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## What Covid-19 hath wrought and debt exit options: A note on deficit financing and public debt management

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**What Covid-19 Hath Wrought and Debt Exit Options:  
A Note on Deficit Financing and Public Debt Management**

by

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## **WHAT COVID-19 HATH WROUGHT AND DEBT EXIT OPTIONS: A NOTE ON DEFICIT FINANCING AND PUBLIC DEBT MANAGEMENT**

*BY DANTE B. CANLAS<sup>1</sup>*

### **ABSTRACT**

This paper opens up a study of deficit financing and management of the public debt in the context of the COVID-19 outbreak in the Philippines. Borrowings of the national government from the monetary authority and from domestic and international financial markets, as well as the options for exiting from the public debt enlarged by such borrowings are assessed. At this juncture, public spending to strengthen social safety nets for truly disadvantaged families and firms are imperatives, but taxation that relieves big corporations and shifts to households and small firms the recovery of foregone corporate income taxes through burdensome indirect taxes must be shunned. Meanwhile, growing out of the public debt through sound monetary policy and structural reforms that embrace rise in total factor productivity is the least painful option to exit out of the newly expanded public debt.

*JEL Classification Code: E5, O4*

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# WHAT COVID-19 HATH WROUGHT AND DEBT EXIT OPTIONS: A NOTE ON DEFICIT FINANCING AND PUBLIC DEBT MANAGEMENT

By Dante B. Canlas<sup>1</sup>

## 1. Introduction

The Covid-19 pandemic broke out into the open during the first quarter of 2020. It delivered macroeconomic shocks worldwide that have had immediate and profound impacts adverse to national government budgets and aggregate economic performance. The International Monetary Fund (IMF) in its *World Economic Outlook (WEO) Update* released on June 24, 2020 projects a decline in world gross domestic product (GDP) in real terms of 4.9% in 2020. Most nations have started mounting countercyclical measures to revive their respective economics, causing further ballooning of their budget deficits.

The Philippine government, in response, enacted a law entitled, “*Bayanihan Act to Heal as One*” in April 2020, which gave the President of the Philippines special powers to reallocate and augment funds in the 2019 and 2020 General Appropriations Act (GAA) to public-health programs, activities, and projects (PAPs) geared to fighting the pandemic. In addition, the Act assisted individuals and families that suffered severe setbacks from the public-health crisis with social safety nets, such as, temporary cash transfers and food aid to low-income families, as well as wage subsidies and unemployment benefits to laid-off workers. Congress is still deliberating a follow-up bill called “Accelerated Recovery and Investments Stimulus for the Economy (ARISE).”

The government has for long been piloting social amelioration projects but the PAPs for fighting Covid-19 call for government interventions that go beyond mere pilot projects. In doing so, the financing demands of expanded public-health PAPs and social safety net programs far exceed available government budget funds.

Furthermore, the government ordered total business lockdowns under an enhanced community quarantine (ECQ), particularly, in major urban centers like Metro Manila. The health department expanded testing for the coronavirus. For those who tested positive, quarantine, therapies, and contact tracing were perforce applied. In addition, the government joined international networks spearheaded by the World Health Organization (WHO) engaged in developing vaccines.

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As a result of business lockdowns, real GDP in the first quarter of 2020 declined by 0.2%, according to the Philippine Statistic Authority (PSA). Real GDP growth rate may have declined further in the second quarter as business lockdowns intensified. For the whole year 2020, the IMF in its WEO update forecasts real GDP growth rate to decline 3.6%. The PSA has also released the 2020 Labor Force Survey (LFS) for April; the unemployment rate shot up to 17.7%. These figures suggest that the economy entered a recession in March, following two quarters of consecutive output decline.

Evidently, the lockdowns of businesses and the government declared ECQ of the population in places deemed epicenters of the pandemic have caused sharp falls in economic and business activities. Real product and income have declined sharply. Accordingly, tax and non-tax collections of the government have decreased precipitously.

In consequence, the deficit in the national government budget has increased significantly. The original target deficit-to-GDP ratio of 3.2% in 2020 has been exceeded; the Department of Finance-Bureau of Treasury (DOF-BTr) estimates this ratio to be at least 8.4% for the whole year. When the government borrows to finance the deficit, the public debt grows, with non-neutral effects on the budget. Debt servicing is automatically appropriated in the budget; as debt increases, its servicing crowds out priority spending activities of the government that are discretionary, including items for human resource, such as, education and health, and infrastructure modernization. Moreover, when the government borrows, it absorbs funds that otherwise the private sector can use for investment, thereby hindering economic recovery. As aggregate consumption and investment shrink, so does aggregate output, dampening government revenue collections as a matter of course.

These outcomes have raised concerns about other adverse macroeconomic shocks down the road, such as, high inflation and persistent output declines. Naturally, the question arises: how can the unprecedented size of the budget deficit be financed, and the public debt managed to ensure business survival and economic recovery while the battle against COVID-19 goes on?

This paper has two major objectives: One, it explores the various approaches available to the national government in deficit financing. DOF-BTr can borrow from the BSP or from private financial markets, whether domestically or abroad. In doing so, DOF-BTr is conscious of minimizing further negative macroeconomic impacts from each borrowing option. Two, the paper discusses options that the government can adopt in exiting out of the public debt that has suddenly expanded amid the fight against the pandemic.

Section 2 discusses deficit spending by the government. Section 3 looks at various options the government can pursue to escape sinking deeper into debt. Section 4 concludes.

## **2. Deficit Financing**

Coming from a balanced budget, a deficit emerges if the fiscal authorities, consisting of Congress and the Chief Executive, decide to forego taxes to finance new government spending, consisting generally of public goods and services that promote the public interest.<sup>2</sup> This fiscal decision can emanate from an ideal neoclassical construct of the world, featuring a social planner that seeks the highest possible level of human welfare for society.<sup>3</sup> We adopt this model in organizing our thinking and see how far it can go as a guide to the conduct of fiscal policy. In this ideal world, we assume that the fiscal authorities embrace tax smoothing across time and across states of nature. Tax smoothing avoids weighing down future unrepresented generations with a disproportionate share of the burden of retiring the new debt incurred by the present generation.

Such a view of the world is highly relevant in the context of the Covid-19 pandemic. Some facts are clear at this point: personal and business incomes have both contracted sharply. Many heads of households have been laid off, with hardly any non-work income or wealth that puts food on the table and pays for testing and treatment if the virus responsible for Covid-19 infects a household member. Furthermore, many do not have sufficient insurance coverage, public or private, that pays for health and medical care even if getting sick from the virus is a genuine risk with a good deal of negative spillover effects. The fiscal authorities are thus well advised to adopt tax smoothing, rather than levy new taxes to pay for the expanded public-health measures and social safety nets that have been decreed. In the short run, the fiscal authorities should allow a widening of the budget deficit to be financed by borrowing.

#### *Borrowing by the Fiscal from the Monetary Authority*

To finance the deficit, the Philippine government, through the DOF-BTr, resorts to borrowing, either from the monetary authority, which is the *Bangko Sentral ng Pilipinas* (BSP) with a monopoly over money creation, or from the saving public. Institutions like banks and non-bank financial intermediaries, and corresponding financial and capital markets, have emerged to mediate and facilitate this borrowing and lending process.

DOF-BTr is the agent of the fiscal authorities, the principals; it plans the borrowing mix when there is a deficit to be financed. It coordinates its borrowing program with the BSP, which in 1993 was declared by law as an independent monetary authority.<sup>4</sup> The BSP's independence refers to policy independence from the fiscal authorities, which means the BSP can set monetary policy without seeking approval of the fiscal authorities. The fiscal and the monetary

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<sup>2</sup> The General Appropriations Act (GAA) is the overarching law governing the programs of expenditures and revenues of the national government in a given year; it emanates from the National Expenditure Program (NEP) submitted by the President to Congress on or after a few weeks after a new Congress convenes in the third week of July each year.

<sup>3</sup> There is a large body of literature that uses this model. For a formal model using this construct, see Mirrlees (1971) and Samuelson (1986).

<sup>4</sup> Prior to the enactment of this law, the huge liabilities of the old Central Bank (CB) incurred under misguided monetary policy during the martial-law period had to be written off and transferred to a new entity called CB-Board of Liquidator or CB-BOL. The creation of CB-BOL was deemed a prerequisite to an independent BSP.

authorities, however, must coordinate their respective policies to prevent inflation and excessive indebtedness of the government; currently, this coordination takes place in meetings of BSP's Monetary Board (MB) where the DOF secretary sits as an MB member.

Borrowing from the BSP is equivalent to using the printing press to expand money supply and inject liquidity into the economy. The BSP purchases eligible government securities for an equivalent sum of money, an activity popularly referred to as an open-market operation. The BSP has an open-market operations policy group to oversee this activity. In the context of Covid-19, the BSP used up as a first step some P300 billion to purchase Treasury bills, with maturity period ranging from 30 days to 360 days, payable in six months by DOF-BTr. The latter, however, plans to borrow some more funds by issuing long-term Treasury bonds next, with maturity period exceeding one year. The BSP can decide independently whether it will accommodate further issuance by the DOF-BTr of new Treasury bonds.

It must be noted, however, that there are limits to BTr borrowings from the BSP. The latter is committed to inflation targeting as a monetary policy rule.<sup>5</sup> It cannot lend excessively lest it triggers inflation. Price stability is preferred even during a pandemic so as not to distort further the price system already rendered volatile by disruptions to aggregate demand and supply. Below, we turn to monetary policy designed to ease liquidity constraints with minimal risk of inflation.

In addition to borrowing from the BSP, the BTr also issues Treasury bills and bonds in the domestic financial market. The participants here are institutional investors, such as, commercial banks, including the two government financial institutions (GFIs), namely, the Land Bank of the Philippines (LBP) and the Development Bank of the Philippines (DBP); public pension funds, namely, Government Service Insurance System (GSIS) and the Social Security System (SSS); private hedge and pension funds; and universal banks (unibanks).

The GFIs lend to BTr by holding Treasury bills and bonds that GFIs carry as assets in their balance sheets. Given the wide range of PAPs that the *Bayanihan* has authorized to be augmented, the LBP and DBP can be further sources of financing for some special public PAPs in the Act that are aligned with the lending activities of the GFIs. The LBP, for instance, can expand its lending to small landless farmers and land-reform beneficiaries. The DBP, meanwhile, can expand its lending programs to microenterprises, small and medium-sized enterprises (MSMEs), and to qualified local government units (LGUs).

Similarly, GSIS and SSS, with their investible funds, are institutional participants in the Treasury-bill-and-bond markets. But they can also allocate more funds from their investible funds to PAPs authorized for augmentation by the Act, including financial support, whether in the form of loans or grants to their members undergoing hardships in the labor market. The

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<sup>5</sup> The rule is not pure inflation targeting. The BSP also does monetary-aggregate targeting and to some extent, exchange-rate targeting.

public pension funds can add to the financing of the PAPs of the Department of Labor and Employment (DOLE) eligible for budget support by the Act.

Government borrowings tend to be large while the domestic financial market is relatively thin. To dampen the upward pressure on domestic nominal interest rates exerted by large government borrowings, BTr also borrows from international financial markets in, for example, Tokyo, New York, and London. The BTr calls its debt issuances abroad as either Samurai, Yankee, or Euro bonds, to indicate the currency denominations of Philippine sovereign debt papers. Philippine borrowings in international financial markets are relatively small and do not move the international interest-rate needle. There is, however, a foreign-exchange (FOREX) risk. Moreover, Covid-19 being a pandemic, several countries, developed and developing, are similarly situated; they also need to borrow in global financial markets to finance their expanded public-health and social safety net programs. Once these countries borrow at the same time, the aggregate borrowing puts upward pressure on interest rates in international financial markets. Heavily indebted developing countries struggle in servicing their debts. Some may even default on debt servicing.

Moreover, the government borrows at concessional terms from multilateral and regional institutions. Following the pandemic outbreak, both the World Bank (WB) and the Asian Development Bank (ADB), for example, have opened funding facilities to their client countries for PAPs aimed at battling Covid-19. The Philippines has availed of these facilities, tapping loans for both project and budget support.

At this juncture, the pandemic may persist, and additional government spending for strengthening the public-health system is indicated beyond what the “Bayanihan Act” appropriated. Similarly, the release of the April round results of the Labor Force Survey are very disturbing. The Unemployment rate went up to 17.7%, far worse than what many policymakers projected earlier. For humanitarian reasons alone, food aid and temporary unemployment benefits to the huge number of laid-off workers must be extended.

The national government, however, now faces a severely tight budget constraint. It seeks to avoid the risk of incurring a far bigger deficit-to-GDP ratio than the 8.4% DOF-BTr has projected earlier. A follow-up bill called ARISE has been filed in Congress; the bill seeks to resuscitate an economy in the doldrums and continue many of the social safety net programs stipulated in “Bayanihan.” To avoid further budget and other macroeconomic shocks from ARISE, prioritization, sequencing, and spending cuts are essential. At this point, Congress is reportedly pursuing a three-phased implementation of ARISE.

The Department of Budget and Management (DBM) and the National Economic and Development Authority (NEDA) should identify additional spending cuts that based on these two oversight agencies’ monitoring and evaluation (M&E) of implementing agencies’ (IAs) PAPS are not delivering on their promise. Further spending for slow-moving projects are candidates for termination. Moreover, even infrastructure projects, that breached the annual cash-budget provision of the GAA, should end and the funds reallocated following “Bayanihan.”



Fine tuning ARISE is necessary. Many tasks are involved, including, prioritizing its proposed spending programs for business recovery and social safety nets and implementing these spendings in a phased manner. Identifying candidates for spending cuts and reallocating them to new spendings under ARISE must be a continuing activity of DBM and NEDA.

In short, the current Administration, must adhere to a responsible deficit-reduction program. As it refines and adjusts its target deficit-to-GDP ratio, any deficit reduction must protect society's core values in health, education, and shelter. Since 1986, a succession of Administrations has adhered to this responsible deficit-reduction program. It took a long time, about 27 years, before the country's sovereign debt papers gained investment-grade status in 2013.

Given the high rate of joblessness and depressed wages and incomes of both individuals and firms, whether big or small, a critical factor in resuscitating the economy is the resurgence of household consumption and company investment. New indirect taxes, using value-added taxation (VAT) or excise taxes on specific commodities are ill-advised since they to dampen further consumption and investment spending.

Furthermore, the tax relief being proposed by the DOF and NEDA under Corporate Recovery and Tax Incentives for Corporation (CREATE) is a harmful move. CREATE proposes to accelerate the reduction of the corporate income tax (CIT) rate from 30% to 25% to July 2020, instead of the gradualist approach over 10 years that DOF proposed in an earlier version of CREATE. By its own estimate, DOF foregoes P47 billion of corporate taxes in 2020 from accelerated reduction, and further losses in subsequent years. To recover the foregone corporate income tax collection, the DOF is preparing the imposition of new VAT on digital services and additional excise taxes for sweetened beverages and salty junk food.<sup>6</sup> The proposed tax on digital services specifically is very unfortunate; it comes at a time when the private sector is experimenting with new digital platforms, and the education department is urging schools to institute digital or blended learning in an environment where there are constant threats from Covid-19.

Both taxes are by no means efficient and equitable. There is no guarantee from CREATE that big incorporated enterprises will use their tax relief, given the depressed aggregate demand, in expanding production and recalling laid-off workers. They have other options, such as, declaring income dividends to their investors or repurchasing their own stocks to shore up share values. Meanwhile, indirect commodity taxes are unfair and regressive, the tax burden increasing as income decreases.

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<sup>6</sup> In contrast, Chancellor Angela Merkel and her party allies announced that her government has agreed to reduce VAT in Germany by two percentage points as a fiscal stimulus geared to economic recovery. The German government expects the move to spur consumption and investment.

This seems clear: CREATE and the accompanying indirect taxes being proposed aimed at recovering foregone taxes from accelerated reduction of the CIT worsen income inequality. The latter is a problem in the Philippines that is not yet solved at this point; it's a bad idea to let the income inequality problem take a turn for the worse. The official Gini ratio has ranged between 44% to 46% over the past few decades.<sup>7</sup> Income inequality can lead to social unrest similar to what's happening even in the developed countries nowadays. As everybody knows by now, "an unequal society is corrupt, and a corrupt society is unequal." In an unequal society, market agents that have accumulated sizeable assets use resources at their disposal to transfer wealth, not create new wealth. Exacerbating income inequality is, thus, injurious to growth.

The upshot: CREATE and the companion indirect taxes being proposed by DOF and NEDA will generate huge deadweight losses to the whole economy that need not be incurred by simply junking these proposed tax measures.

### *Further Monetary Policy*

The BSP is the primary agent of the government for ushering in financial stability and a monetary environment conducive to economic growth and development. In this regard, it is responsible for creating sufficient liquidity in the economy. One way for the BSP to achieve this is to calibrate instruments in its toolbox to influence the direction of interest rates. For example, as regulator of banks, the BSP adjusts the minimum reserve requirements (MRR) on deposits of varying maturity. An MRR reduction permits banks to lend a bigger amount of every currency unit deposited with them and keep interest rates low. This expands the money supply. It is noteworthy that even before the outbreak of the pandemic, the BSP had announced that it was going to reduce the MRR over time. In the aftermath of the pandemic, it accelerated reduction of the MRR. Moreover, it reduced the interest rate on reverse repurchase agreements and in its discount window to signal to the banks it regulates its desired downward time path for interest rates in support of economic recovery. Given the expected weakness of the economy in the future, the BSP, moving forward, has announced its commitment to low interest rates and ensure sufficient credit and liquidity.

The business lockdowns are bound to cause financial stress as firm bankruptcies, whether large or small, mount. This is already seen in the difficulties faced, for example, by airlines and tourism-linked enterprises. The share of banks' non-performing loans rises, resulting in an increase in banks' loan-loss reserves. Loanable funds decline and financial intermediation is hindered with adverse effects on growth. Many distressed industries have appealed to the government for financial rescue. In the absence of any legal restriction, the BSP can lend to distressed private companies by purchasing private debt papers including junk bonds, which are debt papers below investment grade. Otherwise, the BSP will need legislation

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<sup>7</sup> The Gini ratio is a statistical construct used to measure inequality in the size distribution of income. Its value ranges between zero and one. Zero means perfect equality while one, perfect inequality. In the Philippines, the PSA releases the official Gini ratio every three years, using figures from the "Family Income and Expenditure Survey (FIES).

to exempt it from legal restrictions to be able to take this path. The BSP, for instance, is proposing to Congress to enact a bill called “Financial Institutions and Strategic Transfers (FIST).” In anticipation of mounting firm bankruptcies and the stress the latter could exert on the balance sheets of banks, the bill, if enacted, will enable banks to transfer their troubled loans to a special-purpose vehicle and permit banks to start lending again. FIST is a laudable move.

At this point, distressed companies are encouraged by the BSP as a first step to open up negotiations with their banks for possible loan restructuring. This is on top of the regulatory relief that the BSP is extending and the low-interest rate extended via its discount and rediscount windows.

Amid the pandemic, we note the vulnerability of banks in the context, for example, of the drastic fall in oil and petroleum product prices. The pandemic has caused the prices of the latter commodities to drop sharply. Oil exploration and production firms are heavily leveraged, at risk of going bankrupt. The associated danger is bank lenders to petroleum companies may go down with the bankrupt borrowers unless the government assists the banks financially.

Bank rescue is an option. For example, the US Federal Reserve Board and the Treasury used this approach to rescue US major banks during the Global Financial Crisis of 2008 through the Emergency Economic Stabilization Act (EESA) of 2008, whose principal provision was the Troubled Asset Relief Program (TARP). The latter allocated USD474 billion for purchasing the toxic assets of large banks. If COVID-19 persists, more firm bankruptcies are expected, which may force the BSP to come up with a financial-rescue package for troubled banks.

Down the road, Covid-19 can bring about serious balance-of-payments difficulties if exports of many countries collapse from disruptions in global supply chains. Many enterprises located in areas under the Philippine Export Zone Authority (PEZA) attest that they have seen drastic fall in their imports of intermediate goods from China. Official foreign reserve assets of banks and the BSP may decline to a critically low level, thereby impeding foreign-trade transactions.<sup>8</sup> In this connection, the BSP may tap swap agreements with other central banks. In Southeast Asia, for instance, the Chiang-Mai Agreement involving swaps of foreign reserves was established in the aftermath of the Asian Financial Crisis of 1997. Efforts have been exerted to multilateralize such swap agreements.

The collapse of multilateral trade is feared in the context of US Pres. Donald Trump’s propensity to wage trade wars, particularly, against China. Moreover, the announcement from WTO Director-General Roberto Acevedo to resign does not inspire confidence in the future of multilateral trade anchored on the most-favored-nation (MFN) principle.

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<sup>8</sup> The BSP reported on June 24, 2020 a marked increase in its official foreign reserve assets. The rise, however, is due to increase in foreign currency deposits of the national government (NG), stemming from foreign borrowings. Such NG deposits are temporary. Once NG spends for their intended purposes, they’re converted into pesos, and held by the BSP for foreign-debt servicing.

If the budget deficit of the national government persists, the borrowings of DOF-BTr to finance the deficit fattens the public debt. Crushing the virus calls for additional spending for testing, tracking, therapies, and vaccines. These new public expenditures are critical to lessen the risk and uncertainty that the pandemic, while it exists, continues to inflict on the economy and its people. This exerts further stress on the government budget. As the deficit further expands, borrowing and debt servicing increases. Since debt servicing is automatically appropriated in the budget-- it is mandatory--it crowds out discretionary spending for education, health, and infrastructure development, to name a few items. Unlimited borrowing even from the BSP is not sustainable since growth is liable to suffer. Managing the public debt is thus of great moment, underpinned by a responsible deficit-reduction program.

### **3. Public-Debt Management**

If the public-health crisis persists and the Philippine government sinks deeper into debt from its growing budget deficit, the concern is how in the future the government can extricate itself from its bigger public debt. We present and assess here at least three options for reducing the public debt: (1) indirect taxes; (2) debt default; and (3) growing out of the debt. Option (3) is recommended.

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#### *Are Indirect Taxes the Answer?*

Many of the programs mandated by “Bayanihan” for budget enhancement are unfunded; deficit financing is inevitable. On May 2, the Chief Executive signed Executive Order (EO) 113 calling for an additional 10% hike in tariffs of imported crude oil and refined petroleum products to help fund the mandated PAPs. Effectively, this is an indirect tax that will be shifted to buyers of the products, such as, jeepney drivers. Higher pump prices are to be expected. The tariff hikes are being justified by the government as timely given the recent sharp fall of crude oil in world markets.

More recently, DOF and NEDA propose to Congress a bill called CREATE to bring about economic recovery from the pandemic. CREATE replaces the Corporate Income Tax and Investment Incentives (CITIRA) bill, which was approved by the House of Representatives (HOR), but still being discussed in the Senate.

CITIRA had been touted earlier by the DOF as the ultimate tax reform, a companion piece to Tax Reform for Acceleration and Inclusion (TRAIN) Act, which was enacted in 2017. TRAIN expanded tax exemption to taxpayers with annual income not exceeding P250,000. To recover the foregone income taxes, TRAIN raised VAT and excise taxes on selected commodities like tobacco, gasoline, and other refined petroleum products.

CITIRA had proposed to reduce the CIT rate from its current rate of 30% to 25% over 10 years. To compensate for the foregone CIT collection, CITIRA seeks a “rationalization” of special tax and investment incentives currently administered by agencies like the Philippine Export

Zone Authority (PEZA). CREATE now proposes to slash the CIT rate (CITR) from 30% to 25% by July 2020 and gives the Chief Executive the power to grant flexible tax incentives subject to recommendation of the Fiscal Incentives and Review Board (FIRB) attached to the DOF. CREATE also proposes as companion measures to recover foregone CIT collections, selective hikes in VAT and indirect taxes: one is a VAT on digital services and the others are excise taxes on sweetened and salty food products.

The upshot: accelerated cut in CIT rate is to be financed by indirect taxes, similar to TRAIN, wherein cuts in personal income tax (PIT) rates have been financed by new indirect taxes. The ultimate concern in taxation is incidence. In other words, who benefit from tax cuts and who are more burdened by tax hikes?

Obviously, big corporations benefit from the tax relief under CREATE. Meanwhile, small unincorporated businesses get no tax relief even if they're hit even harder by the pandemic. Hence, the measure widens the divide between big corporation and unincorporated MSMEs.

Indirect or commodity taxes are generally regressive, that is, the burden increases as income decreases. In short, low-income groups and the poor are burdened more by the new indirect taxes designed to recover foregone income from PIT and CIT rate cuts. For example, a jeepney driver is burdened more by a new excise tax on, say, diesel, than the owner of a Mercedes Benz motor vehicle that is diesel fueled. Indirect taxes fail the equity test.<sup>9</sup>

CREATE and its companion indirect taxes are lamentable. Tax policy is a redistributive policy; it should not comfort the rich while afflicting the poor.

And so in an economic setting with credible threats from Covid-19, new indirect taxes will encounter resistance from families and firms who had suffered drastic cuts in income and have not recovered from their setbacks. The current administration's preference for new taxes to emanate from indirect and excise taxes, which are not equitable, while extending tax cuts to personal and business income of large corporations, must be rejected. These will meet stiff resistance from low-income groups whose share of the burden from indirect and excise taxes is disproportionately large. This option of relying on new indirect taxes to help retire the debt is not promising at all, with humanitarian reasons considered at the very least.

Imposing new indirect taxes does not improve societal welfare. Such outcome dampens incentives for the poor and low-income groups to be productive, thereby hindering economic recovery. The Philippines is likely to slide into a poverty trap instead of moving up and becoming a high middle-income country.

### *Avoiding Debt Defaults*

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<sup>9</sup> There are formal models in different settings that deliver similar conclusions; see, for example, Emran and Stiglitz 2005; and Fleurbaey, 2006.

To be forthright, the Philippines must avoid defaulting on debt servicing. The costs of a debt default are staggering. There are lessons from the 1983 foreign-debt crisis that should not be forgotten.

The Philippines and many other countries, rich and poor alike, are finding themselves falling deeper into debt amid the pandemic. Once these countries borrow at the same time in global financial markets, interest rates rise worldwide. If that happens, heavily indebted countries will find it difficult to service their debts. Debt default becomes an option. The Philippines went through a default in 1983 and found out how wrenching this option was down the road.

The Philippines went into huge deficit financing after the oil-price shocks of the latter half of the 1970s as a countercyclical measure. It borrowed heavily from the big money banks in the US that had amassed exceedingly large deposits of petrodollars. Mexico and Argentina did the same. Interest rates, however, rose worldwide in 1981 following the disinflationary measures of Paul Volcker, then chair of the US Federal Reserve Board. Mexico defaulted on its debts in 1981; Argentina in 1982, and the Philippines in 1983. Argentina defaulted recently, again on account of the government's failure to institute fiscal discipline.

Negotiations with the club of creditors, both private and official, involved discussions on many parameters, including the size of interest-rate cuts, the debt portion that qualifies for relief or forgiveness, and the austerity measures to be undertaken by the client country. In any event, it took a long time before Philippine negotiations were finalized. In the meantime, growth suffered with decreases in living standards. The decade of the Eighties was thus considered a lost decade for the Philippines because of debt default. The country should definitely not take that path again.

### *Growing out of the debt*

New indirect taxes and debt defaults are ill-advised and must be avoided, leaving the least painful option in terms of preserving and eventually raising social welfare, which is to grow out of the debt.

If we embrace the neoclassical construct of the world and adopt the principle of tax smoothing across generations and across states of nature, then we can focus primarily on the appropriate structure of government securities and explore the feasibility of growing and exiting out of a large public debt using government financial instruments.

The basic notion in this construct is for national income to grow at a rate that offsets the interest rate and the inflation rate. An understanding of the factors critical to growth is indicated. The BSP plays a pivotal role in this regard.

The BSP has committed, among other measures, to a continuation of reducing the MRR and the interest rate it charges when banks borrow from it, either through overnight

repurchase or the use of its discount and rediscount windows. It is also committed to inflation targeting as a monetary-policy rule. If the BSP succeeds in keeping interest and inflation rates low, growing-out-of-the-debt approach is likely to succeed. The BSP, however, cannot go it alone. It needs complementary measures from the fiscal authorities.

One is prudent use of the budget. Wasteful spending must not be tolerated. A responsible deficit-reduction program must continue to engage government. The factors that contribute to growth are well understood. Public spending must complement private production. The aim is to raise the productivity in use of all factors of production (e.g., varying grades of labor and vintages of capital); this is what economists refer to as total factor productivity (TFP), alternatively, technological progress. In aid of the latter, it is vital to protect public investments at all levels of education. And seeing how a pandemic can derail an economy, additional spending in strengthening the public-health system must definitely be a part of the future agenda of government. The Philippines must always be conscious and watchful of the risk of falling into a poverty trap and avoiding slippage.

There is also a growing realization that inequality is harmful to growth. Public spending must endeavor to focus its tax and spending policies to benefiting the poor. In the ongoing pandemic, not paying attention to the health, education, and housing needs of the poor has exposed the many negative spillover effects of a pandemic on all families, including the rich, and how the entire economy is pulled down.

There is now a large body of knowledge on how countries can escape poverty traps (see, for example, Azariadis and Stachurski, 2005). Design of policies and institutions are essential. For one, it is important to have a credible legal and judicial system committed to the rule of law, contractual enforcement, and timely adjudication of contractual disputes that arise. At the same time, there must be military and police forces with integrity that are committed to the constitutional provisions on protecting the country from any foreign aggressor and maintaining internal security.

In further support of growth, the government must continue to rely on a market system guided by a decentralized price system to direct resources to their most valued uses. But the government stands ready to regulate industries wherein competition by several small firms is not viable, such as, in water, power, and telecommunication. The economy gets more output growth in the aggregate this way: market reliance and sound regulation in cases where market results are distorted. And when there are market failures, the government steps in to provide public goods through tax-and-spending schemes. In short, market reliance and good governance go together to produce growth.

The government must know by now the importance of having a strong social safety net program. Congress has just seen how difficult to scramble in an ad hoc manner for social safety nets in the context of Covid-19. The government must assess which of the PAPs in Bayanihan are effective in addressing inequality and poverty problems and find out which ones deserve to be instituted. Food aid to food-poor families whose incomes cannot even support a minimum

recommended diet and unemployment insurance to laid-off workers are seemingly good candidates.

#### 4. Concluding Remarks

The pandemic is wreaking havoc on the fiscal position of the government and on the aggregate performance of the economy. Government spending on PAPs mandated by “Bayanihan” results in huge deficit financing, causing an expansion of the public debt. More government funds are needed as the government tries to end business lockdowns and rescue the economy from a depression.

Imposition of new indirect taxes is inequitable. They do not improve social welfare and risk trapping many low-income households in poverty, without income to support spending of USD 2.00 each day. Economic recovery will not be achieved. CREATE, along with its companion indirect taxes, is tax relief for the rich incorporated enterprises and must be avoided in order not to worsen income inequality.

Debt default is a path the government should avoid. The Philippines experienced the difficulties of defaulting in 1983. It took at least a decade to get back on a high growth path and additional years to get investment-grade status for the country’s sovereign debt. Fiscal discipline is vital moving forward. Wasteful government spending must be shunned.

The least painful option is to grow out of the debt. Both sound stabilization policies (high output growth, low inflation and interest rates) and structural policy reforms for long-run growth are essential. Underlying long-run growth is TFP or technological progress. Further accumulation of human capital, consisting of investments in health and education, is essential.

Finally, ARISE with strong social safety nets must be enacted. In line with responsible deficit reduction and sound public-debt management, it needs some refinements and fine tuning.

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