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Fiscal Reform Agenda: Getting Ready for the Bumpy Ride Ahead

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Philippine Institute for Development Studies
Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas

Fiscal Reform Agenda: Getting Ready for the Bumpy Ride Ahead

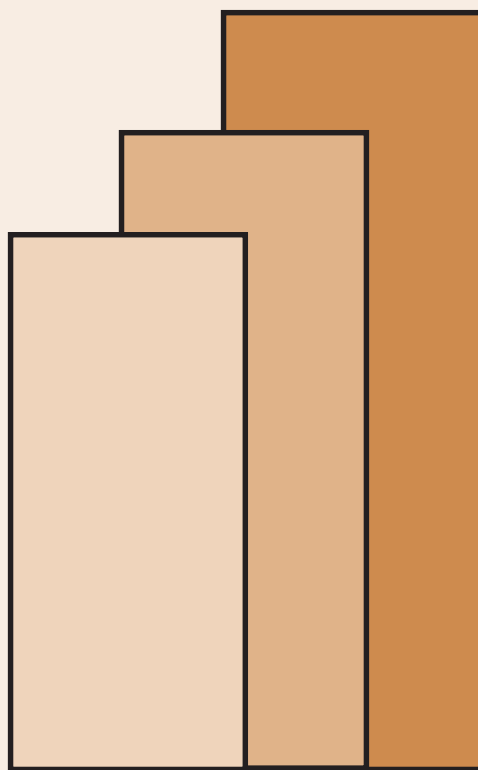
Rosario G. Manasan

DISCUSSION PAPER SERIES NO. 2004-26

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ABSTRACT

The paper traces the roots of the present fiscal problem and concludes that it is largely attributable to the deterioration of the national government's revenue effort. On the other hand, because the government relied heavily on across-the-board budget cuts in order to maintain some semblance of fiscal control in the face of a persistent decline in revenue performance, investments in physical and human capital suffered the brunt of the adjustment.

At the same time, the study points out that it is not enough to focus on the fiscal position of the national government and highlights the need 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 steeply (from 0.6% of GDP in 1996 to over 7% of GDP in 2003) largely on account of government-owned and/or controlled corporations (GOCCs). In turn, outstanding debt of the nonfinancial public sector rose persistently from 75.4 percent of GDP in 1996 to 105.0 percent as of end of September 2003.

The study then proceeds to outline the key elements of a fiscal reform agenda: tax policy and tax administration reform, public expenditure management reform, and GOCC reform. It points out that the burden of the adjustment should rest on the revenue side. At the same time, any further attempt to cut government expenditure in the aggregate is likely to be counterproductive. This does not mean, however, that reforms are not needed on the expenditure side. With or without a fiscal problem, reforms in public expenditure management are essential in ensuring that government gets the biggest bang out of every peso that it spends. In this regard, minimizing waste and curbing corruption should be on top of the agenda.

The paper then spells out in some detail the needed reforms in each of the three areas. A big part of the paper is devoted to an evaluation of the many new tax measures that have been proposed to date.

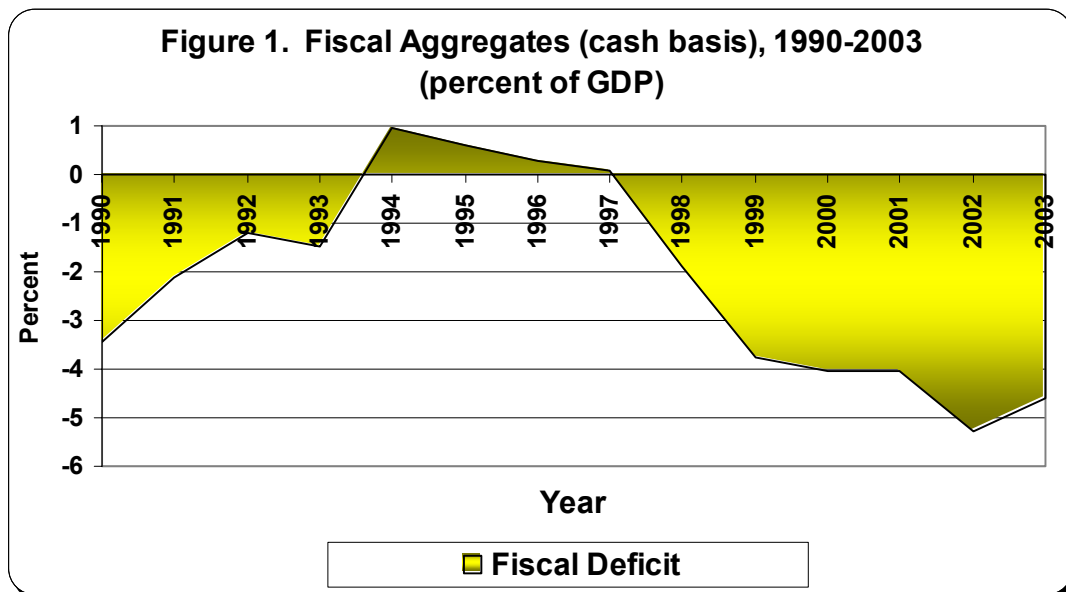
Keywords: fiscal deficit, tax effort, public expenditure management, GOCC reform, consolidated public sector

FISCAL REFORM AGENDA: GETTING READY FOR THE BUMPY RIDE AHEAD

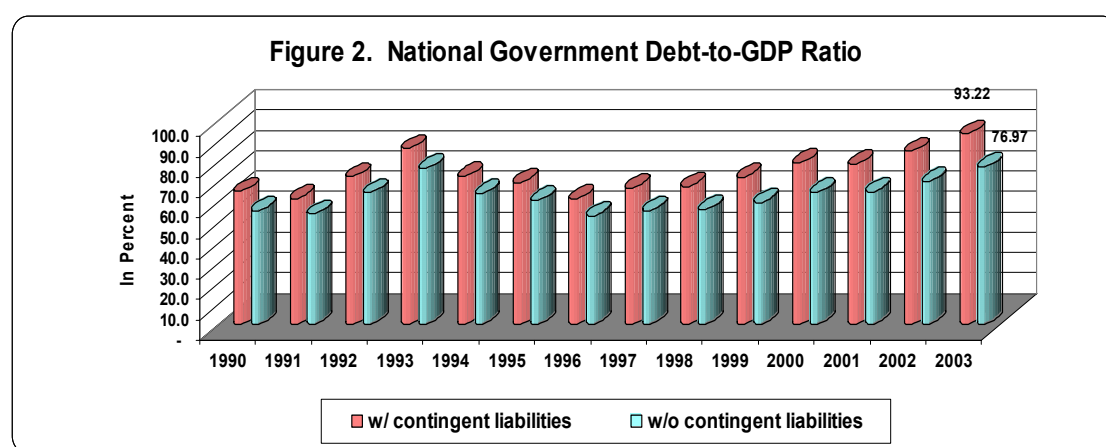
Rosario G. Manasan

1. 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**). However, said fiscal surpluses turned into deficits following the onset of the Asian financial crisis. 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 (e.g., legislative inaction on the rationalization of fiscal incentives and incomplete implementation of what was originally planned to be a comprehensive tax reform program due to the nonissuance of requisite IRRs) and the lack of corrective measures even when the need for such appears to be obvious (e.g., nonindexation of excise taxes). Moreover, it is lamentable that the quality of fiscal 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 93 percent in 2003 (**Figure 2**). If contingent liabilities are included, NG debt rose from 86 percent of GDP in 2000 to 93 percent in 2003.



From a cross country perspective, while the fiscal deficit of the Philippines when measured relative to GDP is not the highest in the region in the period after the Asian financial crisis,¹ 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 the interest rate and the foreign exchange rate. It is, therefore, not surprising that the international credit has started to show some concern. Philippine sovereign bond spreads are one of the highest in the region in 2002-2003 (**Figure 4**). There are also reports that the Philippine bond spreads in April 2004 are even higher than that of Pakistan for the first time in our 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 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.

Although nontax revenues dipped as well, the erosion of the revenue effort in the Philippines is largely due to the weakening of the tax effort. Thus, 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 is due to the reduction in BIR tax effort while the remainder is attributable to the reduction in BOC tax effort.

¹Thailand 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.

Figure 3. Fiscal Balance and Outstanding Debt of the Central Government in ASEAN Countries

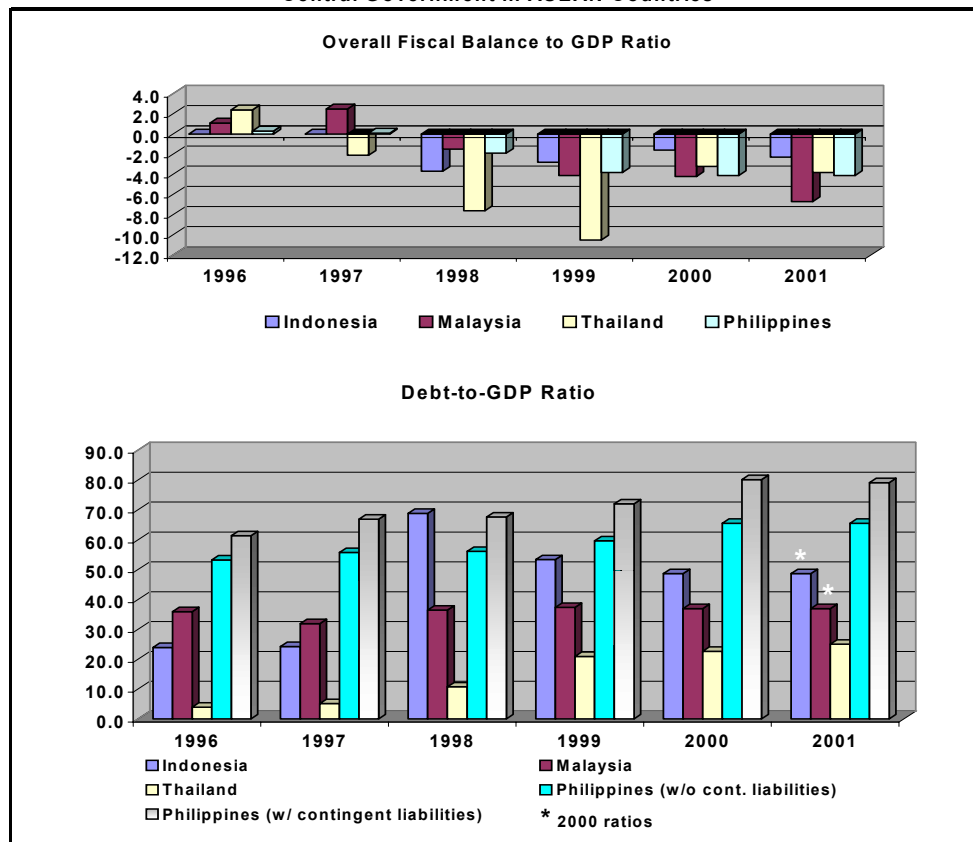
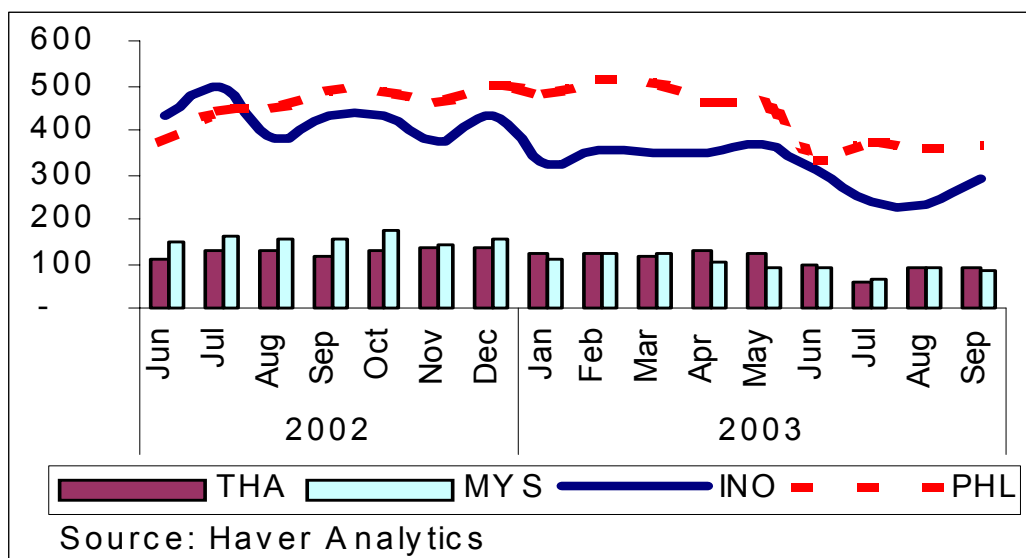


Figure 4. Philippine Bond Spreads One of Highest in Region



(as cited in WB Philippine Development Policy Update, Oct 2003)

**Figure 5. Fiscal Aggregates (cash basis), 1990-2003
(percent of GDP)**

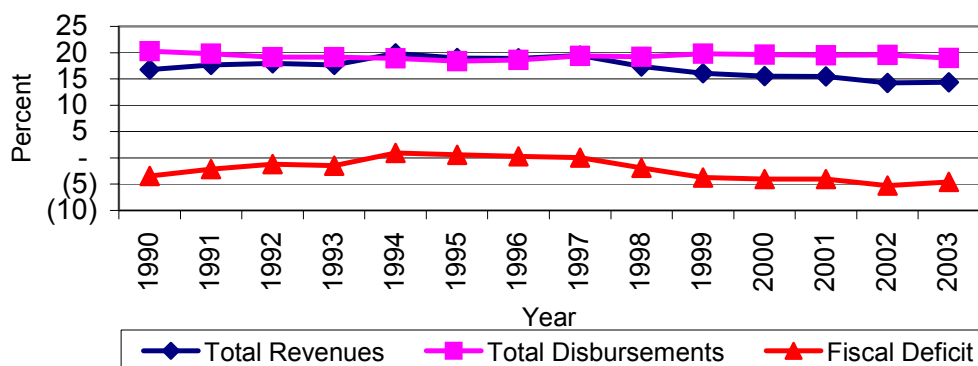
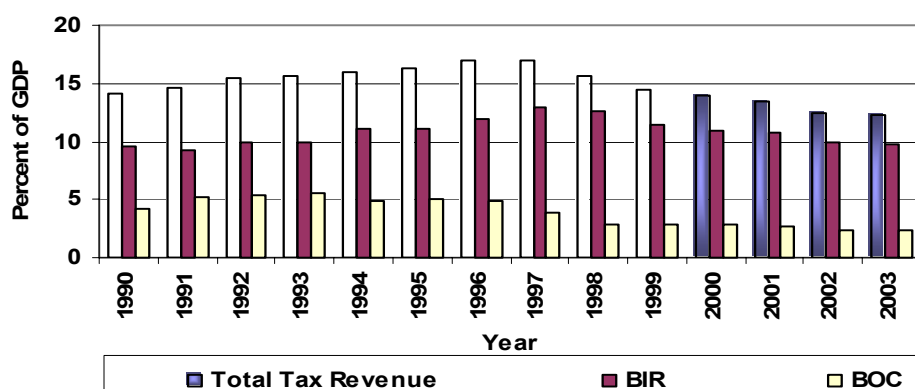


Figure 6. Overall Tax Effort



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).² 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.³ 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

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).

effort declined by about 0.16 of a percentage point yearly on the average in 1997-2003 due to the nonindexation of excise taxes.

The improvement in the national government revenue effort in 2003 is laudable and deserves all the positive attention it has received to date. While the improvement in BIR tax effort in 2003 is slight when compared with its 2002 level, the improvement in its collection efficiency is more significant (**Table 1**).⁴ This underscores the fact that because of problems in tax structure, BIR tax administration has to continually improve so as to enable it to maintain its tax effort. In other words, without changes in tax policy, BIR has to run just to keep in place.

Table 1. National Government Revenue Effort a/
(Percent of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003		
								Actual	Proj. based on 2001 Coll. Eff.	Proj. based on 2002 Coll. Eff.
TOTAL REVENUE	18.9	19.44	17.35	16.07	15.34	15.52	14.32	14.81		
Tax Revenue	16.94	16.98	15.63	14.5	13.71	13.49	12.54	12.70		
of which:										
BIR	12.01	12.97	12.65	11.47	10.76	10.70	9.96	10.06	10.27	9.84
BOC	4.81	3.91	2.85	2.91	2.83	2.65	2.43	2.51	2.65	2.43
Non-tax Revenue	1.96	2.46	1.72	1.57	1.63	2.03	1.78	2.11		
of which:										
Fees/Charges	0.54	0.54	0.79	0.54	0.55	0.67	0.55	0.44	0.67	0.55
BTr Income	1.13	1.46	0.85	0.88	0.91	1.28	1.19	1.34	1.20	1.20

a/ based on July 2004 National Income Accounts data

Meanwhile, the expenditure 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 as many government agencies have had to work with budgets that have either been reduced in nominal pesos or that 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.

Looking for the complete fiscal picture. On the other hand, it is not enough to focus on the fiscal position of the national government. It is even more important 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,

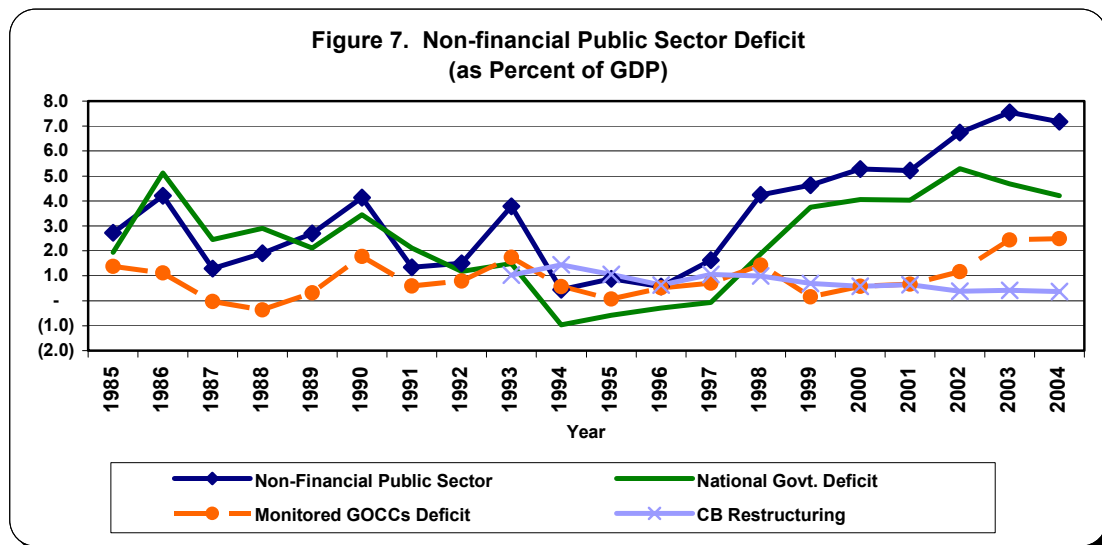
⁴ Nonetheless, said improvement in its collection efficiency is not sufficient for it to equal its performance level in 2001.

from 0.6 percent of GDP in 1996 to 6.7 percent in 2002. The fiscal position of the non-financial 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 non-financial 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) are 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 (**Figure 7**).

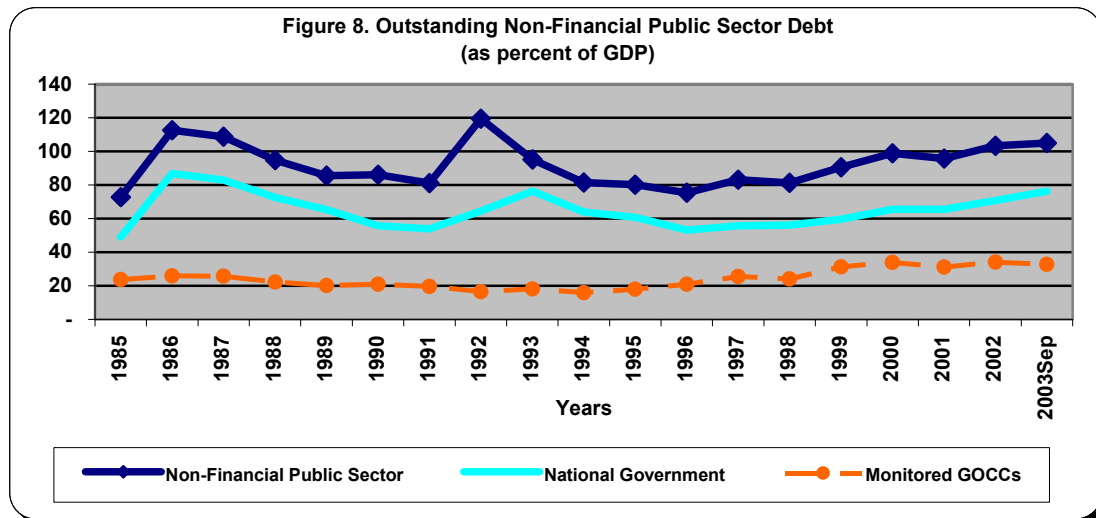
Table 2. Real Per Capita National Government Expenditures on Social Services, 1996-2004 (2000 Prices)

	1996	1997	1998	1999	2000	2001	2002	2003 Prel	2004 Pres
Total Social Services	2,188	2,487	2,417	2,323	2,302	2,035	2,022	2,016	1,999
Education	1,534	1,789	1,761	1,675	1,608	1,516	1,505	1,455	1,412
Health	230	266	221	223	202	166	171	151	141
Soc. Security, Welfare, & Employment	317	392	387	364	376	331	327	392	418
Housing & Com. Devt.	107	39	48	61	115	22	19	19	29



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



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). Also, 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.

However, many of these GOCCs 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 in response to rising costs (e.g., NPC). In the case of other GOCCs, government's subvention policy itself dictates that the prices they charge would be lower than what the cost recovery principle calls for (e.g., NIA since the time of the Estrada administration; MWSS does not charge for raw water but finances development of water source). Meanwhile, the large fiscal deficits of still other GOCCs are linked with the contingent liabilities they have earlier contracted (e.g., NPC, LRTA, 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 National Power Corporation (NPC), the National Food Authority (NFA), the Light Rail Transit Authority (LRTA), the Metropolitan Waterworks and Sewerage System (MWSS), the National Irrigation Administration (NIA) and the Home Guaranty

Corporation (HGC). 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, however, the bulk (77%-78%) of the deficit is attributable to the NPC.

2. Where do we want to go?

Government fiscal managers vow to balance the national government fiscal position by 2010. Medalla (2004) argues that a national government fiscal deficit of 1.4 percent-2.8 percent of GNP may still be sustainable. Nonetheless, there is widespread agreement among experts and practitioners that improving the public sector's fiscal position is the most critical problem that the country faces today. 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.

3. How do we get there?

It is clear from the analysis outlined above that the burden of the adjustment should rest on the revenue side. In this regard, both tax policy and tax administration reform are of utmost important and will have to be undertaken in tandem with one another.

On the other hand, there is no room for further cuts in national government expenditures in the aggregate. Government spending on both infrastructure and human capital investments is severely inadequate and this lack acts as a drag on the country's economic growth prospects. This does not mean, however, that reforms are not needed on the expenditure side. With or without a fiscal problem, reforms in public expenditure management are essential in ensuring that government gets the biggest bang out of every peso that it spends. In this regard, minimizing waste and curbing corruption should be on top of the agenda. At the same time, the overall fiscal situation will not be helped if the fiscal problems of the GOCC sector are not attended to.

Tax policy reform

Numerous proposals for amending the tax structure have been put on the table by various groups. The President herself unveiled 8 new Palace-backed tax measures in a speech before the members of the Makati Business Club and the Philippine Chamber of Commerce: (1) the shift to gross from net income taxation for corporations and self-employed individuals, (2) a two-step increase in the VAT and, possibly, a repeal of the VAT, (3) indexation of the excise tax on sin products, (4) indexation of the excise tax on petroleum products, (5) limiting of fiscal incentives, (6) imposition of a tax on the windfall income of telecommunications companies, (7) targeted tax amnesty, (8) institutionalization of a performance-driven system for revenue collection agencies (BusinessWorld, July 23-24, 2004, p. 1). Prior to this, the government already approved an increase in the duty on petroleum products from 3 percent to 5 percent.

Meanwhile, other sectors have put forward other tax measures that include, among others: (1) reduction in the exemptions from the VAT, (2) use of presumptive income levels for self-employed individuals, (3) imposition of an across-the-board import surcharge, (4) imposition of an excise tax on text messaging, (5) increase in the motor vehicle registration fees, otherwise known as the road user tax, (6) imposition of a franchise tax on telecommunication firms in lieu of the VAT, (7) wider coverage and increase in the rate of excise tax on luxury consumption, (8) increase in minimum gross receipts applicable to common carriers tax, (9) reduction in the corporate/individual income tax rates, (10) creation of independent revenue authority, and (11) increasing the fees for government services.

The merits and demerits of these proposals will have to be evaluated on the basis of four criteria: (1) their ability to raise revenues, (2) ease of administration, (3) tax neutrality/horizontal equity, and (4) vertical equity. In the near term, the first and second criteria will have to take precedence over the others because of the severity of the fiscal problem. However, while the need for “quick fixes” cannot be denied, it should be stressed that the structural problems that continue to eat away at the tax system would have to be addressed squarely.

The need for additional revenues is immediate but the requirement is by no means short-term in nature. The well-defined downward trend in tax effort in 1998-2002 indicates that government cannot rely solely on measures that result in a one-off increase in government revenues (e.g., privatization). It is important that government also adopt tax policy changes that will not hinder the attainment of the longer term goals of tax reform and those that will yield some permanent improvement in the tax-to-GDP ratio.

On the other hand, recent experience in tax reform around the globe tends to put less weight on vertical equity considerations particularly in countries where tax enforcement is poor. The lesson learned in these places suggests that the focus should be on fiscal (i.e., tax and expenditure incidence taken together) rather than tax incidence alone. The shift in emphasis comes from a recognition of the fact that well-designed progressive taxes may not be worth much when they are not evenly enforced. In these countries, it is argued that government’s redistribution function may be better served by a progressive expenditure program that is ably financed by a not-so progressive tax system.

Using these criteria, the following tax measures rank high on the list: indexation of excise tax on both sin and petroleum products, rationalization of fiscal incentives, imposition of an across-the-board-import surcharge, imposition of excise tax on text messaging, and increase in the VAT rate. All of these measures yield substantial revenue with low downside risks (**Annex Table 1**). Needless to say, all will be painful and none will be popular. In the final analysis, choosing which of these measures to pursue will be decided essentially on political grounds. However, because the magnitude of the fiscal consolidation that is needed is not small, it is inescapable that tax policy reform, regardless of the specific measures that will be implemented, will necessarily have to cost the administration a considerable amount of political capital.

Indexation of excise tax on sin products. Nonetheless, the indexation of the excise tax on sin products is clearly a must-do if one wants to stop the continuing erosion of the tax effort. It is notable that the Philippines' tax rates on sin products are significantly lower than those in many places around the world. Moreover, an increase in these rates is justifiable because of the social costs (in the form of resultant additional expenditures on health care services) that are associated with the consumption of these products.

Rationalization of fiscal incentives. An important reform that was originally part of the CTRP but which was bypassed in the legislative mill in 1996/1997 is the rationalization of fiscal incentives system. This is unfortunate considering that the diminution in the tax take arising from the reduction in the effective corporate income tax rate under the CTRP was meant to be compensated for by the potential revenue gain from the curtailment of fiscal incentives. In the near term, limiting the coverage of the Investment Priorities Plan (IPP) of the Board of Investments (BOI) by administrative action will go a long way in generating additional revenues. However, the first best approach would require legislative action and would involve the harmonization of incentives provided under various tax incentive laws (numbering about 100) through the use of a Tax Expenditure Budget.

Indexation of excise tax on petroleum products. In principle, the same arguments that are used to justify the indexation of the excise tax on sin products are applicable to the indexation of the excise tax on petroleum products. Increasing said tax would tend to curtail the environmental costs (i.e., traffic congestion and air pollution) that are associated with the consumption of petroleum products. However, the indexation of the excise tax on petroleum products presents an additional complication due to the fact that an increase in petroleum product taxes tends to set-off a round of wage and price increases. This problem could be mitigated if the tax increase is coupled with tax rebates to public transport and if its implementation is timed with the softening in the world market price of crude oil.

Other high yield tax measures. If an increase in petroleum product taxes is not deemed to be acceptable, then government may have to pursue one or more of the following measures: (1) an across-the-board import surcharge, (2) an increase in the VAT rate, and (3) the imposition of excise tax on text messaging. These measures are by no means perfect candidates for what constitutes a "good tax" but all of them will assure government of well-defined revenue stream.

On the one hand, an across-the-board import surcharge will not affect relative protection across sectors but will likely turn the terms of trade against exports and lead to some increase in prices. On the other hand, the increase in the VAT rate may be difficult to justify given the prevailing leakage from the system.⁵ Increasing the levy on those that are already caught in the VAT net may in fact discourage tax compliance. At the same time, the imposition of an excise tax on text messaging is seen by some as regressive while others aver that the sumptuary nature of text messaging is not clear.

⁵ Estimates indicate that between 26 percent -38 percent of potential VAT revenue is not collected.

Broadening of the tax base. Meanwhile, the government should seriously consider the following proposals that are aimed at broadening the tax base even if the associated revenue may not be high initially. These include the use of presumptive income levels in the computation of the individual income tax liability of professionals, traders and individual nonwage income earners and the reduction in the number of VAT-exempt products and transactions. On the one hand, any analysis of the individual income tax system invariably points to the very uneven tax burden between wage income and non-wage income, thereby indicating the need for the tax system to effectively expand its ambit to cover so-called hard-to-tax groups (e.g., professionals, traders, small businessmen).⁶ The use of presumptive income levels has yielded creditable success in other countries and its application should seriously be considered in the Philippines. This may or may not require further legislative action since Section 6 of the National Internal Revenue Code (NIRC) already allows it. On the other hand, limiting the number of VAT-exempt products and transactions will not only broaden the tax base but will also simplify the administration of the VAT.

Proposals that may be counterproductive. Three of the eight tax measures that are proposed by the administration are not likely to be helpful. These include: the adoption of the gross income tax, the imposition of the windfall tax on telecom companies, and the tax amnesty. The same is also true of the proposal to reduce the corporate and individual income tax rates in order to stimulate supply side effects.

The shift to gross income taxation is perceived by many sectors (business community, tax practitioners and members of academe) to be a bad tax (**Box 1**). This measure will not reduce the scope for negotiations between taxpayers and tax examiners as its proponents aver; rather it will widen it. Instead of plugging loopholes, it will create more. Moreover, if the proposal is meant to put a limit on excessive claims for tax deductions, the NIRC even now permits the BIR to establish and enforce caps on oft-abused expense items. Gross income taxation also tends to violate the tax neutrality principle. Under this scheme, the effective tax burden of firms will vary according to their cost structures, with firms in the services sector likely to be hardest hit.

Meanwhile, the imposition of a tax on the windfall profits of telecommunications firms is another problematic measure. First, is the sector lightly taxed? It is subject to the income tax, the value added tax and the percentage tax on overseas calls/dispatch of messages. Second, how does one define “windfall profits/income?” Third, assuming windfall profits is somehow determined, why penalize a profitable sector?

At the same time, the Philippines has granted tax amnesties much too often and in an almost periodic fashion in the recent past. The experience has not been encouraging in terms of its longer-term impact on the revenues. Worse, it may be that these amnesties have come to be anticipated, thereby sending the signal to taxpayers that government is unable to enforce taxes. Thus, the practice creates a disincentive for taxpayers to pay the right taxes on time.

⁶ While household income is about evenly split between wage and non-wage income, the tax take from wage income accounts for about 80% of total individual income tax revenue.

Box 1. Gross income taxation – why not

Proponents of the shift to gross income taxation aver that changing the tax base from net income to gross income will improve tax collection by simplifying the system and removing the opportunities for overstating expenses for tax purposes. And precisely because of this, they say, the move will minimize as well corruption at the BIR as the scope for negotiations between taxpayers and tax examiners (and the likely harassment of the former by the latter) will be eliminated. Consequently, they argue that the system will become not only fairer because there is less evasion but will also induce a positive impact on revenue as supply side effects come into play.

However, the very premises on which the arguments are based in favor of gross income taxation are faulty. First, gross income taxation does not mean that taxpayers will not be allowed to claim any deductions. In principle, the tax base will be equal to “gross sales/gross receipts less cost of goods sold/cost of sales.” That is, gross income taxation will still allow taxpayers to deduct their direct costs from their gross sales/receipts when computing for their tax liability. This means that there will still be as much room for haggling between taxpayers and tax examiners, if not more under this system. This time though they will haggle which costs are direct (and therefore, tax deductible) and which costs are indirect (and therefore, not tax deductible). Firms engaged in the services sector will tend to be more inconvenienced in this regard because the distinction between direct and indirect costs is not as clear-cut in their case compared to manufacturing enterprises.

Second, a gross income tax is not fair. Because the cost structure of firms in different sectors/industries is widely disparate, the application of a single rate on their gross income is seen as highly inequitable. The business community¹ says that it is not against the gross income tax system provided it applies a revenue-neutral rate² for each sector/subsector. Thus, they argue for the adoption of different rates for different sectors/subsectors. Needless to say, this will make the system more unwieldy and complex.³ However, experience everywhere shows that unfair tax systems breed more evasion. This same is true of more complicated tax systems.

Third, the bigger source of evasion is not over-statement of expenses but under-reporting of sales. From this perspective, therefore, the policy prescription (shifting to gross income taxation) fails to address the real policy problem.

¹ Based on a statement in a paid advertisement of Raul Concepcion’s Consumer and Oil Price Watch in the Philippine Star, 19 July 2004, p. 7.

² A revenue-neutral rate is one that will ensure that their tax payments will remain the same compared to what they pay under the current net income tax method.

³ Now, dishonest taxpayers will have the wiggle room to decide not only on how much to pad their expenses but also on which tax rate should apply to them.

On the other hand, proponents of the new tax amnesty proposal argue that, unlike previous tax amnesties schemes, it will provide government with a potent means to build and widen the tax base because it mandates the filing of a statement of assets, liabilities and net worth (SALNs) by all taxpayers. The challenge then lies in actually making use of such information to help improve tax enforcement in the future. In previous tax

amnesties, hopes were likewise raised that the exercise will allow the BIR to get better information on the gross receipts/income of taxpayers. However, it appears that these aspirations did not materialize.

On the other hand, the proposal to cut the corporate and individual income tax rates is tricky. Proponents argue that this will broaden the tax base because taxpayers will be encouraged to pay the correct amount of taxes if tax rates are not prohibitive. However, the proposal is not likely to work unless enforcement is significantly improved. Moreover, the reduction in the income tax rates under the CTRP has not been found to yield supply side effects.

Tax administration reform

The improvement of BIR's tax effort in 2003 resulted primarily from a number of procedural/systems reforms in tax administration that have been initiated by the incumbent Commissioner. These consist of the implementation of the (1) Third Party Information Matching System including the VAT Reconciliation of Listings for Enforcement (RELIEF) which helped the BIR identify patterns and discrepancies in taxpayers' records, particularly the under-declaration of their sales, (2) taxpayer benchmarking, (3) rationalization of the audit process through the "no-contact audit" scheme and the conduct of pro-active audits based on deviations from benchmarks, (4) tax mapping of business establishments, (5) e-filing and e-payment, and (6) Text-BIR Campaign which encourages end-consumers to demand official receipts for goods purchased. The challenge now lies in the institutionalization of these new procedures and systems in the bureau so as to ensure the continued improvement in its collection efficiency.

Presumptive income levels/expanded withholding tax system. Prospectively, the use of presumptive income levels essentially by extending the benchmarking exercise as well as the use of third-party information to individual nonwage income earners will have to be put in place. Also, ways of expanding the withholding tax system to include the hard-to-reach groups should be explored. In this regard, the creation of the Large Individual Taxpayers Service may also be helpful.

Performance-driven tax administration. The institutionalization of performance-based contracts not only for the tax collections agencies but also for its employees together with some flexibility in their compensation structure will create the appropriate incentive structure in these agencies. The adoption of the lateral attrition scheme will help achieve this. Alternatively this could also be achieved by the creation of an autonomous revenue authority. However, the experience in other countries suggests that the success of the latter depends on degree of independence that is provided (Manasan 2003).

Improved management internal control systems. There is also a need to tighten controls so as to ensure that tax payments made by the public actually reach the government's coffers. It is bad enough that the tax collection agencies are unable to collect the correct amount of taxes. It is even worse when voluntary tax payments are waylaid by tax scams.

Public expenditure management reform

The government has prided itself in pursuing reforms that promote the operational efficiency of government agencies. These initiatives include: (1) procurement reform, (2) the installation of the New Government Accounting System, (3) the establishment of a Medium-term Expenditure Framework (MTEF), (4) the shift towards performance-based budgeting under the Organizational Performance Indicator Framework (OPIF), and (5) the institutionalization of the Sector Effectiveness and Efficiency Review (SEER). These are important reforms and should be sustained.

The passage of Republic Act (RA) 9184 (or the Procurement Act) is laudable and is expected to enhance transparency and public accountability in government procurement. At this point, it is important to continuously monitor its implementation and impact.

On the other hand, progress on the other reforms mentioned above has been rather slow, stymied perhaps by the uncertainty in the government's fiscal situation. For instance, it should be noted that the success of the MTEF is greater when revenues are predictable. Conversely, the MTEF is difficult to implement in an unstable environment precisely because trying to extend the budget horizon when there is severe revenue uncertainty leads to frequent changes in expenditure ceilings which then discredits the MTEF exercise itself (Schiavo-Campo and Tommasi 1999).

On the other hand, the operationalization of both the OPIF and SEER are hampered by the difficulties in defining what "results" for which government agencies should be made accountable. Oftentimes, the confusion centers on the distinction between outputs and outcomes.

In this regard, studies that will help establish the link between outcomes and specific outputs as well as those that will shed light on the relative effectiveness of alternative interventions (i.e., those that establish the link between outcomes and the outputs of alternative interventions) are needed. Also, the determination of standard unit costs should be strengthened. In this way, cost-benefit analysis and/or cost effectiveness analysis can be undertaken to better inform the performance budgeting process.

GOCC reform

Reform in the GOCC sector may include: (1) de-politicization of rate setting (e.g., NPC, MRT/LRT, PNCC, etc.), (2) regulatory reform (e.g., MWSS), (3) divestment of government ownership in activities that are patently private in nature (e.g., commercial banks, television stations).

Other proposals

In addition, other proposals aimed at containing the fiscal deficit have been advanced. These include: (1) reduction of the IRA share of LGUs, and (2) creation of an

Infrastructure Corporation that will leverage funds from the private sector to finance public infrastructure.

On the one hand, the reduction of the LGUs' IRA share is risky for two reasons. First, the Local Government Code provides that such a reduction can only be done if the national government has an "unmanageable fiscal deficit." If the national government admits to this, negative reactions from the market would be forthcoming and may result in higher interest payments for the government. Second, horizontal imbalance characterizes the IRA distribution which means that some LGUs (about half) get more IRA than they need to fund the functions that were devolved to them while other LGUs receive less IRA than they need. An across-the-board cut in the IRA will adversely affect the ability of many LGUs (particularly those with small local tax base) to provide devolved basic services.

On the other hand, the creation of an Infrastructure Corporation is not necessary to encourage private sector participation in the financing of public infrastructure. The BOT law defines such arrangements although some refinements might be in order.⁷ "Corporatization" especially if the new entity is under-capitalized may create moral hazard and result in even larger contingent liabilities.

⁷ This is especially true in reference to the provisions governing the availability of national government debt guarantee to loans of BOT projects and the setting of reasonable rate of return for unsolicited and negotiated projects.

Annex Table 1. New Tax Measures

Tax measure	Revenue Impact (billion PhP)	Remarks
Indexation of excise tax on alcoholic products	4.7	relatively easy to collect; small number of collection points; can be justified on the grounds that consumption impose social costs on rest of economy in the form of add'l health care/ police services
Indexation of excise tax on tobacco products	7.4	
<i>Indexation of excise tax on sin products to 1997 levels</i>	12.1	
<i>Indexation of excise tax on petroleum products</i> (b) 25% increase - P1.10/ P0.40 (a) 50% increase - P2.20 / P0.80 (c) 100% increase - P4.4/ P1.60 (full indexation to 1997 levels) (d) across the board Php 1 per liter	5.3 10.7 21.3 17.0	politically sensitive product; price increase tends to trigger increase in wages and prices of other products; current wave of price increases in int'l market make this reform doubly difficult; question of timing – should gov't wish to impose it, doing so should be timed with softening of prices in world market; may be coupled with rebates to public transport to improve social acceptability; can be justified because of environmental costs (i.e., pollution and congestion) associated with its use
<i>Rationalization of fiscal incentives</i>	14.0 a/	focus on limiting coverage to exports and one or two industry groups; harmonize various tax incentive laws thru tax expd budget
<i>Imposition of excise tax on text messaging</i> (a) 1 centavo (b) 10 centavos (c) 20 centavos	0.9 b/ 9.1 b/ 18.3 b/	sumptuary nature of text messaging unclear; easy to collect; small number of collection points
<i>Imposition of across-the-board import surcharge</i> (a) 1% (b) 2%	8.0 16.0	would not affect relative protection across industries; may be inflationary; may be implemented by administrative action without need of legislation
<i>Increase in VAT rate</i> (a) from 10% to 12% (b) from 10% to 14%	14.9 29.8	may be hard to justify given prevailing evasion at existing tax rate; but may be needed given difficulty in raising revenues from other sources
<i>Reduction in number of VAT- exempt products including petroleum products</i>	4.0 c/	broadens the VAT base; will tend to ease VAT administration; in line with international practice
<i>Use of presumptive income levels for professionals/ traders</i>		broaden tax base to include hard-to-tax groups; make individual tax system more equitable

Con't Annex Table 1.

Tax measure	Revenue Impact (billion PhP)	Remarks
<i>Shift to gross income taxation</i>		not consistent with neutrality of tax system, i.e., one that avoids interfering with resource allocation decision of private sector; does not really reduce venue for tax negotiation between taxpayers and tax examiners
<i>Imposition of tax on windfall profits of telecommunication firms</i>		Is the sector lightly taxed? If not, why penalize a profitable sector
<i>Imposition of franchise tax on telecommunications firms in lieu of the VAT</i>	5.0 d/	frequent tax regime change will not sit well with industry
<i>Increase in motor vehicle tax (or road users tax)</i> (a) 25% increase (b) 50% increase	1.6 3.2	Revenue earmarked for road maintenance; increase partly explained by inflation adjustment
<i>Imposition/ increase in tax on luxury items</i>	0.8 e/	improves progressivity of tax system; may take the form of higher excise tax on automobiles; coverage may be expanded to include other items; is it worth the effort?
<i>Increase in minimum gross receipts for common carriers tax</i>	4.1	levels set in 1976 yet
<i>Reduction in corporate/ individual income tax rate</i>		tricky; not likely to work unless enforcement is significantly improved; reduction in CIT and IIT under CTRP did not yield supply side effects
<i>Grant of tax amnesty</i>		Philippines granted 16 amnesties in last 14 year; results not encouraging; dis-incentive effects on timely payment of correct taxes
<i>Institutionalize performance-driven systems in tax collection agencies</i>		may be linked with creation of autonomous revenue authority but not necessarily; application of lateral attrition
<i>Creation of autonomous revenue authority</i>		experience elsewhere shows mixed result with respect to revenue effect negative revenue impact in first year likely; long-term revenue impact unclear
<i>Increase fees and charges</i>	4.3 f/	

a/ revenue loss from BOI-approved incentives in 2003 (National Tax Research Center)

b/ assumes 200 million text messages sent per day

c/ revenue estimate refers to petroleum products alone

d/ assumes 7% franchise tax

e/ refers to 50% increase in rates but same coverage

f/ assumes 10% increase

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