The Philippines’ fiscal position: looking at the complete picture

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At no time in the Philippines’ recent history has its fiscal position been the subject of so much intense debate and concern as it is today. Indeed, the country’s fiscal position has very well reached crisis proportion, something that has accumulated through a certain period of time and something that many fiscal economists have been forewarning for years now.

Where are we now?
The Philippines had a fairly long period of fiscal consolidation during most of the 1990s when the national government fiscal position improved from a deficit of 3.5 percent of GDP in 1990 to surpluses of less than 1 percent of GDP in 1994-1997 (Figure 1). Said fiscal surpluses, however, turned into deficits following the onset of the Asian financial crisis. And despite the turnaround in the economy, these deficits grew persistently from 1.9 percent of GDP in 1998 to 4.1 percent in 2000, to 5.3 percent of GDP in 2002 and 4.6 percent of GDP in 2003.

In more recent years, the fiscal problem was aggravated by policy mistakes such as the legislative inaction on the rationalization of fiscal incentives and the incomplete implementation, due to the nonissuance of requisite IRRs, of what was originally planned to be a comprehensive tax reform program. In addition, the lack of corrective measures, even when the need for such appears to be obvious, e.g., nonindexation of excise taxes, added to the problem. It is also lamentable that the quality of fiscal

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adjustment has been poor, relying heavily as it did on across-the-board budget cuts.

Consequently, national government (NG) debt rose from 56 percent of GDP in 1997 to 65 percent in 2000. With the higher fiscal deficit in 2002, NG debt increased some more to 71 percent of GDP in 2002 and 77 percent in 2003 (Figure 2). If contingent liabilities were included, NG debt is seen to have risen from 86 percent of GDP in 2000 to 93 percent in 2003.

From a crosscountry perspective, the Philippines’ fiscal deficit, when measured relative to GDP, may not be the highest in the region in the period after the Asian financial crisis; however, the country had always outranked the other countries in terms of the size of its national government debt (Figure 3). In this sense, then, the Philippines is more vulnerable than the other countries in the region to fluctuations in interest rate and foreign exchange rate. It is therefore not surprising that the international credit community has started to show some concern. Philippine sovereign bond spreads were one of the highest in the region in 2002-2003 (Figure 4) and some reports indicate that the Philippine bond spreads in April 2004 were even higher than that of Pakistan for the first time in Philippine history.

What explains the growing fiscal deficit?
Total national government expenditures have remained stable at around 19.4 percent of GDP in 1997-2003, notwithstanding mounting interest payments (which rose from 3.2% in 1997 to 4.3% in 2000 and to 5.2% in 2003). In contrast, the national government’s revenue effort declined persistently from 19.4 percent of GDP in 1997 to 15.6 percent in 2000. The ratio of NG revenues to GDP dipped even further to 14.1 percent in 1997-2003, notwithstanding mounting interest payments (which rose from 3.2% in 1997 to 4.3% in 2000 and to 5.2% in 2003). In contrast, the national government’s revenue effort declined persistently from 19.4 percent of GDP in 1997 to 15.6 percent in 2000. The ratio of NG revenues to GDP dipped even further to 14.1 percent in

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1 Thailand registered the largest fiscal deficit in the region in 1997-1999 while Malaysia posted the highest fiscal deficit in 2000-2001. During this period, however, the Philippines had the second largest fiscal deficit amongst ASEAN countries.
2002 before recovering slightly to 14.4 percent in 2003 (Figure 5). Thus, the increase in the fiscal deficit may largely be attributed to the deterioration of the national government’s revenue effort.

The erosion of the revenue effort in the Philippines is attributed largely to the weakening of the tax effort, albeit the fact that nontax revenues also dipped. Overall tax effort in the Philippines plummeted from a peak of 17.0 percent of GDP in 1997 to 13.9 percent in 2000 and further down to 12.3 percent in 2002 (Figure 6). About two-thirds of the contraction was due to the reduction in the Bureau of Internal Revenue (BIR) tax effort while the remainder was attributable to the reduction in the Bureau of Customs (BOC) tax effort.

While the fall in BOC revenue from 3.9 percent of GDP in 1997 to 2.9 percent in 2000 and 2.6 percent in 2001 may be attributed largely to the tariff reduction program, its further decline to 2.4 percent of GDP in 2002 and 2003 appears to be due to problems with smuggling (Manasan 2003). On the other hand, BIR revenues dropped from 13.0 percent of GDP in 1997 to 10.9 percent in 2000 and 9.8 percent in 2002 due to problems with both tax policy (i.e., decline in effective income tax rates and nonindexation of sin and petroleum product taxes) and tax administration. It should be stressed that the contraction in BIR tax effort resulting from the change in tax policy in 1996/1997 is not a one-off change but has been growing over time. In particular, it is estimated that BIR tax effort declined by about 0.16 of a percentage point yearly on the average in 1997-2003 due to the nonindexation of excise taxes.

Meanwhile, the improvement in the national government revenue effort in 2003 is laudable and deserves all the

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2 It should be noted that tariff rates have been frozen at their 2001 levels in 2002 and 2003.

3 In particular, 46 percent of the 2.3 percentage point decline in BIR tax effort between 1997-2001 is attributable to changes in tax policy (notably the reduction in effective tax rates for the income tax and the excise tax due to nonindexation), another 46 percent to increased evasion and only 7 percent to changes in economic structure. On the average, BIR tax effort declined by 0.23 percentage point of GDP every year between 1997 and 2001 due to the nonindexation of sin and petroleum product taxes (Manasan 2002).
positive attention it has received to date. Still, the improvement in the BIR tax effort in 2003, when compared with its 2002 level, may be considered to be slight and it is the improvement in its collection efficiency that is more significant (Table 1).\(^4\) This underscores the fact that because of problems in tax structure, BIR tax administration has to continually improve in order for the BIR to maintain its tax effort. In other words, without changes in tax policy, the BIR has to run just to keep in place.

With regard to expenditure, the program in 1998-2003 is characterized by its undue reliance on expenditure cuts. The delivery of many public services during the period continues to be at risk because many government agencies have had to work with budgets that have either been reduced in nominal pesos or have grown at a slower pace than the rate of inflation. Consequently, real per capita spending on social services continues to go down (Table 2) and the financing gap for the attainment of the Millennium Development Goals persists to widen. At the same time, government infrastructure investments remain severely underfunded, thereby adversely affecting the country’s competitiveness.

\(^4\) Nonetheless, said improvement in collection efficiency is not sufficient for the BIR to equal its performance level in 2001.

Looking for the complete fiscal picture
It is not, however, enough to focus on the fiscal position of the national government. What is even more important is to look at the complete fiscal picture by examining more closely the consolidated public sector deficit. The fiscal deficit of nonfinancial public sector has been rising rather steeply since 1996, from 0.6 percent to 6.7 percent of GDP in 2002. The fiscal position of the nonfinancial public sector is projected to worsen some more to 7.6 percent of GDP in 2003 and 7.2 percent of GDP in 2004 (Figure 7). Consequently, outstanding debt of the nonfinancial public sector expanded persistently from 75.4 percent of GDP in 1996 to 103.4 percent of GDP in 2002 and 105.0 percent as of end of September 2003 (Figure 8).

From 1996-1999, this trend was largely on account of the national government. From 2000-2004, however, government-owned and/or controlled corporations (GOCCs) have become the primary culprit in the deteriorating fiscal position of the nonfinancial public sector even as the deficit of the CB-BOL has started to taper off (refer back to Figure 7).

Following the government corporate sector reform that was started in the mid-1980s, the fiscal deficit of the 14

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<th>Table 1. National Government revenue effort(^a) (percent of GDP)</th>
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<td><strong>Total Revenue</strong></td>
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<td><strong>Tax revenue</strong></td>
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\(^a\) Based on July 2004 National Income Accounts data
GOCCs was less than 1 percent of GDP for most of the 1990s. However, serious problems have re-emerged starting in 1998 when the fiscal deficit of the 14 GOCCs surged to 1.4 percent of GDP from the 0.7 percent level in the previous year. Although the aggregate fiscal position of these GOCCs has been kept in check until 1999, it has consistently weakened in more recent years, with the 2002 deficit reaching 1.2 percent of GDP. Moreover, the combined deficit of the GOCC sector is projected to rise to 2.4 percent of GDP in 2003 and 2.5 percent of GDP in 2004.

What brought about such situation?

The problems ailing these GOCCs are common to many of them. Although generally viewed as entities that are akin to private enterprises in the sense that they produce private goods (as opposed to pure public goods), government ownership has been justified on the basis of some market failure like the presence of natural monopolies (e.g., power generation and transmission). Moreover, many of the GOCCs are assigned special developmental roles like the provision of public infrastructure services that the private sector may be reluctant to supply given their large investment costs and the associated uncertain and long gestation periods.

Many of these GOCCs, however, suffer from poor cost recovery due to inadequate tariff adjustments. Political interference in tariff setting, often in response to populist clamor, prevents them from increasing their prices to address rising costs such as in the case of the National Power Corporation (NPC). In the case of other GOCCs,
government’s subvention policy itself dictates that the prices they charge should be lower than what the cost recovery principle calls for. Examples of this may be seen in the case of the National Irrigation Administration (NIA) since the time of the Estrada administration, and the Metropolitan Waterworks and Sewerage System (MWSS) which does not charge for raw water yet finances the development of the water source.

Meanwhile, the large fiscal deficits of still other GOCCs are linked with the contingent liabilities that they have earlier contracted such as in the case of the Light Rail Transit Authority (LRTA) and the Home Guaranty Corporation (HGC). In addition, because of the poor incentive structure in the public sector, some of these GOCCs are afflicted with a poor record in collecting fees while others are overstaffed. By and large, many of them are saddled with a large debt stock which further aggravates their already weak fiscal positions.

Of the 14 monitored GOCCs, the most notable in terms of their contribution to the deficit are the NPC, MWSS, LRTA, NIA, HGC and the National Food Authority (NFA). In 2000-2002, the NPC accounted for some 37 percent of the total GOCC deficit, the NFA, 14 percent, the LRTA, 13 percent, the HGC, 8 percent and the MWSS, 6 percent. In 2003-2004, the bulk (77%-78%) of the deficit is attributable to the NPC.

Where do we want to go?
Certainly, the overall fiscal picture calls for immediate action. There is widespread agreement among experts and practitioners that improving the public sector’s fiscal position is the most critical challenge that the country faces today. And not to adequately address the widening fiscal gap now will lead to even further increases in the fiscal deficit as public debt continues to mount and interest payments continue to grow.

But how do we go about addressing it? Four major areas of reform are hereby being recommended to immediately be placed on top of the agenda. On the revenue side, reforms must focus on both tax policy and tax administration, and must be undertaken in tandem with one another. On the expenditure side, public expenditure management reforms must be put into place. And finally, specific GOCC reforms must be adopted. These suggested reforms are discussed lengthily in the Policy Notes that follows after this.

Bibliography

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