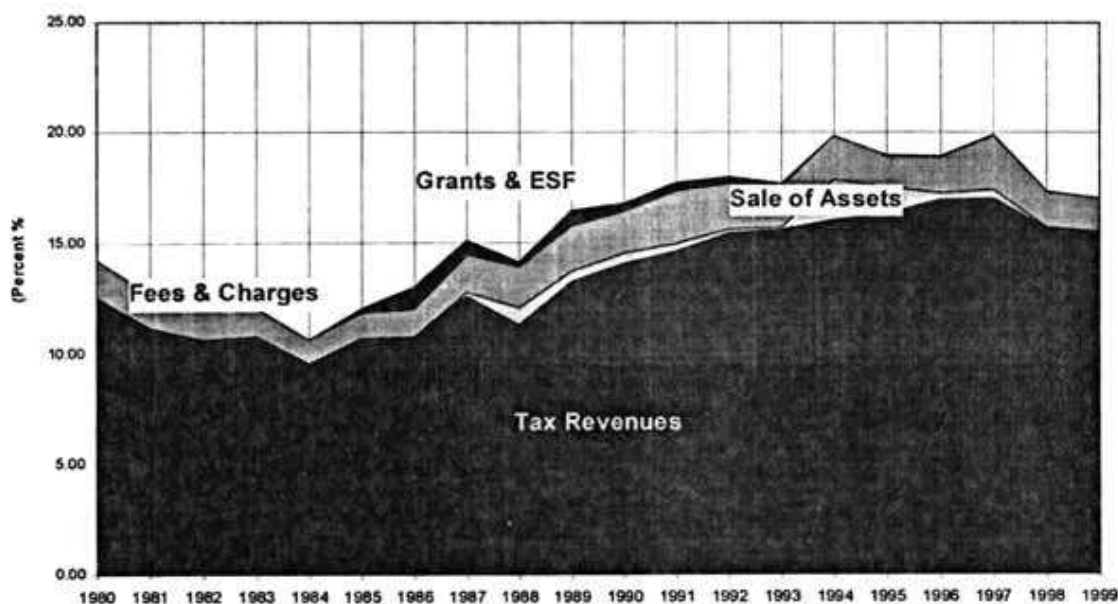
Tax and revenue effort.

The tax effort in the Philippine as a ratio to GDP is relatively low, both in terms of demonstrated need for expenditure programs and in comparison with many countries within the Asian region, at least in comparison with ASEAN neighbors in particular. This is not to say that the tax effort has not risen, for it has demonstrated resiliency in that respect. In 1981, the tax effort was 11.2 percent of GDP. Between 1983 and 1985 at the height of the economic crisis, the tax effort fell to 9.6 percent of GDP. The tax effort has since risen to 17 percent of GDP by 1997.

The "revenue" effort covers both the tax effort and all other non-tax revenues. Non-tax revenues are volatile sources of receipts of the government. Fig. 7 shows tax and other non-tax revenues as percent

of GDP. Over the period under study, the non-tax revenues accounted for around 2 percent of GDP. The

Figure 7. Tax and Nontax Effort, as % of GDP



additional contribution of the non-tax revenue effort could be substantial, as shown by the revenues in 1993 to 1995 when this source showed a sudden bulge in revenues, accounting for close to 1 percent of GDP. This relatively significant addition to public revenues was due to the presence of large-ticket items that were privatized.

Comparison of tax effort among different countries is often made to illustrate the adequacy of the tax effort. Although Philippine tax effort was relatively low by regional standards during the 1980s, the tax effort has almost caught up with Thailand and Indonesia. But the tax effort is qualitatively lower than that of Malaysia and Singapore.

During the 1980s, Philippine taxation was found to be short of the tax effort (as a percent of GDP) of neighboring countries in Southeast Asia. That gap in tax effort was partially closed during the 1990s. But in 1994, for instance, Philippine tax effort was still below that of Malaysia, Singapore, and South Korea. This was before the Asian crisis of 1997-1998.⁴

The problems concerning the tax effort are also commonly found in other countries. The tax base is still relatively narrow. The main obstacle to increased tax effort remains to be the poor overall economic under-performance of the Philippine economy in terms of the growth rate achieved in many countries of East and Southeast Asia. The modest rate of economic growth of the Philippines in comparison with these neighbors has prevented the growth of the tax base sufficiently to raise tax income. With growth, the tax base would widen.

⁴ See Rosario G. Manasan, "Fiscal Adjustment in the Context of Growth and Equity, 1986-1996," Philippine Institute for Development Studies (1997) for the comparisons.

Some taxes with low rates, especially the potentially revenue productive ones, even have lower average effective rates because of poor compliance and loopholes. There is potential room for improvement of revenues from existing commodity and sales taxes. For instance, the basic rate of the value added tax (VAT) that was introduced in 1988 to replace the existing sales tax system is 10 percent. Before 1994, the VAT had many sectors that were not covered by its base, due to exemptions and to zero-rating. Bringing services within the ambit of the VAT has raised the potential coverage. There is also room for a higher rate of taxation, given that the current rate of 10 percent is generally at the low end of the rate of VAT taxation compared to other VATs in the world's tax system.⁵ In 1994, the VAT was made to cover a larger base to include services, including financial services. In due time, a wider coverage of taxation would lead to the expansion of revenues.

A second anomaly is that taxes with high rates are the prevalent sources of either tax exemption or of tax evasion, or some other form of leakage. The industrial protection system and the investment incentives program was based on tax exemptions and tax-like subsidies under a system of high taxation for ordinary, non-promoted industries. Tax exemptions in the agricultural and industrial promotion program have complicated the administration of the tax system. For instance, high taxes had the side effect of encouraging smuggling of competing imports. On the other hand, tax exemptions also weaken the revenue effort.

Also, to account for the impact of tax exemptions and other kinds of services based on fees, tax expenditures were tracked more directly. Tax expenditures represent benefits received by specific sectors and charged automatically as expended taxes, as in the manner of subsidies and fee-based services. This is one way to monitor the services that are implied by particular incentives within the budget. One can only hope to fully account for a number of indirect subsidies received by certain sectors.

Weak tax administration highlights the collection of taxes under existing laws. Corruption in tax administration – both in the internal revenue service and in the customs service – is a problem commonly cited by observers for poor tax collections. For instance, this is an area of weakness that reports of the IMF and the World Bank often refer to whenever they comment on the problem of resource mobilization.⁶ It is commonly noted in public discussion of this problem that the tax laws are sufficient to generate large revenues, but the implementation of the tax laws is inadequate.⁷ Such problems also encourage the

⁵ The basic rate of the VAT at 10 percent is near the basic lowest rates. The VAT has an average rate of 15 percent across countries, which of course, include developed and industrial countries.

⁶ For instance, World Bank, The Philippines: Country Economic Report: Public Sector Resource Mobilization and Expenditure Management (1992), Report No. 100056-PH.

⁷ Manasan (1997) recently estimated the level of evasion from the payment of taxes, including the VAT. She calculated that from 1992 to 1996, the evasion rate for domestic sales ranged between 53 percent to 63 percent, and from imports 48 percent to 55 percent. Estimates of non-payment of taxes from salaries and from professional incomes for the same period ranged between 24 percent to 43 percent for salaries and wages and 65 percent to 83 percent of incomes from professionals (doctors, lawyers, engineers, etc.). These rates of evasion are probably due to actual tax evasions, some tax "avoidance", but probably it reflects a weak administrative system that has failed to cope fully with the required administrative requirements of efficiency in tax collection. Of course, these estimates are sensitive to her particular assumptions. But the principal message of such calculations is to call to mind the failure of the tax system to collect all taxes due from existing tax laws.

**Table 1. Typical Patterns of Tax Revenue Compared with
The Philippine Tax Effort
Percent of GDP**

Tax	Developed Countries	Developing Countries	Philippines
Total tax revenues	31.2	18.0	13.5
Income taxes	11.0	5.5	3.63
Domestic taxes	9.4	5.2	4.23
Foreign trade taxes	0.7	5.1	4.11
Social security	8.9	1.3	1.5
Wealth and property	1.1	0.4	0.71
Other	0.1	0.4	0.82

Source: IMF, WB, and Phil. govt

enactment of temporary measures that are seen largely as revenue measures intended to provide a stop-gap in revenue shortfalls.⁸ Therefore, improvements in tax administration have a potentially a large pay-off.⁹ Partly in response to the weak implementation of the tax laws covering income taxes, for instance, the government has substituted a system of final taxes for various transactions. This has limited the complexity of the income tax filings, both for corporations, and especially for personal, income taxes.

To deal with these weaknesses of the tax system, reforms intended to produce more revenue-productive taxes are undertaken as a continuing effort. The reforms are. Proven sources of revenue-producing taxes are commodity and sales taxes. Expected positive revenue effects were also the reasons for reducing the income tax rates for personal income and for corporate income.

The reforms along the lines of broadening tax coverage and introducing a fairer system of taxation are behind the introduction of the value added tax in 1988. Retail sales and wholesale taxes were eliminated in favor of the VAT. The adoption of the VAT did not remove the regime of excise taxes but supplemented

⁸ An example was the special import tax on crude, which was used as a transitional revenue raising tax to finance the anticipated fiscal deficit in the early 1990s. This tax was allowed to lapse after its period of effectiveness ended.

⁹ High profile cases have an impact on the way the tax-paying public and the tax-collection machinery perceive seriousness of compliance. The celebrated affair of the Lucio Tan tax evasion case, which was initially assessed at 27 billion pesos, is politically charged, since Mr. Tan is widely known to be a benefactor and large political contributor to the ruling leadership. Recently, the Court of Appeals ruled on the matter brought to it by the government. But despite early efforts of the Bureau of Internal Revenue to build up a case, the enthusiasm to pursue the high profile case waned immediately after the change in government. Probably taking the cue from the secretary of finance (Mr. Espiritu) who made a remark in a press interview that the case against Tan was weak, the BIR, the agency under the Department of Finance that collects internal taxes, lost its zeal and weakened the case by not pursuing it. When the Justice department disagreed with the revenue agency and decided to bring the case to court, the lower courts dismissed it on the basis of BIR non-support of it. As a result of this lack of coordination, an adverse ruling against the government was inevitable in the appellate court. The government announced that it would appeal the case to the Supreme Court.

them. In general, excise taxes are maintained on energy consumption, "sin" consumption from tobacco, alcohol, and other supposedly unhealthy habits. Trade liberalization has led to the reduction of import duties. As a result, import duties have instruments for revenue production rather than for protection, although there are many exemptions of a mixed role.

Over the years, there had been efforts to close the gap in tax compliance by introducing various measures to tax income at source. The experience of widespread evasion, under-reporting of incomes, and non-payment of other forms of incomes had led to the institution of essentially a schedular form of income taxation during the late 1980s. The current system is still dominated by taxes that are essentially final taxes and therefore, schedular in character.¹⁰

The change in the relative importance of income taxes to overall tax collection is due to the taxes on other forms of incomes aside from salary and wages which were collected at source. This made it easier to tax other forms of incomes that escaped the tax stream. The schedular taxes on various forms of incomes at the transaction points raised other revenues in the form of direct taxation. Many of these new direct taxes were introduced at source, as was the case of the first of these, the wage withholding tax, that had preceded these measures for decades. These taxes included the final taxes on capital gains, on interest earnings in bank deposits, on royalty payments, and on rental incomes. In the 1990s, the collection of the internal revenue from "other income taxes" had begun to grow significantly so that they deserved to be itemized much more fully. (Unfortunately, and to this day, the BIR reports these other income taxes as a residual group of "Other income taxes"). Recent efforts at reform had tried to re-integrate these schedular taxes back into the income tax framework, by introducing a global income tax return form. The final taxes could then be deducted from global income tax return. The schedular taxes trapped the taxes before they could be lost in the income flows outside of the income tax stream.¹¹

Changing composition of tax revenues.

A growing sign of maturity in the art of financing the state is found in the evolution of the tax structure. This is in spite of the shortcomings of the system as already discussed.

Fig. 8 shows the perspective of tax revenues over the period, which indicates some sharp patterns in the changing structure of taxation. Domestic taxes have now become a larger percentage of overall tax collection compared to international trade taxes. In 1981, 58.4 percent of tax revenues were from domestic

¹⁰ For a review of the issues, see G.P. Sicat, "Tax Reform in the Philippines," in Richard A. Musgrave, C. H. Chang, and J. Riew, Taxation and Economic Development Among Pacific Asian Countries (1994, Westview Press), pp. 64-82.

¹¹ See G.P. Sicat (1994), for the discussion of schedular taxation. And for further treatment, G.P. Sicat and Abdulah, "Trends in Expenditure and Taxation" (2000, forthcoming).

Figure 8. Tax Revenues, by type of Taxes (1980-1999)



taxes. By 1985, they accounted for 63.8 percent. Domestic taxes increased in relative percentage to 79 percent of total tax collections by 1999.¹² Income and profits taxes (both for corporate and individual income taxes, including other forms of profit taxes) accounted for a rising share of domestic taxes. In 1982, income and profits taxes accounted for 24.7 percent of taxes. Income taxes increased their share of total tax revenues, so that in 1999, they account for 43.2 percent of total tax revenues.

With respect to domestic taxes, the increase in share of income taxes to total taxes had been faster than the growth of commodity-taxes. The growing importance of income taxes compared to commodity taxes confirms a common experience in common with many growing economies. During this period, through reforms in income taxation, the tax structure for income taxes had undergone a drastic shift in rates. In the major tax reform in 1986, the tax rates were brought down from a very highly progressive structure that produced low compliance. By reducing the tax rates, improved tax compliance would result.

General sales taxation has become more dominant in revenue production over excise taxes on commodities. This is the result of increasing coverage of the VAT as the primary vehicle for sales taxation. In the context of the falling share of domestic commodity taxes to total taxes, international trade taxes have fallen also in their relative contribution to total taxes. Import duties contributed a falling share of total taxes. In 1981, import duties accounted for 34 percent of total taxes, but by 1999, the share of import duties had fallen to around 20 percent of taxes. In 1989, there was a two-year temporary tax on crude oil imports which caused a surge of revenues from trade taxes. The relative decline of import taxes as a revenue base is therefore well established.

¹² The slight bulge in the share of trade taxes at the beginning of the 1990s was due to the introduction of a temporary surcharge on imports.

Non-tax revenues.

Non-tax revenues are supplemental to taxes. They can make a big difference in raising the level of public expenditure. In a few significant cases such as privatization, they are temporary sources of funding. Collections from fee-collecting agencies, income from services sold to the public, and profit contributions are forms of non-tax revenues. Added to these are supplementary revenues from foreign development grants, such as the Economic Support Fund which was one such extraordinary source of income from US development assistance conceived as a quid pro quo for the military bases until the termination of the military bases agreement.

Unlike regular taxes, non-tax revenues are often the result of extraordinary and temporary situations that produce revenues. Some of the revenues were derived from sales of government property. Government assets long held by the state, such as real property (e.g., military lands being converted into commercial property) could be sold to generate revenues in addition to releasing these properties for private sector use. Other assets included those transferred from public financial institutions, including non-performing assets that eventually came into the property of the banks. The government assumed these assets in exchange for a restructuring program to restore the public banks back to health.

In recent years, the most important single source of non-tax revenues was the sale of state-owned assets. Lumped under "privatization" proceeds, this source of revenues included several types of asset sales: sales of state real property, such as military lands; sale of assets that fell into the hands of the government as a result of the transfer to it of the non-performing assets of state financial institutions; and privatization of public enterprises. The Asset Privatization Trust (APT) was created during the mid-1980s to serve as central agency to hold and dispose of state-owned assets, especially those transferred from state financial institutions. They sold principally government land property assets, sometimes, together with the business.

At any one time, from 1987 to 1999, non-tax revenues from the sale of government assets ranged from 0.11 percent of the GDP to 1.77 percent of GDP (in 1994). These were substantial sources of temporary revenues, and for a while they were able to buy time to raise the expenditure level.

The privatization program of the government was introduced to improve economic efficiency and not primarily to raise revenues. But it had a positive revenue raising impact, even though in all likelihood, the price of the assets sold would not be anywhere near the value of the assets if they had become successful industrial ventures as originally proposed when the loans were made.

IV. The "hidden" deficit from quasi-fiscal activities

Several institutions that are considered directly outside of direct budgetary operations undertake activities that have an impact on the fiscal balance. In recent Philippine experience, these activities led to fiscal instability. As a consequence, a large fiscal burden had to be shouldered by taxpayers.

The first set of institutions consists of government corporations engaged in the sale and provision of special economic services related to the government's economic and social development policies. The enterprises undertake either infrastructure services or they do business in certain highly sensitive essential consumer commodities. The purpose is to give the government a direct market presence to promote price stabilization.

The second set of institutions refers to the public financial institutions, especially banks, to influence domestic finance of commerce and industry. Foremost among these institutions are the Philippine National Bank (PNB) and the Development Bank of the Philippines. In addition to these institutions, the financial losses of the central bank of the country imparted on budgetary operations a huge fiscal burden. Of course, a fuller examination of government financial institutions would include the operations of the two major pension funds, other specialized banks, such as the Land Bank and the Export Loan Guarantee bank, and other credit programs passed on to the private sector which involved some element of government intervention.

This is, therefore, a large topic and it is addressed here in brief. The hidden fiscal problem of public off-budget agencies is that the quality of their assets could deteriorate at the same time that their liabilities are escalating because of the way their business activities are incurring continuing losses. So long as the net worth of these institutions remained positive, they would not pose any fiscal problems to the central government. When their assets deteriorate in quality at the same time that their liabilities increase, a fiscal danger arises. Their net worth could be wiped out and the budget would be forced to undertake a rescue.

Many reasons explain the weak financial performance of public corporations. The causes overlap – inefficiency of operations, excessive employment, lack of true financial autonomy, weak management, and political interference. The results of their operations affect the quality of their assets and not only the size of their liabilities. In due time, therefore, their capital suffers a continuing erosion. If this were not the case, their capital base fails to rise sufficiently to justify the original high hopes that were held for them when the government set them up. In that context, their failure to grow to their full potentials also serves as a deterrent to national economic growth and productivity.

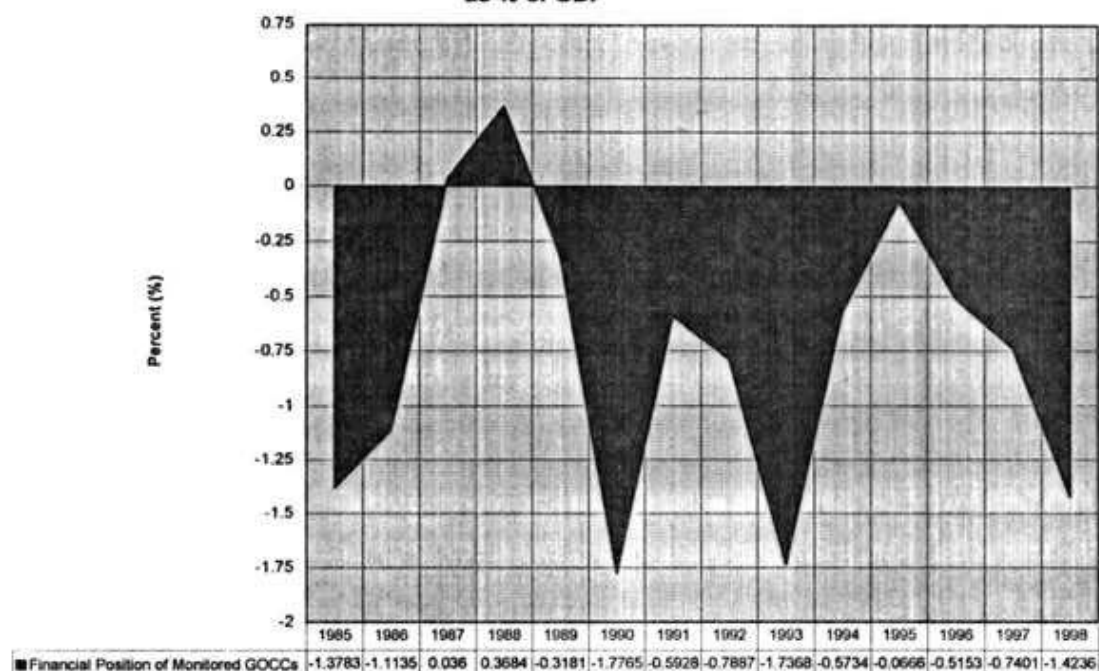
The non-financial state enterprises

As a result of the crisis of 1983-85, fourteen of the largest government non-financial corporations were placed under regular monitoring by the Finance Department. These were major public corporations with significant business operations that carried large responsibilities for public investment programs in the provision of public infrastructure, transport, energy, and food price stabilization.

These corporations include those for the provision of infrastructure (Philippine Ports Authority and National Irrigation Authority); for energy generation and distribution (National Power Corporation, National Electrification Corporation); for transport services (e.g., Philippine National Railways, Light Rail Transit, Metro Manila Transit); for water services (Manila Waterworks and Sewerage Corporation, Local Water Utilities Corporation); for communications (the postal service, telegraph service); for energy production, refining, and distribution (National Power Corporation, Philippine National Oil Company, Manila Gas Corporation); and for food price stabilization (National Food Authority).

Fig. 9 shows the aggregate deficits of these monitored government corporations as a percent of GDP. This monitoring was designed to help install a hard budget constraint to make them financially self-

**Figure 9. Financial Deficits of Monitored GOCCs,
as % of GDP**

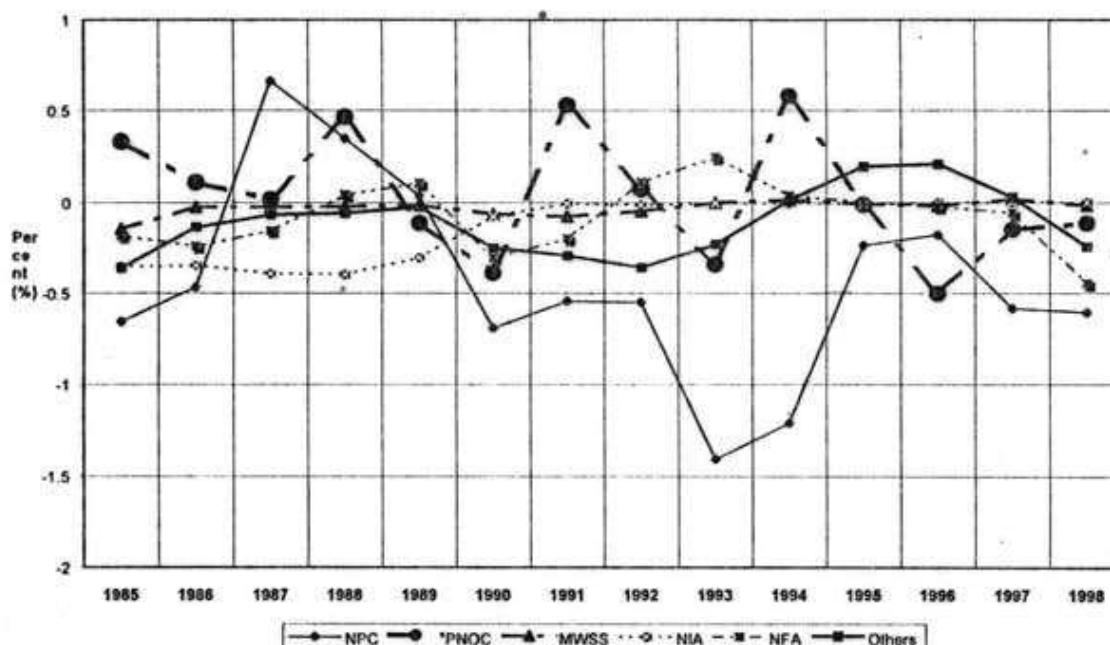


reliant. The objective of the monitoring exercise was to introduce financial information at the national level on their financial as well as business operation. Advance knowledge relating to this information could help to forestall major surprises that could produce large financial problems involving a national remedy. In short, by knowing their overall financial operations together, it was possible to gain greater financial control of future events.

Fig. 10 shows a partial breakdown of Fig. 9, indicating the major corporations that account for the size and volatility of the aggregate deficits.

In 1985, the total deficits of these corporations constituted 1.38 percent of the GDP. Between 1986 to 1991, the level of their deficit was reduced to around 0.57 percent of the GDP. The aggregate financial deficits of these corporations in 1992 to 1997 was 0.74 percent of the GDP. In general, the overall level of the deficits from these corporations had been put under control over time.

**Figure 10. Financial Position of Major Public Corporations
as % of GDP**



The public corporations in the energy sector were the greatest source of volatility. This sector is the most sensitive in relation to the management of price inflation. Such was the case for the National Power Corporation, the state corporation in charge of the power generation and distribution system. At times, it was responsible for about 40 to 60 percent of the overall deficits. The Philippine National Oil Company – in charge of the state's petroleum industry interventions from exploration to importing and refining of petroleum for local sale and distribution – accounted for another part of the deficits. The PNOC is the holding company also for the company designed to retail energy products, and serves in direct competition with the foreign oil companies engaged in petroleum products sale and distribution.

In general, the two corporations provided the mechanism for administering a system of subsidies to hold back consumer prices in times of international volatility. As was the case with many policies involving price controls, the process of intervention became excessively politicized. It became the basis for administering a fuel subsidy scheme that was adjusted to market developments only after problems had become severe. In short, the system promoted a cumulation of losses borne by the state or by the enterprises, or by both. They even added to higher price volatility because, in times of adjustments, the government had to over-compensate for future price increases. By doing so, the system became in part responsible for the cases of macroeconomic booms and busts of the last two decades, despite the efforts to deal with the fiscal deficits.

Operational deficits of these public corporations could therefore have an impact on the level of the budgetary deficit and an all-inclusive measure had to be designed to provide a more complete picture of its true dimension. More important however is to determine the source of the problem and to provide a cure to it.

The energy deregulation law, crafted during the early 1990s, removed the price regulation on energy products that required direct control of the process of price adjustment by the government. This has permitted even a new venue for investments in the private sector within the energy generation sector, whereas such investments had leveled off because of government interventions in the sector during the 1970s and subsequently. This resulted in the entry of foreign enterprises, both to expand capacity of refining and to liberalize the international trade in refined petroleum products. The deregulation was both

undertaken at the level of refining and distribution of the product, permitting new players to enter the field and therefore allowing greater competition. Price setting for energy products was left to the market. This removed the subsidy problem, or its worst impact on the budget while at the same time allowing greater retail competition.

The reform in the energy sector was also partly accomplished by the partial privatization of the PNOC¹³ in 1994. Because the strategic partner chosen (after a public bidding process by interested parties) in this privatization was the Saudi Arabia National Oil Company, the sourcing of supply from one major source stabilized. The volatility that could result from financial deficits that result from the operations of the PNOC could be placed under control.

The National Power Corporation is a different matter. This corporation is at the core of electricity provision to the nation. Electricity tariff setting determines a critical aspect of its income as a corporation, but more important, it also sets the pace for pricing to all electricity utilities retailing it to users and consumers. The huge annual deficits of the NPC (0.67 percent of GDP on the average between 1990-1998 and peaking at 1.40 percent of GDP in 1993) had become unsustainable in relation to the containment of the fiscal deficits. It is also an obstacle towards improving the efficiency of the economy because of the high cost of energy in the country, the result of aging plants on the one hand and high-cost energy generators hurriedly established during the energy crisis of the late 1980s.

The other government corporations have the same problems, but their problems differ. They are not as ubiquitous in their impact on the national scene as the energy companies. But they pose a similar dilemma for the government. The tariff generation issue is a critical one for the economic survival of the enterprises without a deterioration in their service and also without an erosion of their economic viability. In general therefore, these problems are an inadequate generation of a positive cash flow to finance their normal operations and to provide finance for their maintenance and, possibly, their expansion.

The public financial institutions: PNB and DBP

The financial problems of two financial institutions – the Philippine National Bank (PNB) and the Development Bank of the Philippines – affected the fiscal burden of the central government far beyond the operations of line agencies that depended and lived on the budget. The fiscal burden originating from the two banks was the product of a long delayed correction of a process of accumulation of non-performing loans that hobbled the quality of their loan portfolio. In past episodes in the history of the two banks, increase in capitalization and reorganization were the principal vehicles for restoring them to financial health and operational capacity. The economic crisis of 1983-1985 accelerated the financial insolvency of these banks, and in 1986, major reforms were undertaken to rehabilitate them.

To reduce the large liabilities of these banks, their restructuring required transferring their non-performing assets to some other parts of the government. For this reason, the Asset Privatization Trust (APT) was created. By transferring these assets to the national government, the corresponding liabilities were absorbed by the national government. The APT was designed to undertake the sale and/or workout of these assets. The corresponding revenues of the government for these devalued assets were of course so much lower than their book value as transferred assets.

For this purpose, non-performing assets of P10 million or more were removed from the books of the two banks. This was not the first time that they had undergone serious restructuring. The PNB had several cases of restructuring and increase in capitalization during its long history that traced back to 1916. The DBP was established shortly after independence as the bank for long term industrial and development

¹³ The privatization involved the choice of a strategic partner, the national oil company of Saudi Arabia and an initial public offering which divested part of the government holdings to private investors. Thus, the privatization had also the secondary effect of increasing market activity in the stock market.

finance. A major cause of the poor lending records of these institutions was that they mainly financed highly protected economic ventures. Political patronage and cronyism led to behest loans that enabled political favorites and cronies access to special credit accommodations in these financial institutions. Such loans further sacrificed efficiency criteria in lending and weakened these institutions. There were, of course, projects that became failures because they were mis-timed during the sudden economic turbulence of the period.¹⁴ Other projects were essentially limited in future scope for success since they were nurtured by the protectionist industrial policy mantle that discouraged their expansion beyond the market size of the protected domestic market.

After 1986, the stage was set for drastic correction. A financial restructuring involving these two public banks was undertaken. This measure reduced their previously dominant presence in the credit market. After the restructuring, the PNB, for years the largest bank in terms of assets in the country, was reduced to become only the sixth bank in terms of asset size. DBP is unique in being the only long term finance bank in the country, but its size was much diminished, too.

DBP's financial restructuring resulted in the reduction of its total assets from P74 billion to P10 billion. In the case of PNB, financial restructuring involved the transfer of P47 billion in assets to the APT and of P55 billion of liabilities to the national government, including a write-off of P5 billion in assets. In short, the national government suddenly found itself burdened with new assets amounting to almost one hundred billion pesos of doubtful value. The liabilities were substantial. They were assumed as new debt in the national government's book. To the extent that asset recovery was made through privatization and other measures (like swap of new assets with other parties (including former owners!)), the government was able to offset a small fraction of these liabilities. But many of these assets were in the nature of fire sales.

One has only to examine the recent record of the PNB during the 1990s to discover that partial privatization of the bank did not extirpate the problems that had beset it over the years. The poor lending practices had continued, and the non-performing loans of PNB had risen to alarming proportions. Some new problem loans of PNB were again in the nature behest loans that soured quickly as the impact of the Asian financial crisis began to set in.

The central bank restructuring

The problems of the Central Bank set the stage for sizable fiscal burdens. The accumulated losses of the Central Bank of the Philippines were generically not part of monetary management even though they had a strong influence on the level of monetary activity. The losses were fiscal in nature. They arose out of undertakings to implement certain credit and financial policies that were developmental in objective. Some of these losses were the outcome of central banking policy that implemented what was then the received wisdom in that area. Along with the main objective of maintaining monetary policy, the central bank, from its inception had been expected to facilitate the development of some sectors of the economy. This proactive stance engaged the central bank in peripheral interventionist policies. The later losses were to mount in scale because of efforts to defend the exchange rate and to provide guarantees against exchange rate risks for some private sector debt.

A World Bank study of the financial system in 1987 noted that the central bank assets appeared to have been overstated to include large losses in the system.¹⁵ The central bank had become basically

¹⁴ The best example of this was the project on a nickel refinery that was conceived during the late 1960s, and when its implementation had been completed, it was caught by the changes in fundamentals of pricing energy, its major input for the processing of the mineral.

¹⁵ These assets included an item called "Revaluation of International Reserves" which were losses incurred in swap (P13.2 billion) and forward cover (P22.4 billion) operations. Accumulated interest expenses and issuance and servicing costs of central bank securities and open market instruments like CB bills and

insolvent because of these accumulated losses. These findings became the basis for the eventual reforms to recapitalize the central bank through a new entity, renamed as the Bangko Sentral ng Pilipinas. The restructuring of the central bank was therefore similar to the problems that were encountered in the case of the public banks. The latter had become insolvent from the burden of unrecognized non-performing loans and a high debt repayment bill.

In 1984, this was estimated to be 5% of GDP, and the losses were close to 1.6% of GDP in 1992. In 1994, the old Central Bank of the Philippines was renamed Bangko Sentral ng Pilipinas (BSP). It was made much slimmer as an institution. Some of its assets were transferred to the national government, and the government absorbed the losses on its books. In short, the final net fiscal burden fell on taxpayers. The BSP was re-capitalized, and the government provided a fresh set of capital (initially at 10 billion pesos).

Consolidating the fiscal deficit

The conventional fiscal deficit of the central government, which was the focus of the discussion in the first part of this paper, did not cover quasi-fiscal deficits of off-budget enterprises. To that extent, an important omission of a major source of additional demand in government occurred. As it turned out, many of the entities in question had a large role in the economy.

The financial deficits of these enterprises were captured within the budget only partially under the "net lending" budget entry. This line item recorded the transfers by the central budget to all sub-entities in the government. Such financial transfers included the contributions of the national budget in the form of equity contributions, subsidies, and special lending made by the government to these entities. The entry is "net" of profit remittances and other reverse transfers from enterprises to the national government. A profit remittance or financial surplus was of course a rarity as most of the enterprises operated either by incurring intermittent losses or by operating on very slim positive financial margins. In the latter case, the financial surpluses were kept within the enterprise for capital expenditure or reserves. And in the case of losing corporations, their losses accumulated, and their liabilities increased, until their requirements were replenished anew from the budget. Such was the case of the subsidy fund for petroleum products, especially in the 1990s, because explicit funding regarding the subsidies became required. Of course, even when this was the case, there were delays in the transfer of subsidy funds.

For most entities, not until it became essential for the national government to cover the cost of additional capitalization, either through the purchase of additional equity of these enterprises, did the central budget catch up with their budgetary requirements. Indeed, the capture of the deficits directly through the conventional fiscal budget could only be partial in character.

On the other hand, these deficits could have overstated their potential impact on aggregate demand. The quasi-deficits of the financial institutions probably provided a holdback against the contraction of output since at best their deficits were incurred partly to help refinance or to continue financing projects that were midway in implementation. Therefore, their fiscal deficits extended the holdback period against the immediate collapse of operations of major borrowers. Under more normal

Reverse Repurchase Agreements as well as the costs of printing and minting of currency were under an asset item called "Monetary Adjustment Account." If these items were netted from the share of the central bank in the financial system assets, the central bank would account for only 28 per cent of the system and not 43 percent. World Bank, *Philippines: Financial Sector Study* (Report No. 7177-Ph, 1988, Washington D.C.), pp. 20.

circumstances, tightening of loan collections would have called for the major loan accounts to be restructured or cut, therefore reducing demand that had already been partly constricted.

One gauge of the fiscal deficits of the financial institutions was the growth of their loan liabilities (in contrast to their deposit liabilities). The magnitudes of these changes in liabilities swamped the size of the conventional fiscal deficit. For instance, the IMF calculated that the annual changes in the foreign debt (converted into pesos) of the DBP and the PNB at least doubled the value of the conventional deficit during 1981 to 1985. But during the financial crisis of 1983 and 1984, the change in borrowings were estimated to be a factor of 3.5 to one in relation to the fiscal deficit.¹⁶ Such measurements could have exaggerated the total level of the consolidated deficit. But they nevertheless bring home the important point that well beyond the central budgetary fiscal operations could loom a potentially large financial deficit arising from the operations of government enterprises when their houses were not in order.

Figure 11.
Consolidated Fiscal Deficit Compared with
Central Government Budget Deficit,
as % of GDP

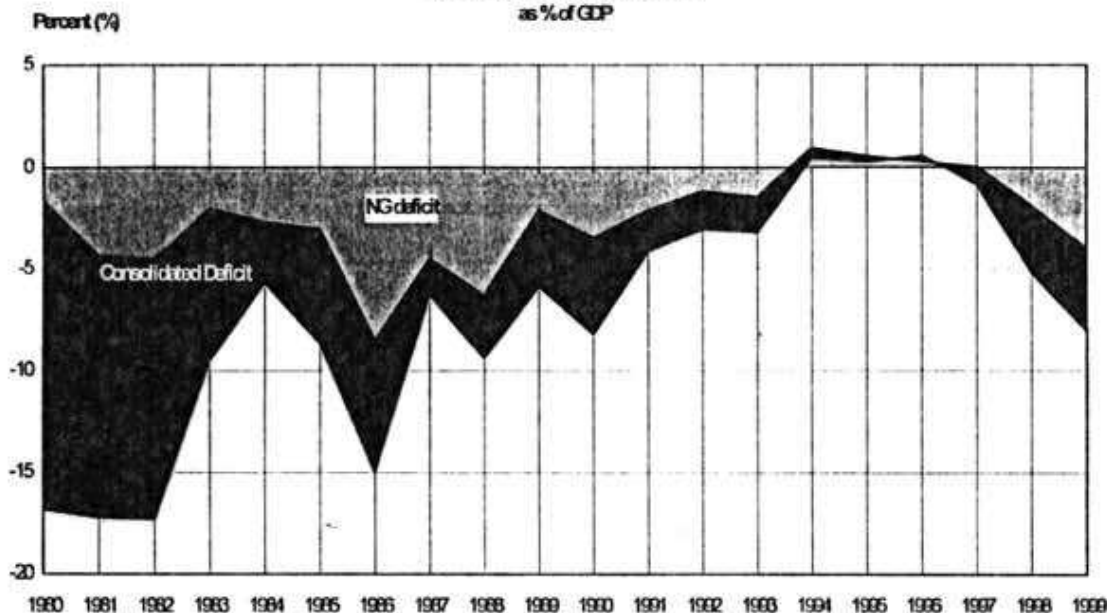


Fig. 11 reconstructs the fiscal deficit, taking into account the other sources of fiscal deficits of the financial and non-financial government corporations. What this consolidation effort indicates is that the operational deficit that should worry fiscal and economic managers is larger than the conventional budget. If off-budget agencies and other institutions are operating profitably or they do not create additional demands that impact on their overall financial health, the conventional fiscal deficit measure would suffice. Throughout the period under consideration, the consolidated fiscal deficit is much higher, almost twice as high as that of the conventional deficit.

¹⁶ See Oded Liviatan, "Impact of Public Financial Institutions in Fiscal Stance," in Mario Blejer and A. Cheasty, eds., *How to Measure the Fiscal Deficit* (Washington D.C., 1994), pp. 259-256.

For purposes of conventional fiscal analysis, the operations of the central budget of the national government is important for monitoring of the total extent of the fiscal problem facing the government. For this, knowing the operations of agencies outside of the normal budget would require a major effort in monitoring and control. Putting their financial position in relative health has a high pay-off. It would put fiscal issues to rest more fully only on the control and reduction of the central budget deficit.

VI. Conclusion

The experience under review covers a period of two decades of during which the country encountered different degrees of macroeconomic turbulence. The fiscal aspects of this experience included some years during which the dominant problems were caused by external economic shocks. Further challenged by domestic factors that threatened inflation and economic stability. The fiscal strategy was influenced for the most part by the need to rein in domestic expenditure to the level of fiscal resources. By and large, this fiscal strategy had been successful in removing the threat of double-digit inflation and in constraining the expansion of the fiscal sector within the limits of the growth of public fiscal revenues.

Strong measures were applied to undertake fiscal repression and to reduce the high fiscal deficit until the primary deficit turned into a surplus. The net fiscal impulse over the years covering central government fiscal operations had been relatively more contractionary, especially during the crisis periods. This is the most important indicator of the high degree of fiscal repression to undertake stabilization. Thus, the record of fiscal management was to remove the inflationary influence on the public fiscal operations. But by undertaking the strong contractionary role during some critical periods, the fiscal sector was less directly helpful in facilitating output growth.

The growth of public expenditure had been largely constrained by fiscal resources. Until a deal could be struck to reduce the fiscal burden from the debt through the conclusion of the Brady deal, it was not possible to raise significantly the real level of expenditure programs. The high buoyancy of government expenditure for most economic and social sector spending implied that – during the most difficult times when economic expansion was constrained, these sectors of government were also hit by reduction in spending. By and large, however, the expenditure for the social sectors was a net beneficiary in the allocation of expenditure.

Even though the bulk of expenditure had shifted from economic development services, this happened partly as a result of the shift in financing of public investment away from public resources and to the private sector. Innovative financing mechanisms for new expenditure like BOT made it possible to commit future resources for meeting bottlenecks in public services until now still reserved to the public sector, like electricity generation, transport and telecommunications. However, this trend would require a complementary streamlining of expenditure in economic development services within the budget, partly to complement new regulatory requirements and partly to strengthen the remaining services.

The changing composition of the sources of taxation indicates a maturing process. The changes in this structure can be discerned by viewing the contribution of domestic and international trade taxes in the economy. Another view of this change in structure is the contribution of income taxation compared to commodity taxation. A third view is the expansion of the network of taxation over a wider set of tax bases, especially with the expansion of the value added taxes to cover services. In spite of these trends, the problem of improving tax administrations remains a sore point. All the other sources of expenditure – non-revenue resources such as privatization proceeds and the sale of state assets such as real estate property – are only temporary measures that fill up the expenditure gap.

In closing, it would be useful to address current fiscal issues that seem to loom especially after the Asian financial crisis hit the region, including the Philippines in 1997. There is an alarming reversal of

some of the major problems that are deemed to have been addressed by the two decades of experience discussed in the paper. Current developments run counter to the recent trends that have been analyzed. These developments are associated with the change in tempo in the government. There is therefore likely to be a reversal of the gains made in recent years as a result of the resurfacing of the fiscal deficit in the central government. The saving grace is that the large quasi-fiscal deficits of off-budget agencies and financial institutions are understood better at this time.

Annex

I. Data

The data used in this study were derived from government sources. Philippine Statistics, compiled by the National Statistical Coordination Board, contains the compendium of varied statistics on prices, income, and the public sector accounts. In addition, the National Census and Statistics Office publishes a most useful Statistical Yearbook. The Bangko Sentral ng Pilipinas (BSP) publishes the Statistical Bulletin. The Department of Finance and its special offices like the Bureau of the Treasury and the Bureau of Internal Revenue have been very helpful in providing gaps, especially, updates in information. We thank Dr. Rosario G. Manasan of the Philippine Institute for Development Studies in guiding us also towards data sources.

II. Fiscal Impulse Estimation

Fiscal impulse assesses the annual contribution of budgetary actions on public expenditure and taxation. This could be expansionary, contractionary or neutral of budget to the aggregate demand. It is used to test actual changes in the budget deficit against a normative neutral change as given by the movement in the cyclically neutral budget. If the actual change in the budget deficit is larger than the normative change, the fiscal impulse is viewed expansionary. This could arise from excessive growth of the expenditure or from inadequate growth in the revenue or some combination of both. Computed as a percentage of previous GDP, it is treated as a growth rate, exacting the initial fiscal contribution to the growth in the aggregate demand.

The net fiscal impulse measure has a number of limitations, and our purpose is mainly to illustrate the implications of central government budgetary actions on aggregate demand. The limitations of this approach, among others, are the following: (1) it includes effect of structural changes in the economy; (2) it suffers from the balanced budget multiplier; (3) it ignores effects on prices, interest rate and exchange rate; and (4) as used in this paper, it is applied against parameters obtained only from the central government budget balance.

The study provides estimates of the net fiscal impulse for the period 1980-1998 and follows the methodology employed by Peter Heller, Richard Haas, and Ahsan Mansur, "A Review of Fiscal Impulse Measures," IMF Occasional Paper, May 1986.

Below is the outline of the measure of the net fiscal impulse.

$$\text{Net Fiscal Impulse} = ((G - g_0 \text{ YP}) - (T - t_0 \text{ Y}))/Y_{-1}$$

where = year-to-year operator

G = government expenditures;

YP = potential output

$g_0 = G_0/YP$; where 0 corresponds to the base year 1980

T = revenues
 $t_0 = T_0/Y$
 Y = actual output
 and Y_{-1} = actual output of the previous year

Potential output is a trend path of Gross Domestic Product, indicating the path that GDP would take at full capacity utilization. It is unthinkable to equate it with full employment GDP, given the labor market conditions in the country. Potential output is estimated for the entire period 1980-1998 using the equation below.

$$\begin{aligned}
 YP_t = & 41,961 + .82 \text{ Consumption}_t + .32 \text{ Investment}_t + 2.22 \text{ Government Consumption}_t \\
 & (4.55) \quad (11.05) \quad (1.34) \quad (2.98) \\
 & + 0.44 \text{ Exports}_t - 0.45 \text{ Imports}_t + 9,996.96 \text{ Time} \\
 & (1.52) \quad (-1.86) \quad (2.53)
 \end{aligned}$$

adjusted $R^2 = .99$
 DW = 1.98
 Prob(F-statistics) = .0000

Figures in parenthesis are t-statistics, in *italics* are t-statistics significant at 5% level