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Financing the MDGs and Inclusive Growth in the Time of Fiscal Consolidation

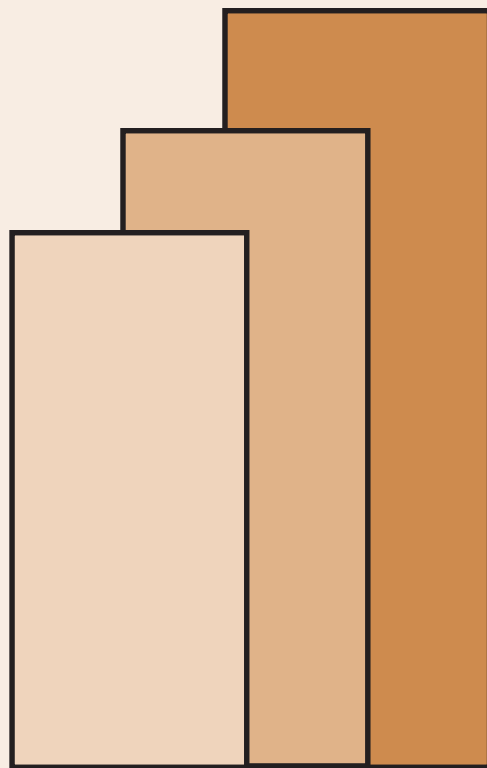
Rosario G. Manasan

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**FINANCING THE MDGs AND INCLUSIVE
GROWTH IN THE TIME OF FISCAL
CONSOLIDATION**

PIDS Discussion Paper No. 2010-34

Rosario G. Manasan

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ABSTRACT

Rosario G. Manasan

The progress made by the national government in consolidating its fiscal position between 2002 and 2006 proved unsustainable as its revenue effort started to go down once again in 2007 after a brief improvement in 2005-2007. With the more expansionary stance taken by the government in 2009 as part of its effort to shield the economy from the effects of the global financial and economic crisis of 2008/9, the national government fiscal deficit jumped to 3.9% of GDP in 2009 and national government debt started to rise when measured relative to GDP.

Clearly, turning around the national government's fiscal health should be high on the policy agenda. In previous episodes of fiscal consolidation, the easiest way to address the fiscal imbalance is by cutting expenditures. However, this option does not appear to be consistent with the government's avowed commitment to achieving the Millennium Development Goals and inclusive growth. After estimating the budgetary requirements of achieving the MDGs and inclusive growth, this paper shows that national government revenues need to increase from 14.3% of GDP in 2009-2010 to 17.5%-17.9% in 2012-2016 if fiscal consolidation were to be achieved while providing the fiscal space for the much needed basic social services and infrastructure.

The Aquino administration has repeatedly said that the much needed revenue increases will be derived solely from improvements in tax administration rather than from the imposition of new taxes or increases in the rate of imposition of existing taxes. The record of the BIR and BOC in increasing their revenue effort through improvements in tax administration does not inspire optimism, however. This study also cautions that tax administration improvements do not happen overnight primarily because the installation and operationalization of system-wide changes take time. Thus, it argues that there is a need for government to consider the imposition of new tax measures if fiscal consolidation is to be achieved without sacrificing the financing of MDGs and inclusive growth. The least distortionary options in this regard include: (i) the restructuring of excise tax on sin products, (ii) the rationalization of fiscal incentives, and (iii) reforming the road user charge. In addition, the government should also consider the simplification of tax structure by reducing the number of rates at which various taxes are levied or by reducing the number of taxpayers/ transactions/ types of income which are exempt from any given tax.

Key words: *fiscal consolidation, fiscal sustainability, inclusive growth, Millennium Development Goals, tax effort, tax gap, zero-based budgeting*

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**FINANCING THE MDGs AND INCLUSIVE GROWTH IN THE TIME OF
FISCAL CONSOLIDATION**

Rosario G. Manasan

1. INTRODUCTION

The national government achieved significant progress in consolidating its fiscal position between 2002 and 2006. However, these gains started to unravel in 2009 as the government pursued a more expansionary expenditure policy in response to the global financial crisis of 2008 and the ensuing recession in the more developed economies even as overall revenue effort contracted. Thus, not only did the national government incur a primary deficit in 2009, total national government debt also started to rise in 2008-2009.

The need for fiscal consolidation now is undeniable. However, while many countries around the world have the option to unwind their fiscal stimulus package by reducing government spending, this pathway towards improved fiscal health is not available to the Philippines at present. The restrictive spending program that the government implemented in 2002-2006 in order to help address the fiscal imbalance in those years has led to underspending on basic social services and the infrastructure sectors.

Low levels of government spending on basic education and health services and the concomitant service deficits in these sectors have put at risk the country's attainment of the Millennium Development Goals (MDGs). As such, the need to increase government spending on basic education and health is important not only because of the direct link between government spending levels and the achievement of the targets in education and health but also because of the positive impact of government spending in these sectors on the elasticity of poverty reduction with respect to economic growth (Habito 2009).

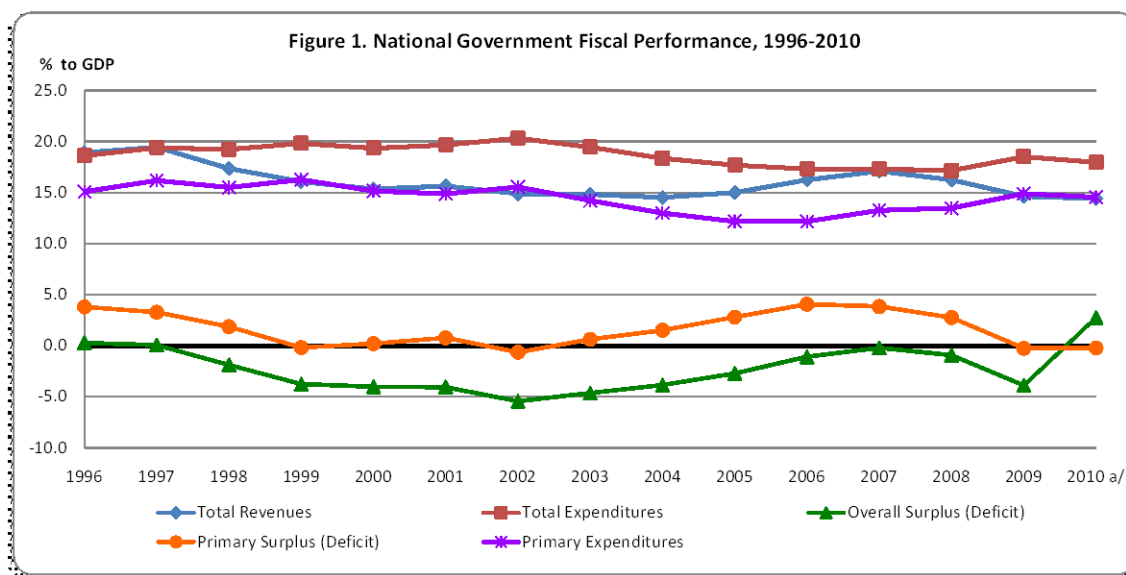
On the other hand, the lack and poor quality of infrastructure, particularly in the roads/transport and power sectors, hold back economic growth by raising the cost of doing business and, thereby, inhibiting domestic and foreign private sector investment. In turn, economic growth has been found to be an important determinant of poverty reduction (Balisacan and Pernia 2002). At the same time, the inadequacy of infrastructure overall tends to make access to education and health services inequitable, thus hampering the poor's capacity to fully benefit from the economic opportunities that comes from economic growth. Moreover, government spending on social protection programs is not only small but the coverage of most of these programs is low.

Thus, the greatest challenge in the fiscal arena today is how to reduce the fiscal deficit while providing adequate budgetary support for the much needed basic social services and infrastructure that are critical for economic growth and poverty reduction. This

means that the challenge to increase revenues is double daunting. There is an urgent need to increase government revenues so as to achieve fiscal consolidation in the medium term, otherwise public debt levels and debt service will rise again and a vicious cycle of high fiscal deficits and expanding debt levels will be set in motion. At the same time, there is a need to increase the government's revenue effort even further in order to sustain, if not increase, current spending levels on MDG-related interventions and infrastructure.

2. OVERVIEW OF RECENT FISCAL PERFORMANCE

Following the Asian financial crisis of 1997/1998, the national government fiscal position deteriorated quite rapidly and continuously, from a small surplus in 1997 to deficits of 1.9% of gross domestic product (GDP) in 1998, 4.0% in 2000 and 2001 and 5.4% in 2002, essentially because of a concomitant decline in the overall revenue effort of the national government (**Figure 1**). Subsequently, the national government successfully managed to turn around its fiscal position, from 4.6% of GDP in 2003 to 1.1% in 2006 and 0.2% in 2007.



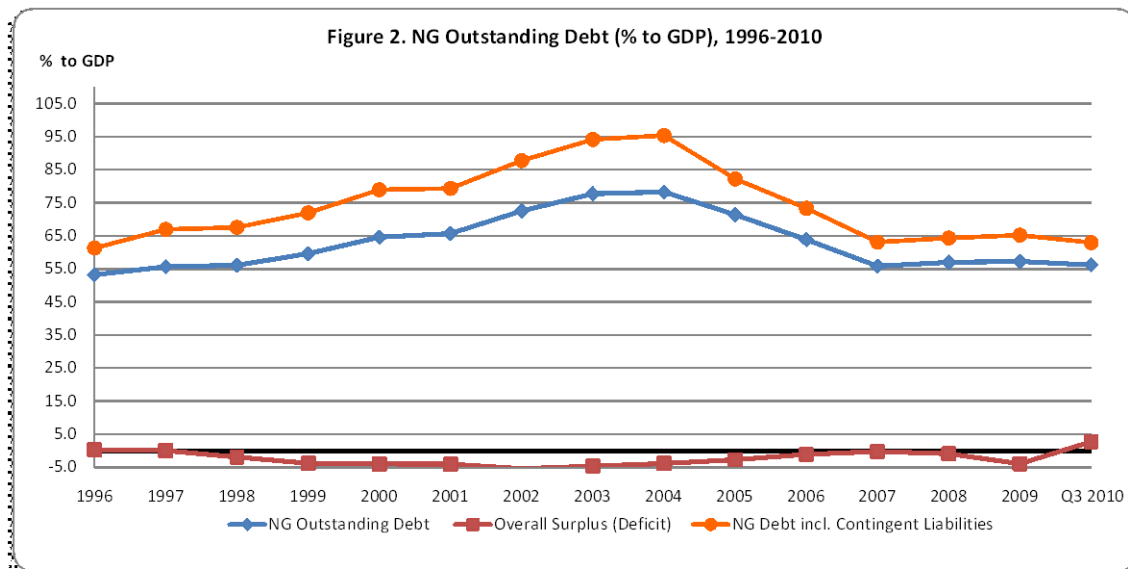
a/ 2010 is estimated based on Jan-Nov data
Source of basic data: Bureau of Treasury

As a result of the fiscal consolidation achieved in 2002-2007, national government outstanding debt contracted from 78.2% of GDP in 2004 to 55.8% in 2007 (**Figure 2**). If contingent liabilities are included, national government debt went down from 95.4% of GDP in 2004 to 63.1% in 2007.

About two-thirds of the reduction in the fiscal deficit during this period was due to expenditure compression as national government expenditures went down from 20.2% of GDP in 2002 to 17.3% in 2006 and 2007 (**Figure 1**) and national government expenditures net of interest payments contracted from 15.5% of GDP in 2002 to 12.2% in 2006. On the other hand, the other third of the reduction in the fiscal deficit in 2002-

2006 was attributable to the rise in tax effort from 13.1% of GDP in 2002 to 14.3% in 2006.

The increase in tax effort was due to the enactment of new tax measures in late 2004 and in the first half of 2005. Republic Act (RA) No. 9334, which amended excise tax rates on sin products was legislated in late 2004 and took effect in January 2005. Meanwhile, Republic Act No. 9337, otherwise known as the Reformed VAT Law, was legislated in the first half of 2005 and took effect in the last quarter of that year. RA 9337 expanded the coverage of the VAT and provided for a temporary increase in the corporate tax rate from 32% to 35%¹ and increases in the gross receipts tax (on royalties, rentals of property, real or personal, profits from exchange and all other items treated as gross income) of banks and non-bank financial intermediaries from 5% to 7%. In addition, as provided under RA 9337, the President authorized the increase in the VAT rate from 10% to 12% in January 2006.



The improvement in tax effort was very short-lived, lasting between 2004 and 2006 only. Thus, the tax-to-GDP ratio slipped persistently from 14.3% of GDP in 2006 to 12.8% in 2009. Furthermore, total revenue effort of the national government, likewise, decreased in 2007 when privatization proceeds are netted out. At the same time, while total national government spending continued to decline in 2005-2008 when measured relative to GDP, primarily due to the downward movement in interest payments, it expanded from 17.2% of GDP in 2008 to 18.5% in 2009 on account of the expansionary fiscal stance that government took in response to the 2008 global financial and economic crisis.

Consequently, the fiscal deficit surged from 0.2% of GDP in 2007 and 0.9% in 2008 to 3.9% in 2009. Even more worrisome, the national government incurred a small primary deficit in 2009, indicating that government had to borrow in order to finance its interest

¹ The reformed VAT law provides that the corporate income tax rate will subsequently be reduced to 30% starting in 2009.

payments. As a result, outstanding debt of the national government started to rise again from 55.8% of GDP in 2007, reaching 57.2% of GDP in 2009 (**Figure 2**). If contingent liabilities were included, total outstanding debt went up from 63.1% of GDP in 2007 to 65.2% in 2009.

3. FINANCING THE REQUIREMENTS FOR ACHIEVING THE MDGs AND INCLUSIVE GROWTH

The improvement in the national government's fiscal position, particularly in 2002–2005, was largely due to expenditure constriction. Moreover, since debt service levels were rigid and remained at fairly high levels, the expenditure adjustment came at the expense of productive expenditures.

On an obligation basis, the ratio of national government spending to GDP was fairly stable at 19%–20% of GDP in 1990–2000. This ratio exhibited a well-defined downtrend starting in 2001, reaching a low of 17.3% in 2006 as the national government doggedly pursued its goal to balance the budget even before progress had been achieved on the revenue side (**Table 1**). At the same time, a high debt stock at the beginning of the period coupled with large fiscal deficits in 1997–2004 led to a rise in debt service from 3.2% of GDP in 1997 to 5.5% of GDP in 2005. Consequently, total national government expenditures net of debt service contracted from 17.1% of GDP in 1997 to 11.9% of GDP in 2005. Also, national government expenditures on the social service sectors went down from a high of 5.5% of GDP in 1998 to 3.2% in 2005 and 2006. Meanwhile national government expenditures on the economic services sectors contracted from 4.5% of GDP in 1997 to 2.2% in 2005. With the improvement in tax effort in 2005–2006 and the reduction in debt services that resulted from the gradual reduction in the fiscal deficit in 2002–2006, total national government expenditures net of debt service as well as national government spending on the social services sectors and the economic services sectors recovered somewhat in 2007 and 2008. On the other hand, government took an expansionary expenditure stance in 2009 amid concerns about the economic slowdown in the developed countries.

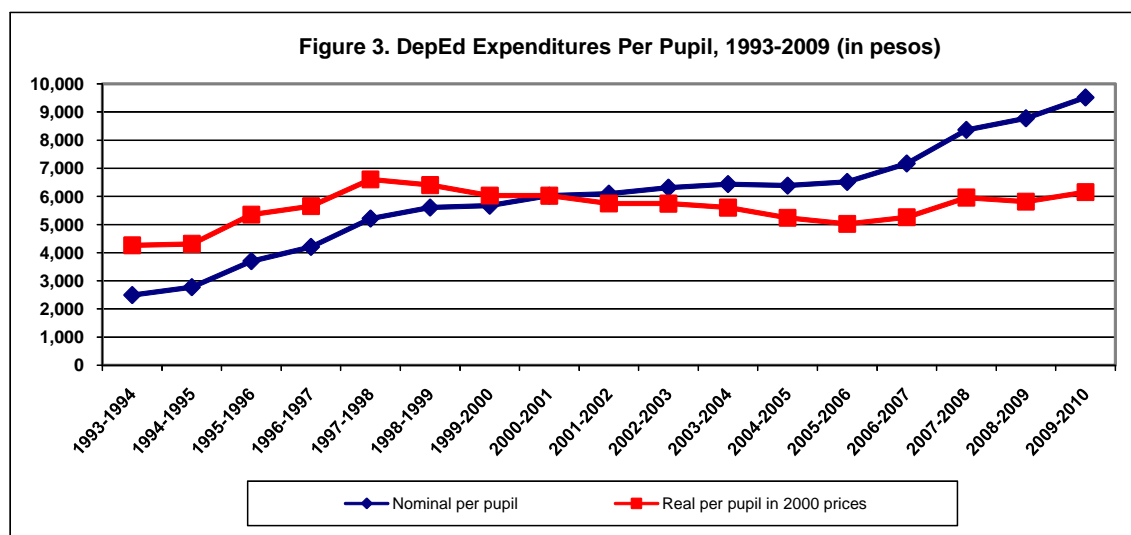
Education. Fiscal pressures initially arising from the decline in national government revenues following the Asian financial crisis led to the continuous contraction of the Department of Education's (DepEd's) budget in 1999–2006 to a low of 2.0% of GDP in 2006 (**Table 1**). With the easing of the fiscal situation in 2006–2008, some increase in the DepEd budget was registered in 2007–2009 but said increase was not enough to bring the Department's budget back to its 1998 level.

Table 1. National Government Expenditures (Obligation Basis) as a Percent of GDP, 1995-2011

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 prelim	2011 proposed
Total NG expenditures	19.5	19.2	20.3	20.2	19.5	20.3	19.5	19.1	19.1	17.8	17.4	17.3	17.4	17.7	18.7	18.1	17.8
Total economic services of w/c infrastructure	4.4	3.9	4.5	3.8	3.6	3.8	3.2	2.6	2.7	2.5	2.2	2.7	3.4	3.8	4.0	3.0	2.4
	2.7	2.2	2.5	2.4	2.3	2.4	2.0	1.5	1.6	1.6	1.2	1.7	2.1	2.2	2.6	1.9	1.6
Social services	4.4	4.9	5.4	5.5	5.2	5.0	4.5	4.4	3.9	3.5	3.2	3.2	3.4	3.4	3.6	3.9	4.2
of which:																	
Education	3.2	3.4	3.9	4.0	3.7	3.5	3.4	3.3	3.1	2.7	2.5	2.5	2.6	2.5	2.8	3.0	3.1
of w/c DepEd	2.7	2.8	3.2	3.2	3.0	2.9	2.8	2.7	2.5	2.2	2.0	2.0	2.2	2.1	2.3	2.5	2.7
Health	0.4	0.5	0.6	0.5	0.5	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.5	0.4
of w/c DOH	0.4	0.4	0.5	0.4	0.4	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.4
National defense	1.3	1.2	1.2	1.2	1.1	1.1	1.0	1.0	1.3	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.2
Public administration	1.5	1.6	1.6	1.6	1.2	1.3	1.3	1.2	1.1	1.0	1.3	1.1	1.2	1.4	1.4	1.2	0.9
Peace & order	1.2	1.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.3	1.2	1.3	1.3	1.3	1.4	1.4	1.4
Debt service	3.8	3.5	3.2	3.7	3.6	4.2	4.8	4.8	5.2	5.4	5.5	5.1	4.0	3.7	3.6	3.2	3.9
Others	2.9	2.7	2.9	3.0	3.4	3.6	3.3	3.6	3.5	3.0	2.9	2.8	3.0	3.1	3.4	4.1	3.9
Total NG expd net of debt service	15.7	15.6	17.1	16.4	15.9	16.1	14.7	14.3	13.9	12.4	11.9	12.2	13.4	14.1	15.0	14.8	13.9

Author's estimates based on data from the BESF (various years)

As a result of the contraction in the DepEd budget between 1998 and 2006 and the rapid growth in public school enrollment during these years, real per pupil spending of the Department in 2000 prices went down from PhP 6,601 in 1997 to PhP 5,022 in 2005 (**Figure 3**). With the greater fiscal space in 2006-2009, the national government accorded higher priority to the basic education sector and real per pupil spending recovered partially to PhP 6,154 in 2009.



Author's estimate based on BESF, various years

Consequently, large input deficit persists in public schools (**Table 2**).² As of the end of SY 2010-2011, the teacher shortage³ in public elementary and secondary schools is estimated to be 75,751 while the classroom shortage is pegged at 120,952. At the same time, the shortage in schools seats is estimated to be 2.2 million at the elementary schools and 1.0 million at the secondary level. Public schools are also short of toilets – 84,883 at the elementary level and 51,734 at the secondary level. Close to 23,500 pure monograde elementary schools do not have a computer laboratory in SY 2009-2010. On the other hand, 2,635 public secondary schools do not have a science laboratory and 1,936 do not have a computer laboratory.

² The input deficits are estimated by grade level per school and aggregated up to the national level. The input deficits are estimated relative to minimum service standards set by the DepEd. The teacher and classroom deficits are estimated assuming single shift and a maximum class size of 45 pupils. Furthermore, the teacher deficit is estimated by providing for teacher specialization in Years I-IV with a teacher specialization adjustment factor of 5/3. On the other hand, it is assumed that every public elementary school should have one computer laboratory while every public secondary school should have one science laboratory and one computer laboratory. Meanwhile, the textbook requirement per pupil is 4 in Grades 1 and 2, 7 in Grades 3-6 and 5 in Years I-IV.

³ The estimate given here assumes the redeployment of excess teachers in schools which have more teachers than they need to teacher-deficit schools.

Table 2. Input Deficits in Public Elementary and Secondary Schools as of the End of SY 2010-2011

	Elementary	Secondary	Total
Teachers	8,723	67,028	75,751
Classrooms	78,523	42,429	120,952
Seats	2,215,640	963,549	3,179,189
Toilets	84,883	51,734	136,617
Computer labs	23,489	1,936	25,425
Science labs		2,635	2,635

Author's estimate based on BEIS SY 2009-2010 and projected enrollment for SY 2010-2011

The funding constraint and the concomitant input deficits in the public school system had an adverse impact on basic education outcomes. The net participation rate at the elementary and secondary level for all public and private schools combined deteriorated persistently between 2000 and 2006 (**Table 3**). On the other hand, the cohort survival rates for both the elementary and secondary levels are erratic during the same period. Although small improvements were posted in 2007 and 2008, the Education for All (EFA) targets⁴ of attaining 95% and 80% participation rates at the elementary and secondary levels and 90% cohort survival rates at both levels by 2015 do not appear to be attainable under a “business as usual” scenario.

Table 3. Basic education outcomes, 1990-2008

	1990	2000	2002	2003	2004	2005	2006	2007	2008	2015 target
Elementary level participation rate	84.6	92.7	90.7	89.3	87.1	84.4	83.2	84.8	85.1	95
Secondary level participation rate	54.7	62.3	59.5	60.9	60.0	58.5	58.6	60.3	60.7	80
Elementary level cohort survival rate a/	69.7	69.3	70.2	69.3	69.6	70.2	68.5	68.5	69.3	90
Secondary level cohort survival rate a/	76.4	71.0	71.7	75.7	76.3	73.5	74.3	71.4	74.8	90

a/ estimated based on public & private schools enrollment data

On the other hand, while some gains in student performance in achievement tests have been made at the elementary level in 2003-2008 (**Table 4**), only 36% of pupils in public elementary schools who took the National Achievement Test (NAT) in 2008 exhibited mastery of the required competencies (i.e., obtained mean percentage scores [MPS] better than 74%). Meanwhile, student achievement scores at the secondary level have largely remained unchanged in 2005-2008. Moreover, only 4% of students in public secondary schools who took the NAT in 2008 exhibited mastery of the required competencies.

To support the achievement of the MDGs, the present leadership of the DepEd under the Aquino administration announced that it will close the input gaps in 2011-12. This move is in consonance with the results of earlier studies (e.g., Orbeta 2005 and Orbeta 2010) which indicate that improving the teacher-to-pupil ratio, the classroom-to-pupil ratio and the seat-to-pupil ratio is likely to improve not only school attendance but also quality of education as measured by student achievement scores.

⁴ The MDG targets for basic education are higher than the EFA targets. To wit, the MDG calls for universal primary education (i.e., 100% net participation rate and 100% cohort survival rate) at the elementary level by 2015.

Table 4. Student Achievement Indicators, 2001-2008

Indicator	Level	Actual					Targets		
		SY 01-02	SY 05-06	SY 06-07	SY 07-08	SY 08-09	Original		
							SY 09-10	SY 10-11	SY 15-16
G1 Readiness	Pre		36%	35%	40%	37%	no data avail.		
	Post		80%	68%	69%	69%			
G3 Reading	English		50%	60%	65%	59%	82	85	
	Filipino		48%	47%	49%	55%	83	85	
NAT (MPS)	Elem.	50%	55%	60%	65%	66%	70	75	85
	Sec.	47%	47%	47%	49%	47%	53	58	75
No. of Learners with MPS of 75 and Above	G6		210,811	365,468	510,151	588,845			
	G6, N		1,501,326	1,609,728	1,644,638	1,656,418			
	% share		14%	23%	31%	36%			
	Y2		67,396	82,270	109,331	41,297			
	Y2, N		948,971	1,245,707	1,183,871	1,171,283			
	% share		7%	7%	9%	4%			

Source: DepEd

However, the 2011 budget of the Department is sufficient to cover about 15% of the estimated existing teacher and classroom shortages only despite the 20% increase in its budgetary allocation. This essentially means that the bulk of the outstanding input gaps will have to be addressed in 2012.

The resource and budget requirements of achieving the EFA targets in basic education is presented in **Table 5**. It shows that the government allocation for basic education should initially increase from 2.3% of GDP in 2009, 2.5% of GDP in 2010 and 2.7% in 2011 to 3.8% of GDP in 2012 before tapering down to an average of 2.7% of GDP in 2013-2016. The estimates of the budget requirement shown in **Table 5** include the cost of additional teachers, classrooms, seats, textbooks and toilets needed to address the existing input deficits and to provide for the requirements of additional enrollment implied by the EFA/ MDG targets.

In addition, the estimates of the budget requirement include the cost of expanding the pre-school program of the DepEd. The large percentage⁵ of school leavers among children aged 6-11 years who appear to lack the readiness to go to school suggests that strengthening early childhood education, including the pre-school program, will likely help in increasing the retention rate.

⁵ Based on the 2007 Annual Poverty Indicator Survey, 34% of children aged 6-11 report they are not in school because they are too young to go to school.

The estimates of the budget requirement include higher allocation for school-level Maintenance and Other Operating Expenditures (MOOE) to provide the financial backing to school-based management (SBM). It is notable that the experience from earlier interventions (e.g., TEEP, SEDIP and BEAM) indicates that SBM contribute to the improving participation rates and student performance.

Table 5. Required resources to achieve the MDG targets in basic education, 2012-2016 a/

	2012	2013	2014	2015	2016
New teacher items b/	124,082	33,397	37,237	40,571	37,197
Classroom construction b/	153,789	26,094	27,790	30,131	26,717
School seats b/	4,656,811	1,174,162	1,250,530	1,355,843	1,202,247
Textbooks b/	23,298,016	23,448,341	23,664,923	23,968,017	50,945,585
Total budget requirement in million pesos	381,558	307,930	325,489	340,769	354,530
% to GDP	3.8	2.8	2.8	2.7	2.6
of w/c:					
Budget requirement for Kinder c/	14,334	17,557	15,494	13,557	12,725
ES enrollment in million	14.8	15.4	16.1	16.7	17.2
% increase	5.9	4.6	4.0	4.1	3.0
SS enrollment in million	6.1	6.6	7.2	7.9	8.6
% increase	6.1	8.1	9.7	9.8	9.0
ES & SS enrollment (in mill)	20.8	22.0	23.2	24.6	25.8

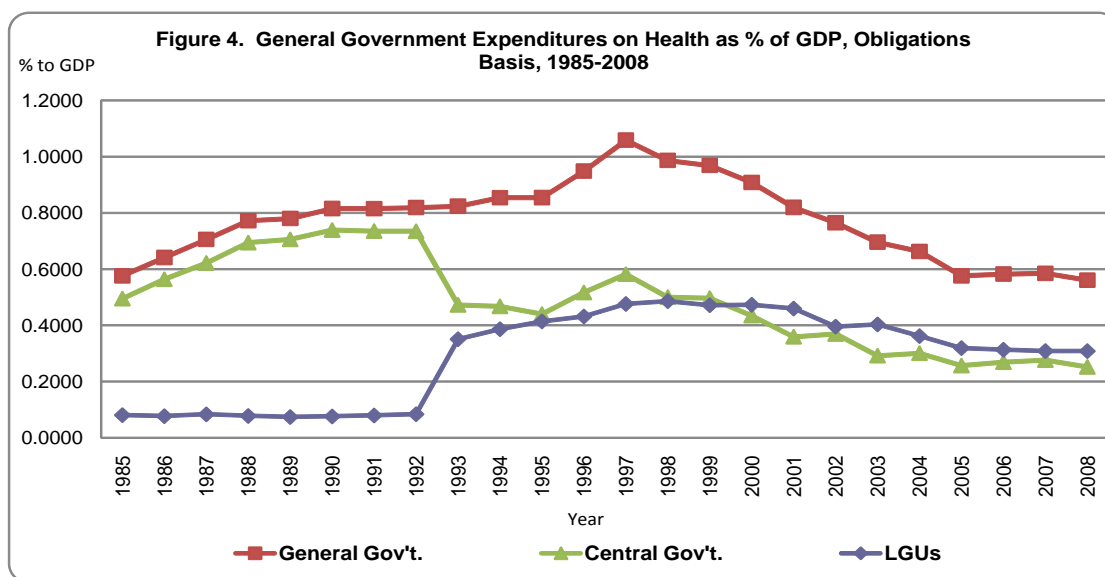
a/ assumes redeployment of excess teachers in schools with too many teachers

b/ these figures refer to the requirements of the elementary and secondary levels only

c/ 15,808 and 16,021 additional teachers are needed for kinder in SY 2012-2013 and SY 2013-2014, respectively, and 12,522 and 12,735 classrooms are needed for kinder in SY 2012-2013 and SY 2013-2014, respectively

Author's estimates

Health. Because of the tight fiscal situation in the country in 1998-2005, national government spending on health deteriorated consistently from 0.6% of GDP in 1998 to 0.3% of GDP in 2006- 2009 (**Table 1**). The share of local government units (LGUs) in general government spending on the health sector became larger than that of national government (NG) starting in 2000, following the more severe contraction in NG health spending between 1997 and 2005. However, LGU spending on health services also declined during the period but to a lesser extent than that of the national government. Thus, general government spending on health deteriorated consistently from 1.06% of GDP in 1997 to 0.58% of GDP in 2006- 2008 (**Figure 4**).



Author's estimates based BESF for central government spending and Annual Financial Report for LGUs, Commission on Audit, various years

Moreover, the high and unmitigated pace of population growth exerts more pressure on the budget. Consequently, the reduction in government health spending is even more pronounced when it is adjusted for inflation and population growth. Thus, national government (NG) health spending in real per capita terms went down by 6.4% yearly on the average from PhP 208 in 1998 to PhP 127 in 2005 (**Table 6**). In comparison, real per capita aggregate LGU health spending went down by 3.4% yearly on the average from PhP 202 in 1998 to PhP 158 in 2005. While some recovery in government health spending was posted in 2006-2008, the level of general government spending in 2008 is still 25% below the peak level in 1998.

Table 6. Real Per Capita Health Expenditure of Government Expenditures, 1998-2008 (in 2000 prices)

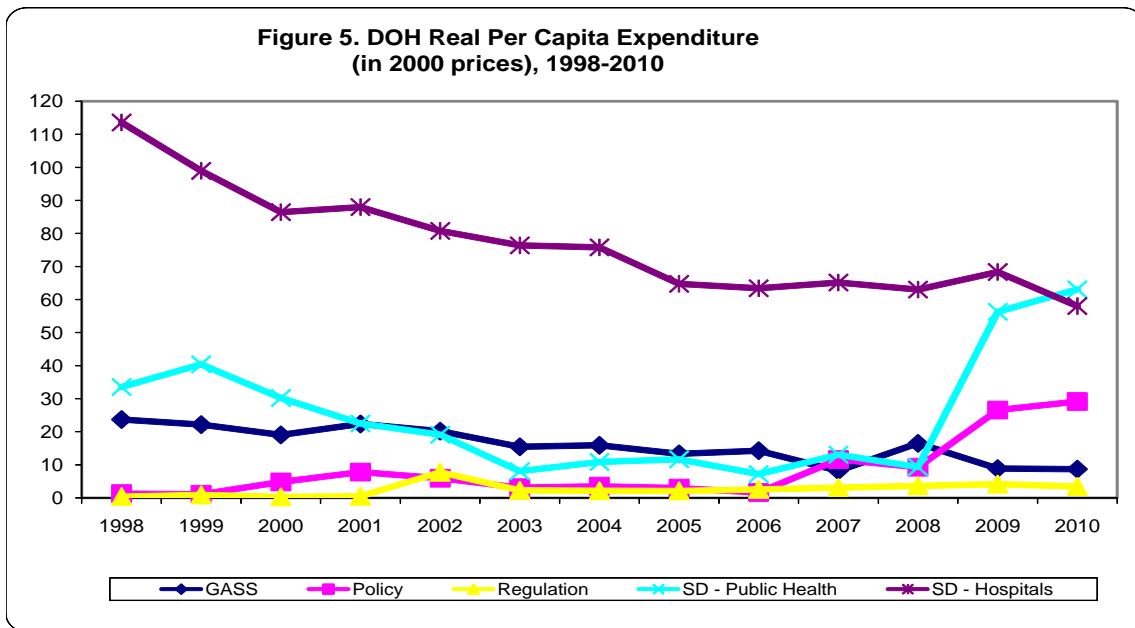
	NG	LGU	Gen Govt
1998	208	202	409
1999	210	199	409
2000	190	208	398
2001	157	201	358
2002	163	175	339
2003	135	186	321
2004	144	174	319
2005	127	158	285
2006	137	160	297
2007	148	165	313
2008	137	168	305

Author's estimates based on BESF (various years) for NG spending and COA LGU AFR (various years) and BLGF SIE (various years) for LGU spending

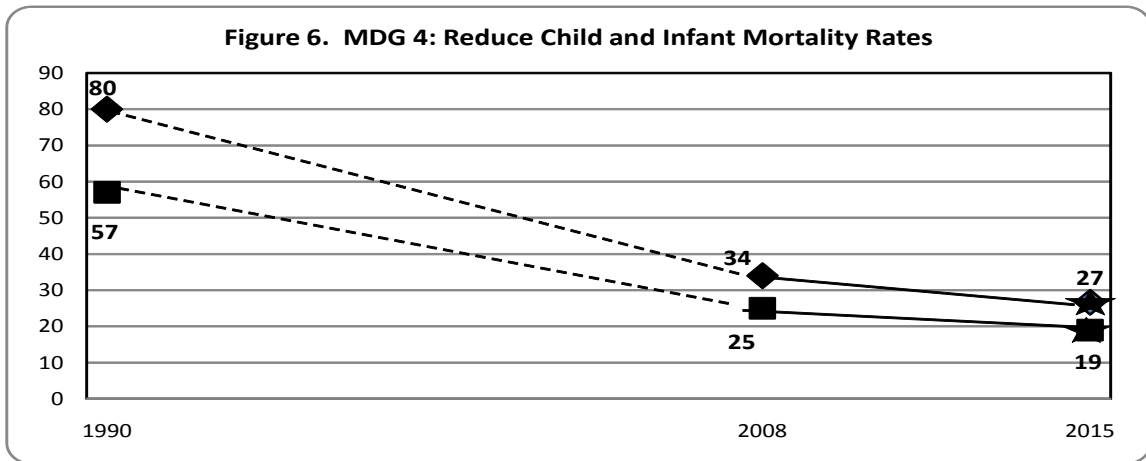
Public health.

National government spending on health is largely driven by the Department of Health (DOH) spending and national government subsidy for the premium contribution to the PhilHealth Sponsored Program. Taken together, the share of these two big ticket items in total NG health expenditures is fairly stable at 82% in 1998-2010.

Perhaps the most worrisome trend in national government health sector spending in 1998-2006 is the sharp drop in real per capita DOH spending on public health (**Figure 5**) as public health services and public health outcomes tend to deteriorate in accordance with the said decline in government spending. The Philippines posted notable gains in 1990-2006 in reducing both the infant mortality rate (IMR) and the under-5 mortality rate (U-5MR). During this period, the infant mortality was halved from 57 infant deaths per 1,000 live births in 1990 to 25 in 2008 (**Figure 6**). In like manner, the under-5 mortality rate went down from 80 to 34 under-five deaths per 1,000 children. In both cases, the rate of progress needed to reach the 2015 target is less than the actual rate of progress to date, suggesting that it is likely that the MDG targets for child health will be achieved.



Source: of basic data: Statement of Appropriations, Allotments, Obligations and Balances (SAAOB) of the DOH, various years

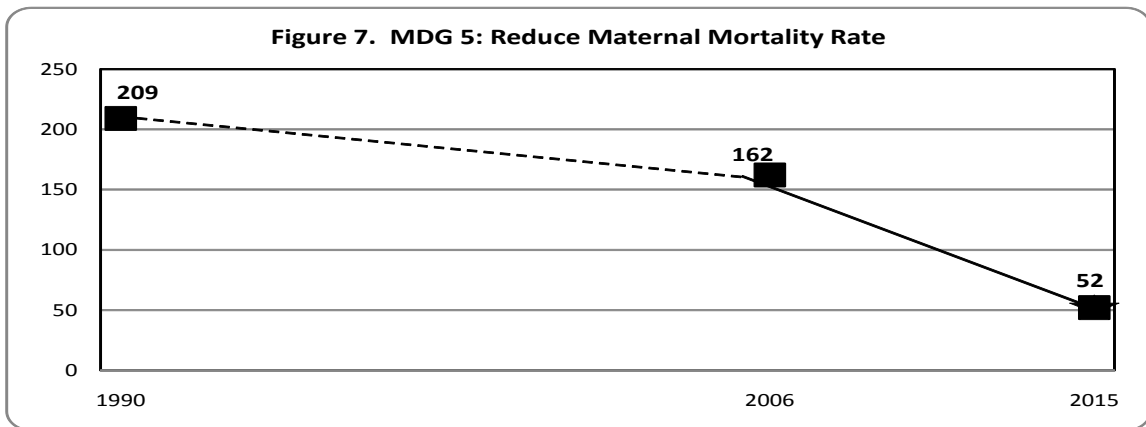


Legend

- Under-5-mortality rate (per 1,000 children)
- ◆ Infant mortality rate (per 1,000 live births)
- ★ MDG target in 2015
- Rate of progress needed to reach budget
- - - Current rate of progress

Source: Philippines Fourth Progress Report on the Millennium Development Goals (2010)

On the other hand, the country’s performance in reducing the maternal mortality rate (MMR) is not as commendable, with the MMR declining from 209 maternal deaths per 100,000 live births in 1990 to 162 maternal deaths per 100,000 live births in 2006 (**Figure 7**). The rate of progress necessary to reach the 2015 target is thus more than 3 times higher than the actual rate of progress in 1990-2006, suggesting that the Philippines would have to reduce the MMR at a considerably faster pace than its historical performance to date. This indicates that the government would have to exert additional effort relative to what it has done in the past, if the Philippines were to attain the MDG target for maternal health.



Legend

- Maternal mortality rate
- ★ MDG target in 2015
- Rate of progress needed to reach budget
- - - Current rate of progress

Source: Philippines Fourth Progress Report on the Millennium Development Goals (2010)

However, the decline in recent years in the proportion of fully immunized children before they turn a year old may put the gains in child health at risk. To wit, the proportion of fully immunized children dipped from 87% in 2000 to 83% in 2006 (**Table 7**). At the same time, the proportion of children with diarrhea given ORS went down from 28% in 1998 to 14% in 2006. Also, the proportion of pneumonia cases among under-5 children given treatment was fairly stagnant at around 95%-96% in 1998-2006, although the indicator reached a high of 97% in 2003 and 100% in 2004.

Table 7. Selected Health Outputs/ Indicators, 1991-2006

	1998	1999	2000	2001	2002	2003	2004	2005	2006
% of pregnant women with 3 or more pre-natal visits	59.4%	65.6%	64.8%	62.9%	60.5%	64.3%	64.7%	62.3%	61.5%
% of pregnant women given tetanus toxoid vaccination at least twice	68.8%	59.4%	62.5%	54.2%	54.3%	59.6%	60.0%	58.8%	59.1%
% of lactating mothers given Vitamin A	49.1%	54.6%	57.0%	55.3%	52.9%	61.6%	53.2%	54.7%	59.3%
% of livebirths attended by medical professional		69.0%	69.0%	70.0%			68.7%	68%	70.0%
% of fully immunized children under 1	84.8%	87.9%	86.5%	81.7%	76.7%	83.7%	84.8%	83.7%	82.9%
% of infants given 3rd dose of Hepa B	37.3%	45.2%	6.2%	41.9%	38.5%	45.2%	45.6%	42.9%	72.9%
% of diarrhea cases amongst children under 5 given ORS	28.4%	25.9%	24.1%	22.4%	17.7%	17.8%	15.5%	14.2%	14.0%
% of pneumonia cases amongst children under 5 given treatment	94.7%	94.5%	93.9%	94.2%	94.7%	97.3%	99.9%	95.3%	96.0%
% of children under 1 given Vitamin A	72.8%	74.0%	76.9%	74.6%	74.7%	89.8%	79.2%	80.0%	81.0%
% of children between 1 and 5 given Vitamin A	89.6%	84.1%	101.3%	95.1%	94.1%	106.1%	111.1%	97.8%	95.7%
TB morbidity rate a/ b/	206.7	203.9	174.1	149.9	154.1	120.3	133.3	137.1	169.9
Malaria morbidity rate a/	96.8	91.8	66.6	39.1	50.3	36.5	24.9	43.3	27.6

* data shown for entire Philippines but data by province and city also available

a/ per 100,000 population

b/ respiratory plus other forms of TB

Source: Field Health Service Information System, various years

In contrast, the performance with respect to some of the key maternal care interventions has stagnated, if not deteriorated (**Table 7**). In particular, the proportion of pregnant women who had three or more pre-natal visits fluctuated around 61%-65% in 1999-2006. On the other hand, the proportion of pregnant women who received tetanus toxoid vaccination went down from 63% in 2000 to 54% in 2001-2002 before stagnating at 60%-61% in 2003-2006. Also, the proportion of births attended by a professional health provider was fairly flat at 68%-70% in 1999-2006.

Meanwhile, after being cut by about 45% from 90 to 50 per 100,000 population over the three-year period between 1999 and 2002, the decline in the incidence of malaria appears to have faltered, posting a reduction of 25% from 37 to 28 over the three-period between 2003 and 2006 (**Table 7**). On the other hand, the incidence of tuberculosis went up from 120 per 100,000 population in 2003 to 170 per 100,000 population in 2006 after declining from 207 in 1998 to 154 in 2002.

Given this perspective, there is a need to ensure that adequate resources from both the national government and LGUs be made available for public health services in order to attain the MDGs for health. The estimates of the resource requirements needed to achieve the MDGs in health

shown below are based on key interventions/ programs including: (1) expanded program of immunization for children that aims to provide maximum resistance against seven vaccine-preventable diseases: tuberculosis, poliomyelitis, diphtheria, pertussis, tetanus, hepatitis B and measles, (2) tetanus toxoid vaccination for mothers, (3) micronutrient Vitamin A and iron supplementation for mothers and children, (4) basic emergency obstetric and neonatal care (BEmONC) and comprehensive emergency obstetric and neonatal care (CEmONC) services for all deliveries, (5) reproductive health, (6) integrated management of children's illnesses namely, diarrheal disease and acute respiratory infection, and (7) prevention and treatment of HIV/ AIDS, TB, and malaria.

Although the delivery of public health services is largely devolved to LGUs in accordance with the provisions of the Local Government Code of 1992, the public good nature of public health services suggests that the central government cannot fully abdicate its role in this sub-sector despite devolution. As such, the estimates of the resource requirements for the MDG interventions are based on the prevailing assignment of expenditure responsibilities between the central government and LGUs. In particular, in child and maternal health care, the national government finances the procurement of antigens for the expanded program of immunization (EPI) while the provision of syringes and safety boxes for the immunization program is assigned to LGUs. Similarly, the procurement of supplies for iron supplements for children and drugs for the control of acute respiratory infections and diarrhea in children is delegated to LGUs. Further, the cost of training frontline health workers (who are part of the personnel complement of LGUs) is largely lodged with LGUs as well. Also, the provision of contraceptive supplies is an LGU responsibility. On the other hand, the national government provides drugs for HIV/ AIDS, malaria and TB while the training of health personnel for the delivery of basic and essential health care, including that related to the prevention and control of HIV/ AIDS, malaria and TB as well as the provision of BEmONC and CEmONC, is the joint responsibility of the national government and LGUs.

Table 8 presents estimates of the budgetary requirement that will help ensure the attainment of the MDGs for health. The most costly component of the MDG interventions in the health sector is the upgrading of the RHUs and BHSs to serve as BEmONC facilities and the upgrading of selected LGU provincial and district hospitals as CEmONC facilities.⁶ The importance of this program is premised on the need to treat every delivery as an emergency case and the importance of facility-based deliveries in reducing the maternal mortality rate. As such, the program proposes that the travel time of households to BEmONC facilities should not exceed 30 minutes. The upgrading of RHUs/ BHSs and selected LGU hospitals is also expected to improve their “gatekeeping” function and, thereby, reduce hospital patient case load.

⁶ The BEmONC/ CEmONC program is a relatively new program that was not included in earlier estimates of the budgetary requirement of MDGs for health (e.g., those provided by Manasan 2006).

Table 8. Summary of DOH budgetary requirements for public health to meet the MDGs and health care financing reform, 2012-2016 (in million pesos)

	2012	2013	2014	2015	2016
Child care					
EPI	504	536	570	607	641
EPI (including hepatitis)	454.4	483.6	514.7	547.7	578.4
2nd dose of measles vaccine	49.5	52.6	55.8	59.3	62.7
Vitamin A (w/ some targeting)	34.5	35.5	36.6	37.6	38.7
Assistance to 5th/6th class munis for CARI	3.1	3.3	3.5	3.7	3.9
Maternal care					
Tetanus toxoid immunization	25.4	27.6	30.1	32.7	34.5
Micronutrient supplementation	90.2	92.9	95.6	98.3	101.1
Vitamin A (w/ some targeting)	45.1	46.5	47.8	49.2	50.5
Iron (w/ some targeting)	45.1	46.5	47.8	49.2	50.5
BEmONC/ CEmONC training	35.2	13.8	14.2	14.7	15.3
BEmONC/ CEmONC facilities upgrading	7,763.2	7,735.8			
Disease control					
STI and HIV/ AIDS	1,730	1,889	2,066	2,261	2,476
STI treatment	1,673.1	1,818.2	1,976.0	2,147.4	2,333.7
HIV/ AIDS treatment	56.4	71.2	89.8	113.2	142.8
Malaria treatment and control	1,095	1,943	1,218	1,284	2,221
Malaria treatment	2.3	2.2	2.1	2.0	1.9
Lab supplies for malaria	6.0	5.8	5.6	5.3	4.9
Mosquito nets (w/ some targeting)	0.0	788.4	0.0	0.0	866.3
Spraying	896.8	950.3	1,007.0	1,067.0	1,130.7
Malaria training (net of LGU share)	189.6	196.2	203.1	210.2	217.5
Tuberculosis treatment and control	3,644.2	3,807.7	4,127.6	3,754.3	3,885.7
Filariasis	290.2	300.3	310.9	321.7	333.0
Non-PS requirement of MDG-related interventions	15,214.1	16,385.5	8,472.4	8,415.2	9,750.9
Non-PS requirement of F1 health care financing policies	8,584.8	8,896.2	9,218.9	9,553.4	9,900.0
NDP	2,185.0	2,272.4	2,363.3	2,457.8	2,556.1
HFEP	6,399.8	6,623.8	6,855.6	7,095.5	7,343.9
Total DOH budgetary requirement to meet MDG & health care financing reform	44,900.1	47,587.5	41,546.1	44,403.9	50,007.3
% of GDP	0.45	0.44	0.35	0.35	0.36

Author's estimates - updated version of Manasan and Cuenca (2010)

In 2007-2009, some 499 RHUs and BHSs were upgraded to the level of a BEmONC facility while 429 LGU hospitals were upgraded to the level of a CEmONC facility (**Table 9**). In 2010, another 100 RHUs/ BHSs and another 83 LGU hospitals are due for similar upgrading. However, there is a need to upgrade an additional 1,200 RHUs/ BHSs and 175 LGU hospitals to help ensure sufficient reduction in the MMR in order to meet the MDG for maternal health. Given unit cost estimates, the total amount of additional resources needed for the BEmONC/ CEmONC program as of the end of 2011 is estimated to be equal to PhP 14 billion.

Table 9. Estimate of Budgetary Requirement for BEmONC/CEmONC Upgrading

	Overall Targets	Upgraded in 2007-2009	To be upgraded in 2010	Gaps	Average unit cost	Budgetary requirement (in PhP mill)
1. Upgrading of RHUs & BHSs as BEmONCs incl. GIDA	1799	499	100	1200	PhP 5 million	6,000
2. Upgrading of Level 1 & Level 2 hospitals as CEmONCs						
Level 1	319	176	50	93	PhP 30 million	2,790
Level 2	282	199	25	58	PhP 60 million	3,480
Level 3	32	29	3	0		
Level 4	54	25	5	24	PhP 70 million	1,680
TOTAL						13,950

The estimates of the budgetary requirements of attaining the MDGs for health given in **Table 8** assumes that the completion of upgrading the identified facilities and the training of personnel in these facilities will be staggered over two years (2012 and 2013). They also assume some poor targeting in the delivery of some public health programs (namely, micronutrient supplementation, reproductive health and management of children's illnesses) in contrast to what is typically assumed by program managers. This implies that non-poor households will self-finance these services.

Health care financing reform.

The share of out-of-pocket expense in the country's total health expenditure surged from 51% in 2000 to 59% in 2005 (**Table 10**). This occurred as the share of social insurance in total health expenditure failed to compensate for the contraction in share of general government spending in THE from 41% in 2000 to 29% in 2005. Note the disappointing increase in the share of social insurance from 7% in 2000 to 11% in 2005.

Table 10: Share in Total Health Expenditure by Financing Agents, 2000 – 2005 (%)

	2000	2001	2002	2003	2004	2005
Government	40.6	36.2	31	31.1	30.7	28.7
National	21.2	17.1	15.8	15.2	15.7	15.8
Local	19.3	19.1	15.2	15.9	15.0	12.9
Social Insurance	7.0	7.9	9.0	9.1	9.6	11.0
Philhealth	6.8	7.7	8.8	8.6	9.4	10.7
Employees' Compensation	0.2	0.2	0.2	0.5	0.3	0.4
Private Sources	51.2	54.5	58.6	58.6	58.5	59.1
of which:						
Out-of-Pocket	40.5	43.9	46.8	46.9	46.9	48.4
Private Insurance	2.0	2.5	2.9	2.3	2.5	2.4
HMOs	3.8	3.1	3.6	4.7	4.3	3.9
Others	1.3	1.3	1.4	1.2	1.2	1.2
Memo item:						
Total Health Expenditure in billion pesos	114.9	116.6	117.2	148.6	165.3	180.8
% of GDP	3.4	3.2	3.0	3.4	3.4	3.3

Source: National Health Accounts, NSCB, various years

Given this situation, the DOH has reassessed its progress towards reforming country's health care financing system in the direction of:

- providing financial protection to all,
- ensuring equitable financing,
- ensuring equitable access to health services, and
- establishing universal coverage (DOH Health Policy Note 6:1 2009, DOH Health Care Financing Strategy 2010-2020 2010).

Thus, the DOH has started to put in place reform measures that are aimed at improving the health care financing system. At present, the most important aspects of this reform package are the Health Facilities Enhancement Program (HFEP), the National Drug Policy Program and the expansion of the coverage of the PhilHealth.

The HFEP involves the rehabilitation and upgrading of national and LGU health facilities so that the said facilities are able to secure the appropriate PhilHealth accreditation. As such, the HFEP aims: (i) to enhance the ability of these facilities to provide quality and appropriate services that are responsive to the priority health needs of their catchment population, and (ii) to enable government hospitals to operate on a more sustainable basis. On the other hand, the National Drug Policy Program aims to reduce the out-of-pocket cost of health care by reducing the cost of drugs and medicines.

Table 11 shows the breakdown of the remaining resource requirement totaling PhP 34.5 billion for the Health Facilities Enhancement Program (HFEP). This amount is divided as follows: PhP 6.5 billion for the upgrading of LGU hospitals in the 13 roll-out provinces and ARMM which are part of F15, PhP 21.0 billion for the upgrading of LGU hospitals in 42 roll-out provinces under F44, and PhP 7.0 billion for the establishment of the additional specialty centers in Luzon, Visayas and Mindanao.

Table 11. Estimate of Budgetary Requirement for Health Facility Enhancement Program

	Original Targets	Upgraded in 2007-2009	To be upgraded in 2010	Gaps	Average unit cost	Budgetary requirement (in PhP mill)
1. Upgrading of LGU hospitals to meet DOH % PHIC accreditation						
* selected priority provinces with approved PIPH & RAT	16 F1 priority provinces			13 roll-out provinces & ARMM in F15	PhP 500 million	6,500
	2 volunteer provinces			42 roll-out provinces in F-44	PhP 500 million	21,000
	2 roll-out provinces in Region 12					
2. Establishment of Specialty Centers in Northern Luzon, Southern Luzon, Visayas & Mindanao for the ff specialties: Heart-Lung-Kidney Centers, Cancer Centers, Blood Centers, Toxicology Centers, Trauma Centers, Orthopedic Center, Burn Centers, Ear/ Eye Centers, Neurosurgery Center, Psychiatry Center	at least 1 subspeciality in Luzon, Visayas & Mindanao	6 HLK Centers (2 each in Luzon, Visayas & Mindanao); 1 Orthopedic Center, 1 Eye Center and 1 Geriatric Center in Luzon	1 Trauma Center in Luzon; 1 Cancer Center in Mindanao	funding of other identified specialty centers in LVM	PhP 600 million to PhP 800 million	7,000
TOTAL						34,500

a/ estimated number of BEmONC facilities based on estimate number of BEmONC teams to be trained

On the other hand, **Table 12** shows the breakdown of the resource requirement for the National Drug Policy Program (NDPP) in 2011-2016. It shows the total resource requirement for the NDPP rising from PhP 1.6 billion in 2011 to PhP 2.6 billion 2016.

The estimate of the total resource requirement for the HFEP and the NDPP are summarized in **Table 8** above. The estimate of the resource requirement for the HFEP assumes that the program will be completed in toto by 2016. The combined budgetary requirement for the non-PS component of the HFEP and the NDPP ranges from PhP 8.6 billion in 2012 to PhP 9.9 billion in 2016.

Table 12. Resource Requirement for National Drug Policy Program, 2012-2016 (In million pesos)

PROGRAMS/ACTIVITIES	2012	2013	2014	2015	2016
I. Drugs and Medicines					
A. Botika ng Barangay Millenium Development Goal (MDG)	158	165	171	178	185
B. P100 Project	273	284	295	307	319
C. Vulnerable Group MDG					
1. Women & Mother Basic Emergency Obstertric & Newborn Care (pilot)	150	156	162	169	175
2. Children (Anti-leukemia)	100	104	108	112	117
3. Elderly (Inflenza Polyvalent Vaccine)	75	78	81	84	88
II. RA 9502 Strategies to lower costs of drugs and medicines	1,020	1,061	1,103	1,147	1,193
III. Administrative Cost	300	312	324	337	351
IV. Capital Outlay	109	113	117	122	127
Total Budget	2,185	2,272	2,363	2,458	2,556

In summary, the DOH budget will have to grow from 0.27% of GDP in 2009, 0.32% in 2010 and 0.37% in 2011 to 0.45% in 2012 and 0.44% in 2013 before declining gradually to an average of 0.36% of GDP in 2014-2016 (**Table 8**).

Social protection. National government spending on non-contributory social protection programs was PhP 17 billion (or 0.3% of GDP) in 2007. In response to the rapid rise in food and fuel prices in the first half of 2008, government spending on social protection went up more than 3.5 times to PhP 62 billion (or 0.8% of GDP) in 2008 (Manasan 2009).

Despite this, national government spending on social welfare programs, social safety nets and active labor market programs compares unfavorably with that of other countries. National government spending on social protection, including active labor market programs and community driven development projects, in 2008 is less than half than the mean spending on social safety nets (1.9% of GDP) in 1996-2006 by a group of 87 countries surveyed by Weigand and Grosh (2008). The need to increase national government spending on social protection is underscored by the rise in poverty incidence between 2003 and 2006, and its stagnation between 2006 and 2009 (Reyes 2010).

With chronic poverty remaining at high levels, there is clearly a need for a social protection program that will not only address the immediate needs of the chronically poor but will also provide adequate incentive to these households to invest more in the education and health of their children because this is the only way they would be able to escape the poverty trap. The Pantawid Pamilyang Pilipino Program (4Ps), a conditional cash transfer program, is envisioned to do exactly this. Thus, the 4Ps complements the increased investments in basic education and health that are discussed above by providing poor households incentives to send and keep their children in school and to utilize key public health services aimed at improving the health status of mothers and their children.

The General Appropriations Act of 2011 increased the funding for the 4Ps from PhP 10 billion in 2010 to PhP 21 billion in 2011 with the programmed increase in the number of beneficiaries to 2.3 million (or about 50% of total number of poor households in 2006). It cannot be over-emphasized that *sustained funding for the 4Ps is critical* if the long-term gains from the 4Ps in terms of increased investments in human capital are to be realized. In line with this, the estimates of the budgetary support necessary for achieving the MDGs and inclusive growth that are used in the conduct of the fiscal sustainability analysis in **Section 4** below ensures that funding for the 4Ps is sustained.

Infrastructure. National government expenditure on the infrastructure sectors declined from an average of 2.4% of GDP in 1995-2000 to an average of 1.7% in 2001-2007 before rising briefly to an average of 2.4% in 2008-2009 and slipping back to 1.6% in 2010 and 2011.

If one were to include private sector infrastructure spending through various BOT projects, total public and private sector infrastructure spending is estimated to be equal to an average of about 2.8% of GDP in 1990-2008, with government accounting for 70% of the total.⁷ This indicates that total Philippine infrastructure spending is well below the World Bank benchmark of 5% of GDP for middle-income countries in East Asia (World Bank 2005).

As a result of the continuing underinvestment in infrastructure, the overall state of the country's infrastructure compares unfavorably with that in other countries in the region. For instance, less than 25% of the total road network in the Philippines is paved. In comparison, the paved-roads ratio is 99% in Thailand, 81% in Malaysia, and 58% in Indonesia.⁸ Consequently, the paved road length per unit area, per capita and per vehicle is the lowest in Southeast Asia. At the same time, while the country's total road length per unit area is one of the highest in the region, its total road length per capita and per vehicle are among the lowest in Southeast Asia (ADB 2007). Moreover, of the paved national road network, about 15% are in poor condition and 32% are in bad condition.

ADB (2007) also notes that per capita power consumption in the Philippines is lower than that of its neighbors in the region - about one third that in Thailand and one fifth that in Malaysia. Per capita availability of telephone lines in the Philippines is also below those in Malaysia and Thailand.

The poor state of infrastructure in the Philippines is associated with a higher cost of doing business in the country in comparison to its neighbors as reflected in the following:

- i. vehicle operating costs and intercity freight costs are more than 50% higher than in Indonesia and Thailand,

⁷ These estimates are derived by adding the project cost of all existing/ completed BOT projects from the BESF (DBM various years) to actual national government expenditures on an obligation on the infrastructure sectors.

⁸ The paved-roads ratio for the national road network in the Philippines is considerably higher at 70% but even this figure is lower than that of other countries.

- ii. the Philippines has the highest cost in the ASEAN for exporting a container, partly because of inefficiencies in port handling,
- iii. power tariffs for businesses in Manila were 20–80% higher than tariffs in the other nine cities in Southeast Asia
- iv. the dependability of power supply is also a cause of concern (ADB 2007).

Consistent with these findings, the Philippines' overall competitiveness and investment climate rankings pale in comparison with other countries. In particular, the Philippines is ranked behind other countries in the region, except Lao PDR, in terms of the inadequacy of infrastructure in a 2007 World Bank study (as cited in ADB 2007).

The importance of increasing infrastructure spending is further bolstered by the well-documented causal link from infrastructure capital stock to GDP (World Bank 2005) and from real infrastructure spending to GDP growth (Manasan 1994). In turn, economic growth is found to be an important lever for poverty reduction even if economic growth does not translate into a one-for-one increase in the incomes of the poor. Moreover, the provision of basic education when complemented with infrastructure (roads) is found to have a positive impact on the well-being of the poor (Balisacan and Pernia 2002).

The costing of the medium-term investment requirement of the infrastructure sectors is beyond the scope of this study. However, we argue that even with greater private sector participation in the financing, construction and operation of various infrastructure projects through public-private partnership (PPP) schemes as envisioned by the Aquino administration, the national government still needs to spend at least 2.5% of GDP on the infrastructure sectors yearly in 2012-2016. For instance, the investment requirement of the national roads sub-sector alone is estimated to be equal to 2.0% yearly (Encarnacion 2009). Moreover, the share of PPPs in the financing of investments in the national road sub-sector has been limited in the last decade.

4. FINANCING THE MDGs AND INCLUSIVE GROWTH AND FISCAL SUSTAINABILITY

In this section, the implications on fiscal sustainability of financing the budget requirements of achieving the MDGs and inclusive growth are analyzed. In this study, two scenarios are considered using standard debt sustainability analysis.⁹

⁹ Debt sustainability analysis is anchored on the dynamics of the evolution of public debt. The following derivation is drawn from Fedelino *et al.* (2009). The total stock of public debt at time $t+1$, D_{t+1} , may be expressed as:

$$D_{t+1} = [(1 + \varepsilon)(1 + r_f)DF_t] + (1 + r_d)DD_t - PB_{t+1}$$

Where ε refers to changes in the foreign exchange rate,⁹
 r_d is the domestic interest rate,
 r_f is the foreign interest rate,
 DF is public debt denominated in foreign currency,
 DD is public debt denominated in domestic currency, and
 PB is the primary balance.

Debt stock is composed of debts denominated in both domestic as well as foreign currencies. Domestic-currency debt at time t (DD_t) depends on the domestic interest rate in the market (r_d), while foreign-currency debt at time t (DF_t) when expressed in domestic currency rate is affected the foreign interest rate (r_f) and changes in the exchange rate.⁹ Note that a depreciation of the local currency ($\varepsilon > 0$) leads to an increase in foreign currency debt, expressed in local currency terms.

Public debt relative to GDP:

Lower-case variables are defined as equal to the upper-case variables expressed as a proportion of GDP (e.g., $d_{t+1} = \frac{D_{t+1}}{Y_{t+1}}$),

Thus, the equation above can be expressed, in percent of GDP, as:

$$d_{t+1} = \left[\frac{(1 + \varepsilon)(1 + r_f)}{(1 + g)(1 + \pi)} df_t \right] + \frac{(1 + r_d)}{(1 + g)(1 + \pi)} dd_t - pb_{t+1}$$

with π being equal to the change in the domestic GDP deflator, and g the real GDP growth rate.

Simple algebra yields:

$$d_{t+1}(1 + g + \pi + g\pi) = (1 + \varepsilon)(1 + r_f)df_t + (1 + r_d)dd_t - (1 + g + \pi + g\pi)pb_{t+1}$$

Expanding terms and rearranging, with $d_t = df_t + dd_t$, we get:

$$d_{t+1}(1 + g + \pi + g\pi) = d_t + \varepsilon(1 + r_f)df_t + (r_f df_t + r_d dd_t) - (1 + g + \pi + g\pi)pb_{t+1}$$

Since data on domestic and foreign interest rates may not be consistently available, the equation is further simplified. Letting α represent the *share of total public sector debt that is incurred in foreign currency* ($df_t = \alpha d_t$), the third term on the right-hand side of the equation can be rewritten as $\hat{r} = \alpha r_f + (1 - \alpha)r_d$

Adding and subtracting $(g + \pi + g\pi)d_t$ to the right-hand side, allowing r_f to be approximately equal to \hat{r} , and rearranging the equation leads to the following equation:

$$d_{t+1} - d_t = \frac{1}{(1 + g + \pi + g\pi)} (\hat{r} - \pi(1 + g) - g + \varepsilon\alpha(1 + \hat{r}))d_t - pb_{t+1}.$$

In the conduct of debt sustainability analysis for these two scenarios, it is assumed that:

- GDP will grow by 7.3% in 2010, 5.5% in 2011, and 4.5% in 2012-2016
- Inflation will be 3.3% in 2010 and 3.5% in 2011-2016
- Overall interest rate on national government debt is 6.6% in 2011-2016, same as in 2010
- Peso-dollar exchange rate will rise from PhP 46.5 in 2010 to PhP 47.5 in 2016

The first scenario attempts to answer the following question:

- How much should national government revenues increase if national government expenditures were enough to support MDGs for education and health and if national government infrastructure spending were pegged at 2.0% of GDP in 2012 and 2.5% of GDP in 2013-2016 while the fiscal deficit declines gradually from 3.6% of GDP in 2010, to 3.1% in 2011, 2.5% in 2012, 2.0% in 2013, 1.5% in 2014, 1.0% in 2015 and 0.5% in 2016?

Under this scenario, national government revenues will have to rise from 14.3% of GDP in 2010 to 15.2% in 2011 (as assumed in 2011 President's Budget Proposal) to 17.5%-17.9% in 2012-2016 (**Table 13**).¹⁰ As a result of the fairly aggressive pace of fiscal consolidation that is projected under this scenario, debt-to-GDP ratio of the national government is projected to decline monotonically from 57.3% in 2009 to 56.2% in 2010, 54.8% in 2011 to 53.3% in 2012 and 43.8% in 2016.

Table 13. Debt Sustainability Simulation: Scenario 1

	2007 actual	2008 actual	2009 actual	2010 prelim	2011 projected	2012 projected	2013 projected	2014 projected	2015 projected	2016 projected
Assume:										
Non-interest expd (in million pesos) ^{a/}	891,201	998,804	1,142,877	1,237,806	1,363,933	1,670,428	1,756,031	1,872,177	1,999,114	2,134,881
% to GDP	13.4	13.5	14.9	14.5	14.7	16.6	16.1	15.9	15.7	15.5
Fiscal deficit (in million pesos)	12,441	68,117	298,532	310,400	290,000	251,347	217,481	176,416	127,205	68,791
% to GDP	0.2	0.9	3.9	3.6	3.1	2.5	2.0	1.5	1.0	0.5
Implied NG total revenues:										
NG total revenues (in million pesos)	1,136,560	1,202,905	1,123,211	1,219,000	1,410,000	1,756,698	1,893,957	2,066,742	2,255,773	2,459,596
% to GDP	17.1	16.2	14.6	14.3	15.2	17.5	17.4	17.6	17.7	17.9
NG outstanding debt (in million pesos)	3,712,487	4,220,903	4,396,640	4,784,327	5,090,585	5,358,792	5,593,649	5,787,885	5,933,266	6,020,489
% to GDP	55.8	57.0	57.3	56.2	54.8	53.3	51.4	49.2	46.6	43.8

a/ assumes non-interest spending is enough to meet address the MDGs for education and health plus infrastructure outlays equal to 2% of GDP in 2012 and 2.5% in 2013-2016

¹⁰ In contrast, if a slower rate of fiscal consolidation is assumed (say, with the fiscal deficit declining more gradually from 3.2% of GDP in 2011 to 2.0% in 2016), national government revenues will have to rise from 15.2% of GDP in 2011 to 17.1% in 2012 and an average of 16.7% in 2013-2016 and outstanding national government debt contracting from 57% in 2009 to 48% in 2016.

On the other hand, the second scenario attempts to answer the following question:

- What happens to the national government fiscal deficit and debt-to-GDP ratio if national government revenues were to increase only marginally¹¹ while national government expenditures are enough to support MDGs for education and health and if national government infrastructure spending is pegged at 2.0% of GDP in 2012 and 2.5% of GDP in 2013-2016?

Under this scenario, the fiscal deficit of the national government revenues will rise from 3.6% of GDP in 2010 and 3.5% in 2011 to 5.0% in 2012, 4.4% in 2013, about 3.7% in 2014-2015 and 3.1% in 2016. Consequently, outstanding debt stock of the national government will not post any significant reduction during the period under study but will hover around 56% of GDP in 2012-2016 (**Table 14**).

Table 14. Debt Sustainability Simulation: Scenario 2

	2007 actual	2008 actual	2009 actual	2010 prelim	2011 projected	2012 projected	2013 projected	2014 projected	2015 projected	2016 projected
Assume:										
NG total revenues (in million pesos)	1,136,560	1,202,905	1,123,211	1,219,000	1,378,277	1,510,818	1,655,811	1,814,406	1,987,857	2,177,533
% to GDP	17.1	16.2	14.6	14.3	14.8	15.0	15.2	15.4	15.6	15.8
Non-interest expd (in million pesos) ^{a/}	891,201	998,804	1,142,877	1,237,806	1,363,933	1,670,428	1,756,031	1,872,177	1,999,114	2,134,881
% to GDP	13.4	13.5	14.9	14.5	14.7	16.6	16.1	15.9	15.7	15.5
Implied fiscal deficit & NG outstanding debt:										
Fiscal deficit (in million pesos)	12,441	68,117	298,532	310,400	321,723	499,331	474,181	464,371	449,909	427,156
% to GDP	0.2	0.9	3.9	3.6	3.5	5.0	4.4	3.9	3.5	3.1
NG outstanding debt (in million pesos)	3,712,487	4,220,903	4,396,640	4,784,327	5,122,308	5,638,564	6,130,697	6,613,986	7,083,754	7,531,671
% to GDP	55.8	57.0	57.3	56.2	55.1	56.1	56.4	56.2	55.7	54.7
Interest payments (in million pesos)	257,800	272,218	278,866	291,594	336,067	339,722	373,961	406,600	438,653	469,809
% to GDP	3.9	3.7	3.6	3.4	3.6	3.4	3.4	3.5	3.4	3.4

a/ assumes non-interest expd enough to meet address the MDGs for education and health plus infra outlays equal to 2% of GDP in 2012 and 2.5% in 2013-2016

In summary, the analysis suggests that a credible consolidation of the national government's fiscal position will require total national government revenues to rise from the 2009 level of 14.6% of GDP to about 17.6% in 2012-2016 if enough budgetary support were to be provided towards the achievement of the MDGs in education and health and inclusive growth. The question then is: Is such an increase in the national government revenue effort doable?

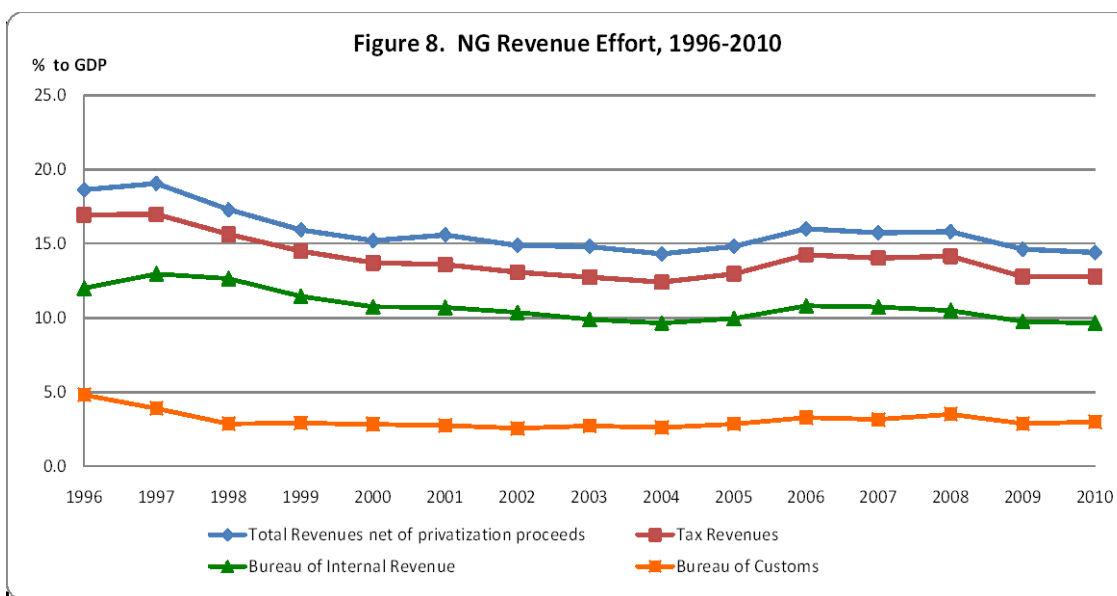
5. OPTIONS IN INCREASING NATIONAL GOVERNMENT REVENUE EFFORT

After reaching a peak of 19.1% of GDP in 1997, total national government revenues net of privatization proceeds exhibited a downward trend in 1998-2004 (**Figure 8**). This decline largely

¹¹ In this analysis, total national government revenue is assumed to increase by 0.2% of GDP yearly in 2012-2016.

mirrors the collapse in overall tax effort during the period. About 70% of the reduction in tax effort in 1997-2004 following the onset of the Asian financial crisis may be attributed to the contraction in BIR tax effort while the remaining 30% is due to the decline in BOC revenues. Most of the decrease in BOC tax effort during this period may be explained by the programmed reduction in tariff rates under the trade liberalization program of the government while changes in the composition of imports (i.e., the shift away from dutiable imports) also adversely affected the BOC's tax take in 1998-1999 (Manasan 2002).

On the other hand, it is notable that the tax policy changes introduced as part of the 1996/1997 Comprehensive Tax Reform Package (notably the shift from *ad valorem* to specific rates sans indexation in the excise taxation of cigarettes and alcoholic beverages, the phased reduction in the corporate income tax rate and the top marginal rate of the individual income tax and the increase in the level of personal exemptions from the individual income tax) contributed persistently and substantially to the deterioration in BIR's tax effort in 1997-2004. At the same time, the weakening of tax administration also explains a significant part of the said decline in BIR's tax effort. In particular, 46% of the 2.3 percentage point decline in BIR tax effort between 1997 and 2001 is attributable to changes in tax policy, another 46% to increased evasion and only 7% to changes in economic structure (Manasan 2002).



a/ 2010 is estimated based on Jan-Nov data
Source of basic data: Bureau of Treasury

Faced with a looming fiscal crisis in 2004, Congress enacted three laws that are meant to increase the revenue take of the central government. In late 2004, Congress passed Republic Act 9334 (amending the excise tax on so-called sin products) and Republic Act 9335 (otherwise known as the Lateral Attrition Law). RA 9334 provides for discrete increases in the tax rate on cigarettes (15%-80% in 2005) and on alcoholic products (22% in 2005) and every other year

thereafter until 2011.¹² On the other hand, RA 9335 provides for the creation of a reward and incentives fund in the BIR and the BOC equal to at least 15% of the difference between their actual collection and their revenue target, proceeds of which will be apportioned to the various units, officials and employees in proportion to their relative contribution to the “excess” collection. It also provides that officials and employees of these bureaus may be removed from the service if their revenue collection performance falls short of the target by at least 7.5%.

In April 2005, Congress then passed another amendment of the National Internal Revenue Code (RA 9337), better known as the reformed VAT law. It expanded the coverage of the VAT (to include power and electric cooperatives, petroleum products, medical and legal services, agricultural non-food products, and works of art). It also converted the Philippine VAT system from a “consumption-type” VAT (where producers are allowed to get credit for taxes paid on their inputs including their capital goods purchases) to an “income-type” VAT (where producers are allowed to get credit for taxes paid on all their inputs but the credit on the capital goods purchases is limited only to the depreciated part of capital). RA 9337 also limits the input VAT credit to 70% of the output VAT. At the same time, it zero-rates the transport of passenger and cargo to foreign countries, services provided to aircrafts/ vessels engaged in international transport, and sales of goods, supplies and fuel to aircrafts and vessels engaged in international transport even as it continues to apply a zero rate to all exports. In order to mitigate the impact on consumers of the inclusion of petroleum products, electricity and domestic shipping in the VAT net, the reformed VAT law reduced the excise tax rate on kerosene, diesel and bunker fuel, eliminated the franchise tax on power distribution utilities and domestic airlines, removed the common carriers tax on domestic shipping and increased the presumptive input VAT of selected agro-processors (specifically, manufacturers of noodles, sardines and sugar) from 1.5% to 4%. RA 9337 also provided for a temporary increase in the corporate tax rate from 32% to 35%;¹³ and increased the gross receipts tax (on royalties, rentals of property, real or personal, profits from exchange and all other items treated as gross income) of banks and non-bank financial intermediaries from 5% to 7%. In addition, as provided under the reformed VAT law, the President authorized the increase in the VAT rate from 10% to 12% in January 2006.

These pieces of legislation helped increase tax effort in 2005-2006. Thus, total tax revenue increased from 12.4% of GDP in 2004 to 14.3% in 2006 as the tax effort of the BIR and BOC improved. To wit, BIR tax effort increased from 9.6% of GDP in 2004 to 10.8% in 2006 while BOC tax effort rose from 2.5% to 3.3% (**Table 15**).

In line with these changes in tax policy, a significant rise in the tax-to-GDP ratio is exhibited by the corporate income tax and the VAT in 2005-2006. Surprisingly, however, the excise tax effort continued to wane during this period despite the increases in rates mandated under RA 9334.

¹² Under the amendment, the tax rate on cigarettes in 2011 will be 34%-143% higher than that in 2003 while the tax rate on alcoholic products in 2011 will be 122% higher than that in 2003.

¹³ The reformed VAT law provides that the corporate income tax rate will be subsequently reduced to 30% starting in 2009.

Consequently, the share of the excise taxes in the total tax take contracted persistently from 15.3% in 1997 to 6.8% in 2007 (**Table 16**).

However, the gains in tax effort have not been sustainable and the overall tax effort slipped downwards once again starting in 2007 to a low of 12.8% of GDP in 2009. This development is not unexpected altogether as the positive revenue impact of the excise tax amendment and the reformed VAT law have built-in sunset provisions. The reformed VAT law temporarily raised the corporate tax rate to 35% but this rate is scheduled to be reduced to 30% in 2009. On the other hand, after the mandated adjustment in excise tax rates on sin products in 2011, they will remain fixed at that level in nominal peso terms unless Congress passes a new law mandating otherwise.

At the same time, Republic Act 9504 was passed in early 2008 in order to give some (tax) relief to minimum wage earners. However, it did so by increasing the amount of so-called personal exemptions for all income tax payers. The revenue loss arising from this provision is estimated to be about 0.8 percentage points of GDP per year in the initial years of implementation. In addition, a number of revenue eroding measures have also been legislated in 2009-2010.

Given this perspective, the need to improve tax effort cannot be overemphasized.

5.1. Improving Tax Administration

The Aquino administration's pronouncement that the much needed revenue increases will be derived solely from improvements in tax administration rather than from the imposition of new taxes or increases in the rate of imposition of existing taxes is understandable given the large and persistent leakages in tax collections. The tax gap from the VAT and the individual income tax on non-wage income alone is estimated to exceed 4% of GDP in 2007-2009 (**Table 17**).¹⁴

On the average, only 36% and 86% of potential revenues from the VAT and the individual income tax on non-wage income earners, respectively, are actually collected in 2004-2009. Moreover, **Table 17** also shows that tax evasion tends to make the tax system inequitable. To wit, the average effective individual income tax rate on wage earners (4.9%) is 7 times that on non-wage income earners (0.7%) in 2009.

¹⁴ The tax gap is estimated as the difference between potential tax revenue and actual tax revenue. Potential VAT revenue is estimated using a VAT simulation model with 56 sectors that corresponds to the finer sectoral disaggregation found in the Philippine National Income Accounts. This model makes use of the most recent Input-Output Tables to derive parameters for VAT-able input ratios in both VAT-able and VAT-exempt sectors. On the other hand, potential revenue from the individual income tax on non-wage income is estimated by applying the effective individual income tax rate on wage income to the net operating surplus of the household sector as measured in the National Income Accounts.

Table 15. BIR and BOC Collections as % of GDP, 1997-2009

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
TOTAL TAX	17.0	15.6	14.5	13.7	13.6	13.1	12.8	12.4	13.0	14.3	14.0	14.2	12.8
BIR	13.0	12.7	11.5	10.8	10.7	10.0	9.9	9.6	9.8	10.8	10.7	10.5	9.8
Taxes on net income & profits	6.8	6.9	6.2	6.0	6.2	5.7	5.7	5.7	5.9	6.3	6.4	6.5	5.7
Corporate income tax	3.4	2.9	2.6	2.6	2.7	2.5	2.6	2.7	2.8	3.2	3.6	3.9	3.3
Individual income tax	2.5	2.4	2.4	2.5	2.2	2.2	2.1	2.1	2.2	2.2	2.1	2.0	1.8
Others	0.9	1.6	1.1	1.0	1.2	1.0	0.9	0.9	0.9	0.8	0.7	0.6	0.6
Excise tax	2.6	2.4	2.1	1.8	1.6	1.4	1.3	1.2	1.1	1.0	0.8	0.8	0.8
Alcoholic products	0.6	0.5	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Tobacco products	0.7	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.3
Petroleum	1.2	1.2	1.0	0.8	0.7	0.6	0.5	0.4	0.3	0.2	0.2	0.2	0.2
VAT	1.9	1.8	1.9	1.6	1.6	1.7	1.9	1.6	1.6	2.3	2.2	1.9	2.2
Other Percentage Taxes	0.8	0.8	0.7	0.7	0.8	0.6	0.4	0.6	0.6	0.6	0.6	0.6	0.6
Other Taxes	0.8	0.8	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.6	0.7	0.7	0.6
BOC	3.9	2.9	2.9	2.8	2.6	2.5	2.5	2.5	2.8	3.3	3.2	3.5	2.9
Import duties	1.8	1.6	1.4	1.4	1.1	0.9	1.0	1.0	1.3	1.1	1.0	1.2	0.9
VAT	1.8	1.2	1.2	1.3	1.3	1.3	1.2	1.2	1.3	2.0	1.9	2.1	1.7
Excise tax	0.1	0.0	0.0	0.1	0.2	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2
VAT (BIR & BOC)	3.7	3.0	3.1	2.9	2.9	3.0	3.1	2.9	2.9	4.3	4.1	4.0	3.9

Source of basic data: BIR and BOC

Table 16. Percent Distribution Tax Revenues, 1997-2009

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
TOTAL TAX	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
BIR	76.4	80.9	79.1	78.4	78.7	76.1	77.4	77.4	75.9	75.9	76.5	74.2	76.4
Taxes on net income & profits	39.8	44.1	42.6	44.0	45.3	43.7	44.3	46.0	45.8	43.8	45.8	46.0	44.4
Corporate income tax	19.9	18.6	18.2	18.7	20.0	19.4	20.4	21.7	21.9	22.7	25.8	27.2	25.9
Individual income tax	14.5	15.3	16.6	18.0	16.3	16.7	16.6	16.7	16.6	15.2	15.1	14.4	13.9
Others	5.5	10.2	7.8	7.3	9.0	7.6	7.3	7.6	7.3	5.9	4.8	4.4	4.5
Excise tax	15.3	15.1	14.3	13.4	11.9	11.0	10.4	9.8	8.8	6.8	6.0	5.9	6.2
Alcoholic products	3.3	3.0	2.9	2.8	2.5	2.5	2.5	2.6	2.4	1.9	2.0	1.9	2.1
Tobacco products	3.9	4.0	3.8	3.8	3.9	3.9	3.6	3.8	3.4	3.1	2.5	2.6	2.5
Petroleum	7.1	7.4	6.9	6.2	5.0	4.2	3.9	3.0	2.7	1.5	1.1	1.1	1.3
VAT	11.5	11.4	12.8	11.7	12.0	12.7	15.0	13.3	12.5	16.4	15.5	13.4	17.1
Other Percentage Taxes	4.9	4.9	5.1	5.3	5.6	4.6	3.4	4.6	4.9	4.4	4.4	3.9	4.4
Other Taxes	4.8	5.4	4.2	3.9	4.0	4.1	4.2	3.7	4.0	4.5	4.8	5.1	4.4
BOC	23.0	18.2	20.0	20.7	19.5	19.0	19.3	20.2	21.9	23.0	22.4	24.8	22.4
Import duties	10.8	10.2	9.8	10.5	7.9	7.2	7.5	7.7	10.1	8.0	7.2	8.4	7.0
VAT	10.3	7.7	8.5	9.2	9.6	9.7	9.6	9.7	9.8	13.8	13.8	14.9	13.6
Excise tax	0.5	0.3	0.3	0.5	1.2	2.0	2.1	2.8	2.1	1.3	1.4	1.5	1.8
VAT (BIR & BOC)	21.8	19.1	21.3	20.9	21.6	22.7	24.6	23.0	22.2	30.2	29.4	28.3	30.8

Source of basic data: BIR and BOC

Table 17. Tax gap for selected taxes, 2004-2009

	2004	2005	2006	2007	2008	2009
VAT (in billion pesos)	63.2	93.6	125.0	160.8	192.0	199.3
% of potential revenue	31.2	37.4	32.5	37.0	39.3	39.7
% of GDP	1.3	1.7	2.1	2.4	2.6	2.6
Individual income tax from non-wage earners (in billion pesos)	87.6	91.0	103.2	124.4	133.6	108.1
% of potential revenue	87.6	83.0	84.0	87.6	88.4	85.2
% of GDP	1.8	1.7	1.7	1.9	1.8	1.4
Ave. effective tax rate (%) on wage income a/	6.0	6.0	6.1	6.3	6.0	4.9
Ave. effective tax rate (%) on non-wage income a/	0.7	1.0	1.0	0.8	0.7	0.7

a/ Average effective tax rate is estimated as the ratio of actual tax collection to the tax base.

Author's estimate

Thus, it cannot be denied that the tax collection agencies have not been able to maximize the revenue potential of existing taxes. However, the question remains: Can large enough improvements in tax administration be made soon enough? Note the need to frontload the increases in national government revenues because of the necessity to address the input and service deficits in basic education and health in 2012-2013, if the MDGs are to be attained in 2015.

The record of BIR and BOC in this regard is not encouraging. An analysis¹⁵ breaking down the sources of change in the tax-to-GDP ratio of the major types of taxes in 2005-2009 suggests that tax-to-GDP ratio for the VAT, corporate income tax and the excise tax on tobacco and petroleum products would have been higher than they actually were during the period if collection efficiency had been maintained at the 2004 level.

Value added tax. The reformed VAT law, which expanded the coverage of the value added tax, took effect in November 2005. The President subsequently raised the VAT rate from 10% to

¹⁵ In this analysis, the actual change in the tax-to-GDP ratio in a given period is decomposed into: (i) change in tax policy, say, implementation of a new tax measure, (ii) change in economic structure, e.g., economic growth being led by more heavily taxed sectors of the economy, and (iii) change in collection efficiency or tax leakage. The change in tax-to-GDP ratio for each tax type for each year in 2005-2009 is always measured relative to the tax-to-GDP ratio in 2004. For each of the type of tax studied, the contribution of the change in economic structure to the observed change in tax effort (or tax-to-GDP ratio) was derived by estimating the amount of tax revenue that would have been collected if there were no changes in the composition of the economy relative to 2004 (i.e., if the tax-base-to-GDP ratio was kept at the 2004 level). On the other hand, the contribution of the change in tax policy to the deterioration of tax effort was computed by estimating the amount of tax revenue that would have been collected if the effective tax rates that were prevailing in 2004 were applied to the current year's tax base. Subsequently, the contribution of change in collection efficiency was derived as a residual. That is, what cannot be explained by the first two factors was attributed to improvement/ deterioration in collection efficiency.

12% in 2006. The VAT-to-GDP ratio¹⁶ rose by about 1 percentage point of GDP from 2.9% of GDP in 2004 to 3.9% in 2009 (**Table 15**). This improvement is primarily attributable to the increase in the VAT rate. The analysis also shows that the changing composition of nominal GDP likewise had a positive impact on tax collections (**Table 18**). However, the VAT-to-GDP ratio in 2009 would have been higher had the tax leakage not increased between 2004 and 2009.

**Table 18. Decomposing changes^{a/} in value added tax^{b/} effort, 2005-2009
(percent of GDP)**

	2005	2006	2007	2008	2009
due to change in policy	0.12	1.85	1.27	1.15	1.03
due to change in econ. structure	0.15	0.13	0.25	0.34	0.33
due to change in tax leakage ^{c/}	-0.24	-0.53	-0.25	-0.33	-0.28
Total	0.02	1.45	1.27	1.15	1.08

a/ changes in tax effort measured relative to 2004

b/ refers to VAT collected by BIR and BOC combined

c/ negative number implies increase in tax leakage relative to 2004

Author's estimate

Excise tax on tobacco products. RA 9334 provides for discrete increases in the tax rate on tobacco and alcoholic products in 2005 and every other year thereafter until 2011. Despite this, revenues from the excise tax on tobacco products declined from 0.47% of GDP in 2004 to 0.32% of GDP in 2009. While the increase in the excise tax rate would have increased the tax-to-GDP ratio by 0.11 percentage point of GDP between 2004 and 2009, this improvement was more than wiped out by the increase in the tax leakage - which was estimated to be equal to 0.19 percentage point of GDP during the same period (**Table 19**). On the other hand, a change in consumption/production pattern is evident and contributed to decline in the excise tax-to-GDP ratio. To wit, a shift towards the production of brands subjected to a lower tax rate and a small decline in the volume of production of tobacco products, as measured by the total volume of cigarette removals from the plants, were reported between 2004 and 2009.¹⁷ Also, the data on volume of removals indicate that cigarette producers reported higher than normal volume of removals in 2004, 2006 and 2008, apparently in anticipation of the mandated increase in specific tax rates in 2005, 2007 and 2009.

¹⁶ VAT effort here pertains to VAT collections of both BIR and BOC.

¹⁷ The reported drop in volume of cigarette removals from the plants in 2005-2009 is not consistent with the positive growth in personal consumption of tobacco products in real terms as per the National Income Accounts.

**Table 19. Decomposing changes in excise tax effort (on tobacco), 2005-2009 a/
(percent of GDP)**

	2005	2006	2007	2008	2009
due to change in policy	0.09	0.08	0.10	0.09	0.11
due to change in econ. structure	-0.06	-0.02	-0.08	-0.03	-0.08
due to change in tax leakage b/	-0.07	-0.09	-0.14	-0.17	-0.19
Total	-0.04	-0.03	-0.12	-0.10	-0.16

a/ changes in tax effort measured relative to 2004

b/ negative number implies increase in tax leakage relative to 2004

Author's estimate

Excise tax on petroleum products. As part of the so-called mitigating provisions of RA 9337, excise tax on selected petroleum products (e.g., diesel and bunker fuel oil) was reduced. Following this, the excise tax revenues from petroleum products went down from 0.37% of GDP in 2004 to 0.15% in 2007 (**Table 20**). The decline in the tax-to-GDP ratio may be attributable to the combined effect of the lower tax rate and increased tax leakage. In 2005, the decline in tax effort could have been worse if not for compensating change in economic structure.

**Table 20. Decomposing changes in excise tax effort (on petroleum), 2005-2009 a/
(percent of GDP)**

	2005	2006	2007	2008	2009
due to change in policy	-0.02	-0.14	-0.13	-0.10	-0.07
due to change in econ. structure	0.01	-0.01	-0.04	-0.04	-0.06
due to change in tax leakage b/	-0.01	-0.01	-0.06	-0.08	-0.08
Total	-0.03	-0.16	-0.22	-0.22	-0.21

a/ changes in tax effort measured relative to 2004

b/ negative number implies increase in tax leakage relative to 2004

Author's estimate

Corporate income tax. RA 9337 not only expanded the coverage of the value added tax but it also increased the corporate income tax rate from 32% to 35% from November 2005 to December 31, 2008 and then reduced it to 30% starting in 2009. Thus, corporate income tax effort went up from 2.7% of GDP in 2004 to 3.9% of GDP in 2008 before slipping to 3.3% in 2009. Improvements in the tax-to-GDP ratio in 2005-2008 were due to the combined positive effect of the change in the tax rate and the change in economic structure (**Table 21**). The contribution of changes in the tax leakage to the gains in tax effort was erratic. It was positive in 2007-2008 but negative in 2005-2006 and 2009. In other words, the corporate income tax effort in 2005, 2006 and 2009 would have been higher had there been no slippage in collection efficiency in those years relative to 2004.

Table 21. Decomposing changes in corporate income tax effort , 2005-2009 a/ (percent of GDP)

	2005	2006	2007	2008	2009
due to change in policy	0.04	0.25	0.25	0.25	-0.17
due to change in econ. structure	0.81	0.39	0.25	0.61	0.67
due to change in tax leakage b/	-0.70	-0.10	0.43	0.14	-0.44
Total	0.15	0.55	0.93	1.01	0.07

a/ changes in tax effort measured relative to 2004

b/ negative number implies increase in tax leakage relative to 2004

Author's estimate

Individual income tax. The tax-to-GDP ratio for the individual income tax on wage income improved from 1.7% of GDP in 2004 to 1.8% in 2007 before declining back to 1.7% of GDP in 2008 and 1.5% in 2009 because of the increase in personal exemptions that was put into effect starting in 2008. On a positive note, the collection efficiency for the individual income tax on wage income in 2005-2008 was better than that in 2004 (**Table 22**). However, the tax leakage appears to have increased in 2009.

Table 22. Decomposing changes in individual income tax effort (on wage income)a/ (percent of GDP)

	2005	2006	2007	2008	2009
due to change in policy	0.000	0.000	0.000	-0.033	-0.066
due to change in econ. structure	-0.003	0.001	0.005	-0.003	0.048
due to change in tax leakage b/	0.001	0.025	0.067	0.017	-0.256
Total	-0.002	0.025	0.072	-0.019	-0.274

a/ changes in tax effort measured relative to 2004

b/ negative number implies increase in tax leakage relative to 2004

Author's estimate

On the other hand, the tax-to-GDP ratio for the individual income tax on non-wage income (i.e., income of self-employed and professionals) rose from 0.26% of GDP in 2004 to 0.33% in 2005 before slipping to 0.26% in 2007, 0.24% in 2008 and 2009. Again, it is creditable that improvements in collection efficiency were evident in 2005-2009 perhaps because of the increases in withholding tax rate for non-wage income earners during this period (**Table 23**).

Moving forward. There are indications that the very intense focus of the tax collection agencies and the Department of Finance (DOF) on meeting revenue targets in 2005-2009 may have had adverse effects on collection effort in periods other than the very near term. For instance, it has been reported that great effort have been put in finding ways of frontloading tax payments sometimes at the expense of systems that help improve the collection of the correct taxes. The tax collection agencies have also implemented various tax campaigns (or Oplans) that may have temporary and limited impact on collections.

Table 23. Decomposing changes in individual income tax effort (on non-wage income) a/ (percent of GDP)

	2005	2006	2007	2008	2009
due to change in policy	0.000	0.000	0.000	-0.046	-0.092
due to change in econ. structure	-0.005	-0.005	0.000	0.000	-0.001
due to change in tax leakage b/	0.092	0.078	0.009	0.028	0.083
Total	0.087	0.072	0.009	-0.017	-0.010

a/ change in tax effort measured relative to 2004

b/ negative number implies increase in tax leakage relative to 2004

To be fair, the BIR has already started to work on the institutionalization of systemic improvements in processes and procedures with respect to taxpayer registration, audit and enforcement. However, there is a need to further intensify efforts in implementing these reforms. These programs include:

- (i) improvement of the taxpayer registration system by cleaning up the existing record and broadening the tax registry;
- (ii) use of third party information from other agencies against which to verify information provided by taxpayers themselves; expanding the list of agencies to include the Social Security System, Bangko Sentral ng Pilipinas, Land Transportation Office, the Register of Deeds, the Land Registration Administration and LGUs, in addition to BOC and SEC; introduction of some flexibility in the Bank Secrecy Law;
- (iii) expansion of the coverage of *e*-filing and *e*-payment so as to improve taxpayer services and voluntary compliance as well as to facilitate the audit process;
- (iv) installation of a risk-based audit system; and
- (v) provision of adequate IT support to the BIR and BOC to enable them to achieve (i) – (iv) above.

At the same time, the BIR and BOC have pursued with greater vigor two programs that were started in 2005: the Run After Tax Evaders (RATE) and Run After the Smugglers (RATS). The two programs were initiated by the DOF to investigate and prosecute individuals or entities engaged in tax evasion. As such, these programs aim to promote voluntary compliance by deterring tax evasion. Under the new administration, the leadership of the BIR and BOC have vowed to intensify their implementation of the RATE and the RATS by filing at least one new case against suspected tax evaders/ smugglers once every two weeks.

Many, if not all, of the programs discussed above are not new. This observation underscores the fact that tax administration improvements do not happen overnight primarily because the installation and operationalization of system-wide changes take time.

5.2. Introducing New Tax Measures

Given this perspective, the present administration may have no recourse but to consider new tax measures in order to generate the much needed revenues to finance the MDGs and inclusive

growth in the context of fiscal consolidation. The challenge then is to identify tax measures that will generate additional revenues in the least distortionary manner.

Amending the excise tax on sin products. As pointed out earlier, revenues from the excise tax on tobacco products declined monotonically from 0.69% of GDP in 1996 to 0.32% of GDP in 2009. On the other hand, revenues from the excise tax on alcoholic products went down from 0.51% of GDP in 1997 to 0.27% of GDP in 2009. This contraction is largely explained by the fact that the excise taxes on sin products are levied on a specific basis and are not indexed to inflation.

Tobacco products

The existing excise tax on cigarettes makes use of a four-tiered schedule that is based on the net retail price¹⁸ of each brand of cigarette as of October 1, 1996 when the original law (RA 8240) that effected the shift from *ad valorem* rates to specific rates was passed.¹⁹ RA 9334 (which took effect in 2005) provides for discrete increases in the tax rate on tobacco and alcoholic products in 2005 and every other year thereafter until 2011 (in lieu of the automatic indexation of the specific tax rates to inflation). However, the increase in the tax rates implemented in 2005 was not enough to compensate for the inflation rate between 1996 and 2005. Moreover, the mandated increases in the excise tax rates between 2005 and 2009 under RA 9334 are less than actual rate of increase in prices during the period with the exception of the rate applicable to low priced cigarettes. Thus, revenues from excise tax on sin products declined persistently in 1996-2009 when measured relative to GDP because they were continuously eroded by inflation.

Given this perspective, the minimum requirement for the reform of the excise tax structure on cigarettes is the automatic indexation of the specific tax rates to inflation. Moreover, the 2011 excise tax rate schedule under RA 9334 needs to be adjusted upwards by an additional 20 percent so as to compensate for the incomplete inflation adjustment that was allowed under RA 8240 and RA 9334 between 1997 and 2011. Prospectively, this revised rate schedule should then be adjusted automatically in line with inflation. This move is estimated to increase the annual excise tax take by PhP 5 billion in 2011.

Note that RA 9334 changed the specific rates that are applicable to each tax tier (namely, low-priced bracket, medium-priced bracket, high-priced bracket and premium-priced bracket) but did not change the classification of the brands in the four tiers in accordance with prices prevailing in 2005. If RA 9334 had legislated a reclassification of cigarette brands in accordance with current prices, most of the cigarette brands that are packed by machine would have been subjected to the tax rate that is applicable to either the next higher tier or the one above the next higher tier in the

¹⁸ Net retail price for tax purposes is defined as the price at which the product is sold at retail outlets less the amount meant to cover the VAT and applicable excise tax rate.

¹⁹ RA 8240 also provided that new brands or variants of brands that existed prior to October 1, 1996 are classified according to their current retail price. This meant that new brands, including imports, tend to be subjected to a higher tax rate than existing brands.

original schedule found in RA 8240.²⁰ This implies that a reclassification of the brands in accordance with current retail prices would have increased excise tax collections from tobacco products by some PhP 37 billion in 2009. Furthermore, if the new specific tax rates for 2009 under RA 9334 were adjusted so that they fully reflect the change in prices between 2005 and 2009, excise tax revenues from tobacco products would have increased by another PhP 3 billion for a total of PhP 40 billion (or 0.5% of GDP) in 2009.

In principle, the excise tax on sin products is imposed for the purpose of (i) raising revenues and (ii) discouraging the consumption of the good being taxed. It is argued that higher excise taxes on tobacco will “induce some smokers to quit, reduce consumption of continuing smokers, and prevent others from starting” (Sunley 2009). Because the demand for cigarettes is relatively price inelastic, the expectation is that higher taxes will yield higher revenues in the near term while deterring smoking in the longer term.

Excise taxes on cigarettes are also justified in terms of the negative externalities imposed on passive smokers and the taxpaying public who bear the burden of paying for the health care costs associated with smoking. If the tax rate is set in relation to the social costs of smoking, then it should be levied on a uniform rate per stick (or per pack) since the social costs associated with cigarette smoking is the same regardless of the price of the cigarette.

From this standpoint, the first best approach to reforming to the excise tax on cigarettes is to levy a uniform tax regardless of the brand and to index the specific rate to inflation automatically subsequently. A uniform rate of PhP 13.90 per pack (in 2010 prices) is estimated to yield revenues equal to 0.66% of GDP (the excise tax effort obtaining in 1996). Needless to say, if the uniform specific tax rate on cigarettes is estimated based on the health costs associated with smoking, the tax rate will conceivably be much higher than this rate. However, depending on the price elasticity of demand, revenues from the excise tax may decline if the specific tax rate were set above a certain level.

In this regard, it is also noteworthy that the excise tax rate burden on cigarettes in the Philippines is lower than those in other countries (**Table 24**). Also, the price of cigarettes in the country is one of the lowest in the world.

Alcoholic products

The reform of the excise tax on alcoholic products is generally analogous to that of the excise tax on tobacco products. At the minimum, a one-time upward adjustment of 6% and 32% should first be applied to the 2011 excise rate schedule for distilled spirits and fermented liquor, respectively. Subsequently, this revised rate schedule should then be indexed automatically to inflation. This move is estimated to increase the annual excise tax take by PhP 5.5 billion in 2011.

²⁰ This conclusion is based on 2004 retail prices of various brands of cigarettes as cited in dela Cruz (2004) and 2009 retail prices of various brands of cigarettes as cited in Latuja *et al.* (2010).

Table 24. Retail Sales Price, Excise Burden and Total Tax Burden on Cigarettes for Bloomberg Initiative Countries, July 31, 2009.

Country	X-rate (LC/\$)	Retail Sales Price		Total Excise Burden		Total Tax Burden	
		(US\$/20)		(as % or RSP)		(as % or RSP)	
		Premium Brand (Malboro)	Cheapest Brand	Premium Brand (Malboro)	Cheapest Brand	Premium Brand (Malboro)	Cheapest Brand
Bangladesh	69.02	1.34	0.21	57.0	32.0	72.0	47.0
Brazil	1.97	2.16	1.02	26.7	38.2	62.7	74.2
China	6.82	2.20	0.30	42.7	31.6	62.2	49.8
Egypt	5.56	1.53	0.49	38.2	55.6	39.4	59.3
India	49.12	1.83	0.51	39.1	65.5	61.8	71.0
Indonesia	10,520.00	1.01	0.64	43.4	22.2	51.8	30.6
Mexico	13.34	2.10	1.27	48.6	48.6	61.7	61.7
Pakistan	80.67	0.79	0.24	55.5	49.1	69.3	62.9
Philippines	47.22	0.65	0.16	37.5	32.9	48.2	43.6
Poland	2.94	3.38	2.11	59.2	76.1	77.3	94.1
Russia	31.57	1.33	0.14	13.1	41.3	28.4	56.6
Thailand	34.94	2.15	1.20	61.6	51.1	73.2	62.6
Turkey	1.48	3.50	2.04	58.0	64.1	73.3	79.3
Ukraine	7.86	1.02	0.37	31.7	41.4	48.3	58.0
Vietnam	17,780.00	0.96	0.20	31.7	30.8	40.0	38.7

X-rate = foreign exchange rate; LC/\$ = local currency/US\$

Source: Philip Morris International as cited in Sunley (2009)

At the same time, a price survey of alcoholic products should be conducted immediately to permit the reclassification of said products for excise tax purposes in accordance with their current prices. However, the first best approach is to levy a uniform specific rate regardless of the brand and to index said specific rate to inflation automatically subsequently. The shift to a single rate from a multi-tiered rate structure does not only tend to reduce harmful health effects of excessive consumption of alcoholic beverages by eliminating the opportunity for consumers to switch to cheaper brands, it is also expected to improve collection efficiency by eliminating the occasion for mis-classification of the different brands for purposes of reducing the applicable tax rate.

Rationalization of fiscal incentives. Fiscal incentives are wide ranging - across activities/ sectors, type of instrument, and incentive-granting bodies. The most important of these are these are:

- (i) the fiscal incentives provided by the Board of Investments under the Omnibus Investment Code of 1987 (or Executive Order 226):
 - income tax holiday (ITH) of 3-6 years,
 - exemption from import duties and tax on capital goods,
 - an additional deduction of 50% of the wage bill, and
 - tax credit for taxes and duties on imported raw materials, supplies and semi-manufactured products used for the production of exports to selected industries.

- (ii) the fiscal incentives provided by the Philippine Export Zone Authority (PEZA) and those to locators in special economic zones:
- income tax holiday of 3-6 years and the application of a 5% tax on adjusted gross income after the income tax holiday expires,
 - duty free importation of machinery equipment and spare parts, and
 - tax credit for taxes and duties paid on imported raw materials and inputs used in the production of export products.

Studies have raised various concerns with the Philippine fiscal incentives in terms of: (i) the fiscal cost arising from the redundancy of the fiscal incentives (Reside 2006; Bird 2010), (ii) the relative effectiveness of the different types of instruments used (Medalla 2006, Botman *et al.* 2008) and (iii) too wide coverage of the investment priorities list (Medalla 2006).

On the one hand, Reside (2006) estimates that 90% of non-ITH incentives and 80% of the ITH provided by the BOI are redundant in 2004.²¹ On the other hand, Bird (2010) estimates that the ITH provided by the BOI is 27%-52% redundant depending on the methodology used in estimating redundancy. Depending on the estimate of the redundancy rate, the revenue foregone from redundant fiscal incentive provided by the BOI is estimated to be equal to 0.2%-0.6% of GDP in 2004.²² Given this finding, it is imperative that the selection of the sectors to be included in the Investment Priorities List be improved in order to reduce the redundancy of the fiscal incentive system.

On the other hand, Botman *et al.* (2008) shows that while the effective tax rate is higher in the Philippines than in neighboring countries for companies that do not enjoy fiscal incentives, the effective tax rate in the Philippines is comparable to those of its neighbors when fiscal incentives are taken into account. They also found that the proposal made by the Department of Finance (DOF) in 2008 to abolish the ITH and replace it by a 25% corporate income tax or a 5% tax on gross income will reduce the marginal and average effective tax rates of registered firms relative to the ITH regime, thereby ensuring the country's competitiveness in attracting foreign direct

²¹ A fiscal incentive is said to be redundant if it is given to a firm that would have made the investment anyway with or without the fiscal incentive. Redundancy is primarily related to the market-orientation (i.e., producing for the domestic market or producing for the export market) of the investment project with investments in the latter tending not to be redundant. In more technical terms, Reside (2006) estimated the amount of redundancy by first classifying investment into three types (market seeking, resource/ asset seeking and efficiency seeking) and then assuming that all incentives to investments other than those which are efficiency seeking are redundant.

²² These estimates are much lower than the 1% of GDP estimate of Reside (2006) because (i) his estimate included the revenue foregone from tax credit for taxes and duties on imported raw materials and inputs to export production which is necessary if exports are to be treated on an equal basis as their counterparts in the rest of the world, and (ii) these estimates assume that the corporate income tax rate is equal to 30%.

investment, other things being equal.²³ Their results also indicate that the effective tax rates faced by firms under the said proposal will lead to actual tax payments, in contrast to the ITH regime. Thus, revenue collected under the said proposal will increase.

In sum, the abolition of the ITH and its replacement by either a 25% corporate income tax or by a 5% tax on gross income will improve the country's fiscal incentive system. In addition, there is a need to unify the fiscal incentives provided by all the investment promotion agencies.

Road user charge. The annual requirement for preventive and routine road maintenance of the national road network is PhP 20 billion annually (Encarnacion 2007). However, revenues from the motor vehicle user charge (MVUC), 80% of which is earmarked for road maintenance, is only PhP 9 billion – PhP 10 billion in 2009-2010.

Thus, there is a financing gap of at least PhP 12 billion for road maintenance per year. At present, part of the gap is financed through the GAA. Prospectively, it could be financed by either one or a combination of the following: (i) an increase in motor vehicle registration fees especially on heavy trucks which are taxed at a rate that is disproportionately less than the cost of damage they cause on the roads, and (ii) the introduction of a variable road user charge in the form of an additional excise tax on petroleum products.

Increasing the excise tax on petroleum products will discourage wasteful consumption of fuel, thereby helping control pollution and congestion. Such a move also will help improve the overall progressivity of the tax system because the distribution of the burden of the petroleum product excise is found to be heavier on households in the higher income bracket.²⁴ That is, the distribution of the burden of the excise tax on petroleum products is mildly progressive as indicated by its Suits index of 0.02 (**Figure 9**).²⁵

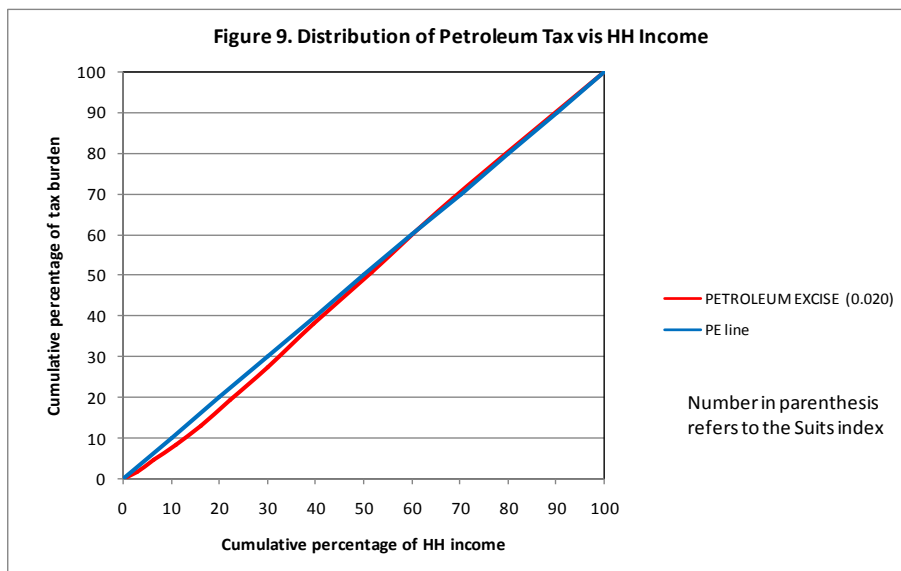
²³ Botman *et al.* (2008) argue that income tax holidays are most attractive to footloose industries that tend to exit the country when the tax holiday expires and firms investing in short-lived assets who are able to recover their cost within the tax holiday period. In addition, income tax holidays are not cost effective because profits are exempted regardless of their amount, with the most profitable investments that most likely have been made anyway anyway receiving more benefits relative to other firms.

²⁴ This analysis is based on the expenditure pattern of households in different income deciles in the 2006 Family Income and Expenditure Survey.

²⁵ The Suits index is a summary measure that is used to assess the impact of changes in the tax structure on income distribution. It is defined with reference to a Lorenz-like curve (or concentration curve) which plots the cumulative percent distribution of household income on the horizontal axis and the cumulative percent distribution of tax burden on the vertical axis. If E is the area below the 45-degree line and L is the area below the Lorenz-like curve, then the Suits index is defined as $S = (E-L)/E = 1 - L/E$. If the tax is progressive, the Lorenz-like curve will lie below the 45-degree line but if the tax is regressive it will lie above the 45-degree line. The Suits index varies between -1 and +1. In the limiting case of extreme progressivity where the highest income household bears the entire tax burden, the Suits index is equal to +1. Conversely, in the case of extreme regressivity where the lowest income household pays the entire tax burden, the Suits index is equal to -1. If the tax is proportional, the Suits index is equal to 0.

It is estimated that if PhP 6 billion (or half of the PhP 12 billion financing gap for road maintenance) were to be raised from an increase in the excise tax on petroleum products, the excise tax rates will have to increase by close to 50%. This translates to a PhP 2 increase in the price of gasoline.

Increase in VAT coupled with reduction in CIT or IIT. Some sectors are proposing an increase in the VAT rate from the present 12% to 15% coupled with a reduction in the corporate income tax rate from the present 30% to 25%.²⁶ The objective of the proposal is ostensibly to shift the tax system away from the taxation of income towards the taxation of consumption. If indeed this is the intention, the VAT-CIT pairing is not quite the logical one. The more logical combination is an increase in the VAT rate and a reduction in the individual income tax rate.

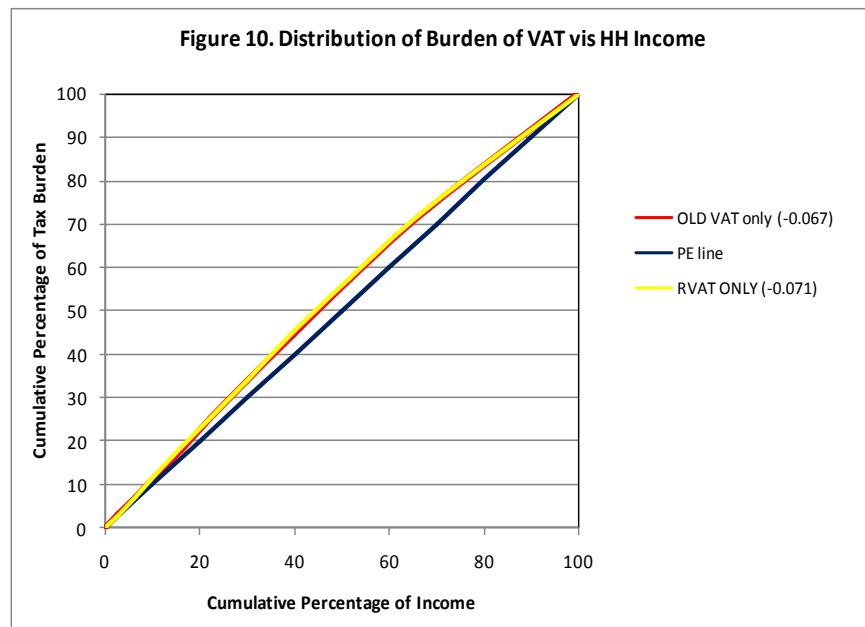


Now, if the increase in the VAT rate is paired with a decrease in the individual income tax rate, the downside risk arising from such a move is not small because of the difficulty in predicting its revenue impact. The overall effect on total collections of an increase in the VAT rate and a simultaneous reduction in the individual income tax rate depends on whether the VAT collections and individual income tax collections from non-wage income earners will increase enough (because of improved tax compliance associated with the reduced rates) so as to compensate for the certain reduction in revenues from wage income earners (which are subject to withholding tax).

Assuming the overall revenue impact is positive, this effect will have to be weighed against the distributional effect of the increase in the VAT rate. An analysis of the distribution of the burden

²⁶ The proposed 3 percentage point increase in VAT rate is estimated to result in a PhP 75.5 billion (or 1 percentage point of GDP) increase in VAT collections while the proposed 5 percentage point reduction in the CIT rate is estimated to result in a PhP 42.4 billion (or 0.6 percentage point of GDP) reduction in CIT collections.

of the VAT indicates that the reformed VAT is mildly regressive despite the fact that agricultural food products are VAT-exempt. Also, the reformed VAT is found to be slightly more regressive than the expanded VAT before it (**Figure 10**). As such, increasing the VAT rate may face serious opposition from the public at large. Meanwhile, proposals to exempt from the VAT goods and services that the poorer households consume more relative to households in the higher income deciles to counteract the regressivity of the VAT may be counterproductive since it will tend to complicate VAT administration.



Moreover, the VAT rate in the Philippines (12%) is already the highest in the region in 2009. The VAT rate in Indonesia, Malaysia and Vietnam is 10% while that in Thailand is 7%.

On the other hand, proposals to reduce the corporate income tax rate will have to be considered in the context of enhancing the country's competitiveness in attracting FDI given the rationalization of fiscal incentives and the fiscal cost of a generalized reduction in the CIT. In 2009, the corporate income tax rate in the Philippines (30%) is the same as that of Thailand (30%), lower than that of India (34%), and higher than that of Indonesia (28%), Malaysia (25%), and Vietnam (25%).²⁷

Value simplified tax (VAST). House Bill 1790 (15th Congress) proposes to replace the 12% value added tax (VAT) by the 6% Value Simplified Tax (VAST). Plain and simple, the VAST is a turnover tax because it disallows firms from claiming tax credits for taxes paid on inputs and capital goods and because it is levied not just on final consumption but also on intermediate and

²⁷ These figures are based on the World Bank, 2010 World Development Indicators (<http://data.worldbank.org/indicator/GB.TAX.IMAR.CD/countries>; accessed January 3, 2011)

capital goods. Abstracting from the abolition of the input tax credit, the tax base of the proposed VAST is the same as that of the VAT because goods, services and transactions that are exempted under the VAT are likewise exempted under the VAST. The VAST also exempts all retired personnel of the AFP, PNP, Coast Guards, Customs Police. In addition, retired public school teachers who have been in the service for at least 30 years will also be exempted from the VAST.

In principle, the VAST is inferior to the VAT from the perspective of economic efficiency, tax administration and revenue adequacy. Because the VAST is collected at every stage of the production and distribution chain, it will result in tax cascading. That is, the tax base of the VAST at any given stage will include all the taxes already paid at earlier stages of production/distribution, i.e., the VAST will impose a tax on taxes that were previously paid on intermediate inputs.

Although the nominal tax rate under the VAST is 6 percent for VAST-able sectors, the average unweighted effective tax rate under this system is estimated to be equal to 16.9 percent.²⁸ In comparison, the average unweighted effective tax rate under the 12 percent VAT system is estimated to be equal to 11.4 percent. These numbers are indicative of the extent of tax cascading under the VAST. On the other hand, the effective tax rates for exempt sectors (e.g., rice, fruits, vegetables, fish, unprocessed meat) are, in general, slightly lower under the VAST compared to those under the VAT (**Table 25**). In contrast, the effective tax rate on goods that are subject to VAST/VAT are, for the most part, higher under VAST relative to those under the VAT. Moreover, the difference tends to be larger for goods that are more downstream in nature.

Table 25. Comparative effective tax rates under the VAST and the VAT for selected goods

	VAST	VAT
Rice	2.3	3.4
Banana	3.8	5.4
Leafy Vegetable	2.5	3.6
Fish (Ocean)	3.1	4.0
Fish (Inland)	0.9	1.4
Slaughtering	2.6	4.0
Milk	13.9	13.2
Noodles	12.8	13.1
School supply	14.8	13.1
Gasoline/ diesel	15.0	13.5
Electricity	13.6	12.5

Author's estimates

²⁸ This number is derived based on the 240x240 Input-Output Table for 2000.

As such, the VAST will provide undue advantage to more vertically integrated enterprises vis-a-vis firms engaged in operations that are focused on a more specialized segment of the production / distribution chain. Because the VAST does not allow firms to claim credit for taxes paid on inputs, the inefficiencies on the production side of the economy under the VAST will tend to be more exaggerated compared to that under the VAT.²⁹ Moreover, exports tend to be less competitive under the VAST because they will have to bear the burden of the tax on their inputs.³⁰

Ostensibly, the tax credit provision for taxes paid on inputs will be abolished under the VAST because said provision is abused by taxpayers, resulting in the overstatement of input purchases. However, the VAST creates a loophole even as it tries to plug another one. This is so because the VAST exempts AFP, PNP, Coast Guards, Customs Police and public school teachers/retirees will vastly complicate the administration of the VAT. First, this requires sellers to verify if their buyers are AFP, PNP, or public school teacher retirees. Second, assuming that all sellers are able to do proper verification of their buyers, some sellers may decide to overstate the amount of exempt sales that they report for tax purposes.

At the same time, the VAST eliminates the paper trail of sales invoices that is available under the VAT to check and cross-check the sales and purchases of firms. Note that a taxable firm can claim credit for the input VAT only if the claim is supported by sales invoices under the VAT. In recent years, the BIR launched a program called “Reconciliation Listing for Enforcement” or RELIEF. Under the program, all VAT-registered firms are required to submit to BIR a summary list of their sales/ receipts and purchases for any given taxable period. Using the submissions under the RELIEF by a number of selected big corporations, the BIR was able to discover underdeclarations of sales of some of the suppliers of these firms. Thus, the introduction of the VAST in lieu of the VAT will improve tax administration only if the over-statement of input VAT claims is the bigger source of VAT evasion than under-declaration of sales and if the tax evasion arising exemption of AFP/ PNP/ public school teacher retirees does not offset the potential improvements in collection efficiency from such a move.

Finally, counterfactual analysis based on the household expenditure pattern in the 2006 Family Income and Expenditure Survey indicates that the shift to the VAST will result in a tax loss of PhP 25 billion a year (or 0.3% of GDP), assuming that the collection efficiency (estimated as a percentage of potential revenue) under the VAT is same as that under VAST. Conceivably, the revenue loss from the VAST will be even larger than this estimate because, as indicated in the previous paragraph, the VAST is likely to weaken tax administration.

²⁹ The economic literature suggests that the taxation of inputs “may lead to inefficiencies in that different industries will face different relative prices so that the marginal rate of transformation between inputs or between an input and an outputs would be unequal” (Ahmad and Stern 1987).

³⁰ In comparison, exports are zero rated under the VAT. This means that the tax rate on exports is zero and exporters are given a rebate equal to the VAT paid on the inputs to exports.

To recap. There is a need for government to consider the imposition of new tax measures if fiscal consolidation is to be achieved without sacrificing the financing of MDGs and inclusive growth. The least distortionary options in this regard include: (i) the restructuring of excise tax on sin products, (ii) the rationalization of fiscal incentives, and (iii) reforming the road user charge.

In addition, the government should also consider the simplification of the tax structure. This change will not only enhance the fairness of the tax system but will also make it easier to collect taxes by removing opportunities for misclassification or misdeclaration of goods/transactions. Simplification generally involves: (i) reduction in the number of rates at which any given tax is imposed (e.g., multi-tiered rate structure for excise taxes, different rates for different types passive income), and (ii) reducing the number of exemptions (e.g., exemptions under the expanded Senior Citizens Act, the tax on interest income).

6. BUDGET REFORMS

To complement the reforms on the revenue side, budget reforms should be further strengthened to enhance the quality of spending as well as the manner by which spending is carried out. In this regard, the Department of Budget and Management (DBM) has started a good number of initiatives for some time now.

Zero-based budgeting. Most recently, the DBM has introduced the zero-based budgeting approach in deciding how the 2011 national government budget will be allocated. Through this approach, the DBM reduced and terminated funding for programs found to be suffering from irrelevance, ineffectiveness, leakages and political interference, thereby freeing allocations in favor of critical and effective programs (Abad 2010).

For instance, the objectives as well as intended beneficiaries of the Food-for-School Program (FSP) and the Pantawid Pamilyang Pilipino (4Ps) overlap. However, studies (e.g., Manasan 2009) show that the 4Ps is more effective in identifying the intended beneficiaries. At the same time, the monitoring and enforcement of the conditionalities on school attendance is more stringent under the 4Ps than under the FSP, thereby enhancing the positive impact on school attendance. In the 2011 budget, the FSP was discontinued and the funding for the 4Ps increased.

For zero-based budgeting to be implemented on a sustainable basis, however, a consistent supply of evidence-based research on the effectiveness and impact of various government programs is needed. Also, the availability of good quality data that will allow the evaluation of government programs cannot be overemphasized.

Timely enactment of General Appropriations Act (GAA). The GAA was approved before the beginning of the fiscal year only once between 2001 and 2010. Moreover, Congress failed to enact the GAA thrice during this period – in 2001, 2004 and 2006. This practice tends to: (i) weaken fiscal discipline as the total allotment of some agencies may exceed the new appropriations for the new budget year by the amount of appropriations based on the re-enacted budget (i.e., the previous year's budget) prorated from January 1 until the date of the passage of

the new GAA;³¹ and (ii) reduce the credibility as well as transparency of the budget by increasing the discretion of the President because he/she is empowered to reallocate resources that were appropriated to items that have already been fully executed as he/ she sees fit. From this perspective, Congressional approval of the 2011 GAA in December 2010 is laudable.

Public expenditure management (PEM). The public expenditure management (PEM) reform introduced by the DBM as early as 2000 augurs well for shifting budgetary resources on a more strategic basis. The reforms under the PEM have two major strands: the Medium Term Expenditure Framework (MTEF) and the Organizational Performance Indicators Framework (OPIF). The MTEF is a tool for linking policy, planning & budgeting over the medium-term. On the other hand, the OPIF promotes a result-orientation in the budget process that enhances the accountability of agencies.

The deliberation of the Development Budget Coordinating Committee (DBCC) on the Paper on Budget Strategy (whereby implementing agencies in high priority sectors are called to defend their new spending proposals) serves as the venue for enforcing a more strategic allocation of resources during budget preparation. For instance, the 2011 President's budget is said to have an "unabashed bias for the poor and vulnerable." Thus, social services received the lion's share of the 2011 budget and the highest increase among the sectors.

In this regard, there is a need to help strengthen the capacity of the implementing agencies that play a major role towards the achievement of the MDGs to prepare Medium-term Expenditure Plans. Well-crafted MTEPs will facilitate these agencies' articulation of new spending proposals that will help them upgrade their service levels in a manner consistent with the MDG targets. In this way, they will be in a better position to secure a greater share of the fiscal space that is available.

On the other hand, the prominence given to performance/ results in the budget process under the PEM naturally reinforces the link between the government's budgetary allocations, on the one hand, and the goals, policies, strategies and priority programs, activities, and projects (PAPs) that they have included in their plans. This performance-orientation is enshrined in the OPIF which is essentially an outcome and output framework that describes a logical hierarchy of causal relationships that link the outputs (i.e., goods and services) that government delivers to the outcomes that it seeks to achieve. The OPIF is an accountability framework that helps government agencies to establish the link between the outputs that they are mandated to provide and the outcomes that government wants to achieve, to assess their accomplishments and to report on results. As such, the OPIF helps agencies focus on core activities that deliver results, and helps set priorities for allocating resources to critical outputs and activities. By clarifying how agency performance is to be measured, the OPIF also has the potential of improving the reporting of results, thereby enhancing transparency. To date, the OPIF has been cascaded to all national government department and agencies. To further strengthen the application of the OPIF, there is a need to improve on the performance indicators that have been formulated for the major

³¹ Based on key informant interviews, (i) above is applied selectively.

final outputs of each department/ agency. Also, it is important to enhance the processes and procedures for performance review and reporting of agencies.

To date, efforts on both the MTEF and the OPIF are done exclusively within the Executive branch. OPIF has the potential of enhancing public sector accountability by making more transparent to Congress and the general public the outputs and monitorable performance targets that agencies are supposed to achieve given the budgetary resources they receive. On the other hand, the MTEF is, prospectively, useful in forging a fiscal accord with Congress. In this regard, it is important to engage Congress in the MTEF and OPIF reform process soonest.

Promoting fiscal responsibility. A fiscal responsibility framework refers to a combination of *statutory* fiscal policy rules and procedural rules that impose a permanent constraint on fiscal policy. The fiscal rules are typically expressed as a ceiling on summary indicators of overall fiscal performance – fiscal deficit, debt, borrowing, expenditure or some component thereof. On the other hand, the common procedural rules include: medium-term budget programming and self-financing requirement for each new spending or tax cut proposal in line with the pay-go principle (Kopits 2007). These rules are aimed at promoting a prolonged commitment to fiscal discipline so as to achieve sustained macroeconomic stability and long-term fiscal sustainability. Following New Zealand, which enacted a Fiscal Responsibility Act in 1994, many countries around the world (notably the EU countries, the UK, many Latin American countries and India) have adopted a rules-based fiscal responsibility framework in the last 15 years (Kopits 2007).

In the Philippines, there was some interest in the legislation of a fiscal responsibility framework in the last Congress. The fiscal and procedural rules in the proposed bill include:

- (i) debt cap equal to 80%-90% of GDP for the non-financial public sector and 60%-65% of GDP for national government by 2010 and to maintain a sustainable level in the context of a medium term fiscal accord,
- (ii) deficit-neutral expenditure and tax measures
 - all increases in national government expenditures especially those mandating the creation of recurrent expenditures must be offset by permanent increase in revenue or permanent reduction in other expenditures
 - scrap and build policy for creation of agencies
 - suspension of unfunded laws
 - the grant of tax breaks which effectively reduce government revenues must be offset by tax rate raises, expansion of tax base, or imposition of new taxes,
- (iii) repeal of automatic guarantee for the debt of government owned and controlled corporations.

The experience with fiscal rules in other countries shows mixed results (Kopits 2007). On the positive side, fiscal rules may result in lower risk premia (especially if greater credibility is established as fiscal targets are met), and, therefore, in lower interest rates and indebtedness. On the negative side, fiscal rules may provide an incentive for creative accounting, the accumulation of payment arrears, and expenditure compression. They may also limit government's ability to respond to unanticipated shocks and to implement countercyclical fiscal policy.

Given this perspective, the inclusion of a debt cap in the proposed bill is problematic primarily because of the difficulty in fixing the sustainable level of government debt in the legislation. Moreover, the debt-to-GDP ratio depends on a number of variables, some of which are not directly controlled by government. In this light, a fiscal deficit cap is perhaps more appropriate. However, the fiscal deficit cap should be defined in terms of a cyclically adjusted primary balance in order to provide the government some flexibility in responding to exogenous shocks (Creel 2003).

But, what is perhaps most useful, and also, less controversial is the rule on deficit neutral expenditure and tax measures. In essence, it is an attempt to institutionalize the pay-go principle. The importance of this rule is highlighted by the propensity of Congress to enact legislation that either provides tax breaks or special benefits that require recurrent government funding to various sectors. In this regard, **Table 26** lists the laws that were passed since 2005 that have negative revenue impact.

Table 26. List of Laws with Negative Revenue Impact, 2005-2010

	Revenue Impact (in billion pesos)
RA 9337 - Corporate Income Tax Reduction, 2005	15-20
RA 9504 - Individual Income Tax Relief, June 17, 2008	26
RA 9505 - PERA, August 22,2008	12
RA 9511 - Imposition of Franchise Tax on Power Transmission in Lieu of All Taxes, December 1, 2008	9
RA 9593 - Tourism Incentives, May 12, 2009	6
RA 9648 - Abolition of DST on Secondary Trading of Stocks, June 30 2009	1.4
RA 9679 - Incentives under the PAG-IBIG Charter, July 21, 2009	1
RA 9728 - Bataan Freeport, October 23, 2009	3
RA 9856 - REIT Incentives, Lapsed into law in 2009	2.7
RA 9994 - VAT Exemptions of Selected Goods and Services Purchased by Senior Citizens, February 15, 2010	1.7
RA 9999 - Tax Deductibility of Actual Free Legal Services Rendered for the Poor, February 23, 2010	0.1
RA 10001 - Restructuring of DST on Life Insurance Policies and Reduction of Premium Tax on Life Insurance Policies from 5% to 2%, February 23, 2010	1.4
RA 10020 - Migrant Workers and Overseas Filipino Act (Abolition of DST on OFW Remittances, Lapsed into law March 8, 2010	1
RA 10026 - Income Tax Exemption ad Condonation of Unpaid Taxes fo Local Water Districts, Lapsed into law March 11,2010	0.8
RA 10083 - Creation of Special Economic and Freeport Zone in Aurora, Lapsed into law April 22, 2010	3

Source: DOF

Lastly, Kopits (2007) emphasized that the successful implementation of fiscal rules presupposes progress and sustained effort in a number of structural reform areas that will ensure the sustainability of the fiscal rules themselves, namely: tax policy, public pensions, health care and local government finance.

7. CONCLUSIONS AND RECOMMENDATIONS

The progress made by the national government in consolidating its fiscal position between 2002 and 2006 proved unsustainable as its revenue effort started to go down once again in 2007 after a brief improvement in 2005-2007. With the more expansionary stance taken by the government in 2009 as part of its effort to shield the economy from the effects of the global financial and economic crisis of 2008/9, the national government fiscal deficit jumped to 3.9% of GDP and national government debt started to rise when measured relative to GDP. Moreover, the fiscal deficit is projected to remain high at 3.6% of GDP in 2010 and 3.4% of GDP in 2011.

Clearly, turning around the national government's fiscal health should be high on the policy agenda. In previous episodes of fiscal consolidation, the easiest way to address the fiscal imbalance is by cutting expenditures. However, this option does not appear to be consistent with the government's avowed commitment to achieving the Millennium Development Goals and inclusive growth. Underspending on basic social services and infrastructure and the concomitant service deficit in these sectors in earlier years has put at risk the country's attainment of the Millennium Development Goals (MDGs). On the other hand, the lack and poor quality of infrastructure, particularly in the roads/ transport and power sectors, holds back economic growth which has been found to be an important determinant of poverty reduction. The infrastructure shortage also contributes to unequal access to basic social services which then diminish their ability to benefit more fully from economic growth.

The fiscal sustainability analysis that was undertaken as part of this study suggests that national government revenues need to increase from 14.3% of GDP in 2009-2010 to 17.5%-17.9% in 2012-2016 if fiscal consolidation were to be achieved while providing adequate budgetary support for the much needed basic social services and infrastructure that are necessary for inclusive growth and the achievement of the MDGs. Otherwise, if revenue effort remains lackluster, then the fiscal deficit will rise from 3.6% of GDP in 2010 and 3.5% in 2011 to 5.0% in 2012, about 3.9% in 2013-2015 and 3.1% in 2016. As a result, outstanding debt stock of the national government will not post any reduction during the period under study but will hover around 56% of GDP.

Thus, there is an urgent need to increase national government revenues so that the fiscal imbalance is corrected while providing the fiscal space for the much needed basic social services and infrastructure that are critical for economic growth and poverty reduction. The Aquino administration has repeatedly said that the much needed revenue increases will be derived solely from improvements in tax administration rather than from the imposition of new taxes or increases in the rate of imposition of existing taxes. This emphasis on plugging the leakages in tax collection is well placed. The tax gap (or the difference between potential revenue and actual collections) from the VAT and the individual income tax on non-wage income alone is estimated to exceed 4% of GDP in 2007-2009.

The record of the BIR and BOC in increasing their revenue effort through improvements in tax administration does not inspire optimism, however. An analysis breaking down the sources of

change in the tax-to-GDP ratio of the major types of taxes in 2005-2009 suggests that tax-to-GDP ratio for the VAT, the corporate income tax and the excise tax on tobacco and petroleum products would have been higher than they actually were during the period if collection efficiency had been maintained at the 2004 level.

This paper emphasized the need for the institutionalization of systemic improvements in processes and procedures in the area of taxpayer registration, audit and enforcement including:

- (i) cleaning up the existing record and broadening the tax registry;
- (ii) greater use of third party information by establishing arrangements with the Social Security System, Bangko Sentral ng Pilipinas, Land Transportation Office, the Register of Deeds, the Land Registration Administration and LGUs, in addition to BOC and SEC; introduction of some flexibility in the Bank Secrecy Law;
- (iii) expansion of the coverage of *e*-filing and payment so as to improve taxpayer services and voluntary compliance as well as to facilitate the audit process;
- (iv) installation of a risk-based audit system; and
- (v) provision of adequate IT support to the BIR and BOC.

However, this study also cautions that tax administration improvements do not happen overnight primarily because the installation and operationalization of system-wide changes take time. Thus, it argues that there is a need for government to consider the imposition of new tax measures if fiscal consolidation is to be achieved without sacrificing the financing of MDGs and inclusive growth. The least distortionary options in this regard include:

- (i) the restructuring of excise tax on sin products,
 - as a first best option, levy a uniform rate on all brands and index the specific rate to inflation automatically subsequently; initially, uniform specific rate should be set so as to yield A uniform rate of PhP 13.90 per pack (in 2010 prices) is estimated to result in a tax effort ratio equal to the 1996 level; tax rate may be set at a higher rate than this if one wishes the tax to result in a stronger deterrent effect on smoking/drinking bearing in mind that revenues from the excise tax may decline if the specific tax rate were set above a certain level, depending on the price elasticity of demand.
 - at the minimum, allow for the automatic indexation of the specific tax rates with inflation;
 - alternatively, price survey of tobacco and alcoholic products should be conducted immediately to permit the reclassification of said products for excise tax purposes in accordance with their current retail prices; in addition, the specific tax rates applicable for 2011 under RA 9334 should be adjusted so that they fully reflect the change in prices between 2005 and 2011
- (ii) the rationalization of fiscal incentives,
 - abolish the ITH and replace it by a 25% corporate income tax or a 5% tax on gross income; and
 - unify the fiscal incentives provided by the various investment promotion agencies

- (iii) reforming the road user charge.
 - increase motor vehicle registration fees especially on heavy trucks which are taxed at a rate that is disproportionately less than the cost of damage they cause on the roads
 - introduce a variable road user charge in the form of an additional excise tax on petroleum products.

In addition, the government should also consider the simplification of tax structure by reducing the number of rates at which various taxes are levied or by reducing the number of taxpayers/ transactions/ or types of income which are exempt from any given tax. Tax simplification makes tax administration easier by minimizing the opportunities for evasion. It also improves equity.

Finally, budget reforms that enhance the quality of spending as well as the manner by which spending is carried out should be further strengthened in order to complement the reforms on the revenue side. The more important reforms include:

- (i) continued application of a zero-based budgeting approach; support initiative with the conduct of evidence-based research on the effectiveness and impact of various government programs and improvement in the availability of good quality data that will allow the evaluation of government programs;
- (ii) promotion of the timely enactment of General Appropriations Act (GAA) yearly;
- (iii) strengthening of public expenditure management reforms; enhancement of the performance indicators that have been formulated for the major final outputs of each national government department/ agency; improvement of the processes and procedures for performance review and reporting of agencies; and most important, engagement with Congress in the MTEF and OPIF reform process soonest; and
- (iv) support for the enactment of a fiscal responsibility law anchored on the institutionalization of a rule that all new expenditure and tax measures should be deficit-neutral and a cap on the cyclically adjusted primary balance.

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