

Crisis – a paroxysmal attack of pain and distress or disordered function; an emotionally significant event or radical change in status in a person’s life; the point of time when it is decided whether an affair or course of action shall proceed, be modified or terminate; decisive moment; the turning point such a point in the course of the action of a play or other work of fiction (compare climax, resolution); the immediate sequel to the culminating point of a period of prosperity in rising market at which the business organism is severely strained and forced liquidation occurs (see business cycle); an unstable state of affairs in which a decisive change is impending such as recurrent cabinet crisis trouble (France); a psychological or social condition characterized by unusual instability posed by a excessive stress and either endangering or felt to endanger the continuity of the individual or his group such as social condition requiring the transformation of existing cultural patterns and values (see juncture). (Webster’s Third New International Dictionary)

Crisis – a state of affairs with the distinct possibility of a highly undesirable outcome. (Webster)

Fiscal – relating to taxation, public revenues or public debt management and policies (Webster’s Third New International Dictionary)

***DIMENSIONS OF THE PHILIPPINE FISCAL CRISIS:
A ROADMAP TO FISCAL REHABILITATION***

by

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A thousand needles on thyself before a single needle on thy patient.

Is the Philippines in the midst of a fiscal crisis? Yes, and that is the singular conclusion of eleven UP professors in their paper entitled The Deepening Crisis: Real Score on Public Debt and Deficit released Aug. 23. In his paper “A Roadmap to Fiscal Deliverance”, DOF Secretary Isidro Camacho gave us an earlier glimpse of such crisis in 2003 promptly after resigning.

Fiscal crisis, financial crisis and economic crisis are economic tendencies that usually happen together or one after the other. They are just typologies used interchangeably because they all mean pain particularly to the man on the street. What happened during the time of Marcos was a foreign debt crisis that cascaded into an overall economic crisis due to a political event risk. It was characterized by runaway inflation, receding GDP, business closures and jobs destruction. During the time of Ramos, it was essentially the Philippine version of the Asian financial crisis. It was typified by collapsing stock markets, peso devaluation, falling property prices and rising non-performing loans in the banking sector. However, due to reforms on deregulation, liberalization and privatization, the country was able to prevent it from evolving into an economic crisis, GDP fell by less than -1% in 1999. One can think of fiscal crisis as Typhoon Signal No. 1, financial crisis as No.2 and economic crisis as No. 3. We are in the frying pan, not yet on the fire. It is HIV-positive, not yet AIDS-afflicted. It is a crisis, not yet a catastrophe.

The Philippines is under storm signal no. 1 - a fiscal crisis that is characterized by the structural weakness in government financial condition but which can eventually infect the private sector and the rest of the economy through interest rate shocks as the medium of contagion. Its main features include dependence on borrowings to finance even the most minimum government function and a debt stock-deficit spiral. Moreover, in the 2005 budget proposal, interest payments have become the biggest budgetary item overtaking wages for the first time in our fiscal history. Yet, the private sector is generally healthy with NPLs falling from 19% to 13.7%, corporate profits rising by 12% with telecom giants at a faster clip. With nominal GDP of 6.4% in 1Q, a stable peso and inflation under control, albeit rising, it was just the government; and the economy was doing fine despite the government.

Our task then in the administration is to put a sick government into intensive care and radical surgery and insulate the private sector from the contagion via an interest rate shock. Our financial diagnosis suggests that the country is in advanced stages of fiscal metastasis as shown by the rapid spiral in debt service and debt stock which needed to be contained and reversed immediately while secular growth in revenues was structurally constrained.

The current mood is to avoid finger pointing, look forward and solve the problem. Yet while seeking solutions, as a people, we still need to clarify those events and account for

those decisions that brought us to this 3rd major crisis in barely two decades. The Philippines almost invariably falls into a crisis every 7 years. Thus, this paper represents a seminal attempt in exploring the anatomy of the current Philippine fiscal crisis so that we can arrive at an appropriate prescription.

1. The crux of the fiscal crisis is the unsustainable debt stock of P3.35trillion of the National Government (NG) as of end-2003 and a P5.39trillion total public debt stock as of September 2003. While nominal GNP has grown by only 11%, NG debt has grown at 17% pa and tax revenues grew by only 5.41%. Result: NG debt rose from 53% to 76% of the gross domestic product or GDP while total public debt rose from 103% in 1997 to 137% in 2003. To match maturing foreign debt, the country has tapped international credit by an average of US\$3billion in annual foreign bond issues making it the second biggest issuer in Asia after Japan. This is already one of the fundamental anomalies that manifest our evolving fiscal crisis.
2. The eleven UP economists reached their conclusion using an economic model that showed that the current debt stock of the National Government of P3.355 trillion is unsustainable at 76% of GDP. It is even more appropriate to use the total public debt stock of P5.39trillion as basis for formulating strategy since almost all of GOCC debt naturally migrate to the NG, P500bn, mostly foreign debt, from Napocor is likely to migrate as soon as 2005.
3. Given its sheer size (P3.355trillion), the speed of its increase of three times or P2.011trillion from 1997 to 2003 and the proportion of total public debt (P5.39 trillion) to the national output (137% of GDP), the public debt has assumed a life of its own raising the spectre of a debt-deficit spiral, i.e. debt stock causing high interest payments that in turn cause deficits that bloat the debt stock. Interest payments will reach P302billion in 2005 becoming the largest budgetary item in the General Appropriations Act (GAA) and overtaking government wages for the first time in our fiscal history. At 33.2% of budget, it is also the highest in our history dwarfing the 8% to 18% during the Marcos crisis years (1981-1985).

4. The public sector deficit is projected at P312billion (7% of GDP) in 2004 with NG deficit of P200billion (4% of GDP) and GOCCs, mainly Napocor, at P112billion (3% of GDP). Debt service in 2005 will reach P687billion leaving only P43billion for operations given a P730billion revenue target. And even under the most generous assumptions, the Philippines would only be able pay interest and not a single cent of debt by 2009. And since we target to balance the budget only by 2009, the debt is expected to balloon further although it would ease as percentage of GNP.

5. From a strategic point, the country had to act quickly. The new administration must make a first strike before its modest electoral mandate gets dissipated by political distractions especially given our historical fixation with the peripherals. Hesitation would have been costly as this could foreclose some of the policy options still open to the new government. There were six considerations. The most urgent were the maturing loans bunching up in 2005 pushing total debt service to P687billion, which needed to be refinanced immediately. A mountain of debt suffocates growth but it is the avalanche of maturities that kills you. If GOCCs are included, Napocor alone needs US\$518million for interest and US\$340million for principal for foreign refinancing. Of the P687billion NG debt service, P207billion is foreign bringing total foreign refinancing requirements to US\$4.5billion or 50% higher than the average annual US\$3billion of foreign fundraising from 2001-2003. The Philippines must submit a credible roadmap to justify why creditors should roll it over. And, they would demand more than the usual promises – planned spending cuts and proposed revenue streams should not only be substantial, they also need to be firm, i.e. legislated, and forthcoming.

6. The second consideration was that we had to raise such huge foreign commercial borrowing just when the US Federal Reserve had announced a shift from easy to neutral monetary policy that was expected to tighten and raise global interest rates by 150 basis points (bps) with 50bps already implemented. Coupon rates on bond issuances to refinance maturing forex loans are likely to rise. With the base (10-year US T-notes) rising, we need to work on lower spreads to net interest rates as before. Every one percent rise in global interest rates translates to P19billion in additional cost to service the government's US\$35billion foreign debt. The country has a total US\$57billion foreign debt.

7. Third, global oil prices have risen to new highs and are likely to disturb our positive current accounts, the pillar of our external stability. Oil at US\$45 per barrel easily offsets healthy OFW remittances. Fourth, inflationary expectations started to resurface with the July inflation reaching 6.6% that was triggered by pump price adjustments. Such expectations naturally breed on fiscal deficits, which in turn propagate higher interest rates.
8. Fifth, the real economy was still healthy enough to absorb the pressures of fiscal consolidation and the private sector could take up the slack in aggregate demand particularly in investments as government reduces spending in infrastructure. The current advantage of the Philippines is that it is doing fiscal consolidation within a more robust macroeconomic environment. Unlike the Philippines, Argentina was already in a recession in 1999 (-4.6%), 2000 (-1.7%) and 2001 (-7.0%) while our economy enjoys nice momentum posting 6.4% GDP in Q1 and 6.2% in Q2,. In Argentina, new taxes cum spending cuts only deepened the recession further. In our case, new taxes would be offset by lower interest rates due to lower default risk premium as a result of decisive containment of deficit. Sixth, the underlying yet then unpronounced fiscal crisis was the single biggest destabilizing threat to the economic momentum. Likened to car, it is far better for the government to get its engine to a repair shop now as it may be more difficult and expensive if the whole car crashes on the highway due to interest rate shocks arising from the unsustainable debt stock.
9. In the next three years, we need to reckon with the implicit public debt (IPD) or the actuarial reserve deficiency at SSS and GSIS. By 2007, without hikes in contributions, SSS is expected to run up cashflow deficits for the first time which would naturally be subsidized by the National Government. In a 1997 study, the World Bank estimates the IPD of SSS at P1.4trillion and GSIS at P0.4trillion for a combined P1.8trillion contingent liability. The Philippine experience with public institutions shows such liabilities inevitably find their way to the GAA. P1.8trillion (SSS/GSIS) plus P900billion (3-year CPSD) plus P5.39trillion (existing public debt stock) equal P8.4 trillion by 2007.

10. Lastly, and more importantly, in the next six years, it is crucial to prepare a stronger fiscal platform for the ambitious six-point anti-poverty plan, the 10-point legacy agenda and five reform packages announced by the President during her inaugural and her maiden State-of-the-Nation Address.
11. Between 1997 and 2003, the debt stock of the national government almost tripled. Out of the P2.011trillion increase, NG deficit accounted for 43%; peso devaluation, 19%; and off-budget, 37%. We concentrate first on the usual suspect – the national government deficit – in this paper.
12. Indeed, the principal culprit for the accumulation in debt is the successive deficits of the national government. Since 1986, the national government has balanced the budget only twice (1994 and 1997) out of 18 years with P908billion in cumulative deficits. As they accumulate in the debt stock, the compounded and cumulative impact of servicing them, assuming an average interest rate of 8.67% and disregarding intertemporal distortions (at the risk of oversimplifying), should have reached P1.57trillion or almost half of the total NG debt of P3.355trillion! With devaluation, it would have compounded to P2.1trillion. For example, the P31billion deficit in 1986 had been left to compound to P139billion in government debt by 2004 without peso devaluation and P226billion if we assume peso devaluation impact on 50% foreign debt content. Thus, no administration has monopoly of guilt for the sudden burst of debt and deficit from 1998 to 2003.

**COMPOUNDED IMPACT OF ANNUAL DEFICITS
ASSUMING NO PESO DEVALUATION
(In billion pesos)**

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1986	31																	
1987	34	17																
1988	37	18	23															
1989	40	20	25	20														
1990	43	22	27	22	37													
1991	47	24	30	24	40	26												
1992	51	26	32	26	44	28	16											
1993	56	28	35	28	48	31	17	22										
1994	60	30	38	30	52	33	19	24	-16									
1995	66	33	41	33	56	36	21	26	-17	11								
1996	71	36	45	36	61	39	22	28	-19	12	6							
1997	78	39	49	39	66	43	24	31	-21	13	7	2						

1998	84	43	53	42	72	47	26	33	-22	14	7	2	50					
1999	92	46	58	46	78	51	29	36	-24	15	8	2	54	112				
2000	100	50	63	50	85	55	31	39	-26	17	8	3	59	122	134			
2001	108	55	68	54	93	60	34	43	-29	18	9	3	64	132	146	145		
2002	118	59	74	59	101	65	37	47	-31	20	10	3	70	144	158	158	130	
2003	128	65	80	64	109	71	40	51	-34	21	11	3	76	156	172	171	141	200
2004	139	70	87	70	119	77	44	55	-37	23	12	4	82	170	187	186	154	217

**COMPOUNDED IMPACT OF ANNUAL DEFICITS
ASSUMING PESO DEVALUATION
(In billion pesos)**

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1986	31																	
1987	35	17																
1988	39	19	23															
1989	43	21	26	20														
1990	48	24	29	22	37													
1991	54	26	32	25	41	26												
1992	60	30	36	28	46	29	16											
1993	67	33	40	31	52	32	18	22										
1994	75	37	45	35	58	36	20	25	-16									
1995	84	41	50	39	64	40	22	27	-18	11								
1996	93	46	56	43	72	45	25	31	-20	12	6							
1997	104	51	62	48	80	50	28	34	-22	14	7	2						
1998	117	57	69	54	89	56	31	38	-25	15	7	2	50					
1999	130	64	77	60	100	63	35	43	-28	17	8	2	56	112				
2000	145	71	86	67	112	70	39	48	-31	19	9	3	62	125	134			
2001	162	80	97	75	125	78	43	53	-35	21	10	3	70	140	150	145		
2002	181	89	108	84	139	88	48	59	-39	24	12	3	78	156	167	162	130	
2003	202	99	120	94	155	98	54	66	-43	27	13	4	87	174	187	181	145	200
2004	226	111	134	105	174	109	60	74	-48	30	15	4	97	194	208	202	162	223

13. Any analysis of the fiscal crisis must therefore begin with the origins of the annual NG deficits. It could either be a spending problem, a revenue problem or a mix.

14. The widespread impression is that the current fiscal crisis is largely a result of protracted extravagance in public spending. However, non-debt expenditures (i.e. net of interest payments) have fallen from 15.5% of GNP in 1997 to only 11.69% in 2003. Furthermore, stripping out internal revenue allotment or IRA and personal services, the core budget for social services and infrastructure have collapsed from 6.17% of GNP in 1997 to only 2.65% in 2003. Even if we include the 20% of LGU IRA as capital expenditure, our capital outlay have fallen from 3.9% of GNP to only 1.9%; thereby seriously jeopardizing our capacity for growth that in turn produce our future revenues.

In fact, the government has been in austerity under the Arroyo administration with non-debt expenditures rising by only three percent while revenues grew by seven percent.

REVENUE GROWTH VS. GROWTH IN NON-DEBT EXPENDITURE

		Revenue Growth	Non-debt Exp. Growth	Net Growth	Average Annual Growth in billion pesos in Non-debt
Aquino Administration	1986 to 1992	20%	16%	4%	17,772
Ramos Administration	1992 to 1998	12%	15%	-3%	31,120
Estrada Administration	1998 to 2000	6%	14%	-9%	49,692
Arroyo Administration	2000 to 2003	7%	3%	4%	14,495

15. Admittedly, waste and corruption are congenital to governments. And, their curtailment offers some scope for savings. However, as a policy tool, spending cuts can barely close the budget gap of P312billion as 88% of expenditures are mandatory and the 18% discretionary expenditures for social services and infrastructure were already sub-optimal vis-à-vis GNP. Nevertheless, lack of reforms in this area stands in the way of the more critical solutions due to the *suspicious spouse syndrome*. The ability of the government to pass new taxes and to improve collection efficiency is vastly diluted by fears that new taxes will just end up somewhere except to reduce the deficit or underwrite a water system project. Having been caught wanting not once but many times in the past, the government is currently being measured to a higher standard even, or especially, during a crisis by a wary Filipino public before they pitch in to help by yielding to new impositions.

16. If cutting spending offers little help, spending or growing our way out of the crisis has been tried with tragic outcome. During the post Asian financial crisis, our debt stock suddenly ballooned by 38% or P500billion to P1.8 trillion while the revenues fell from P471billion to P462billion due to the consequent interest rate shocks that slowed down the economy. Thus in 1998, the new administration took a strategic gamble, nonetheless justifiable, to grow out of that debt through deficit financing in 1999-2000. Under the Fiscal Stimulus package, non-debt expenditures grew by 14% annually that only aggravated an already bloated debt stock as revenues grew by only 6%. Although, its

impact on economic growth was lagged to 2001-2002 partly helping the fortunes of the Arroyo administration but which still failing to produce added revenues.

17. Thus, our fiscal crisis is principally a revenue problem with nominal GNP growing by 11% but tax revenues by only 5.41%, non-tax revenues by 4.2% for total revenue growth of 5.2%. Total revenue-to-GNP ratio fell by **4.9%** from 19.5% in 1997 to only 14.6% in 2003. Tax revenues (88% of total) fell by **4.5%** from 17.0% of GNP to 12.5%.

TAX EFFORT (as % of GNP)

	Tax/GNP	BIR/GNP	BOC/GNP
1997	17.0	13.0	4.0
1998	15.6	12.7	3.0
1999	14.5	11.5	3.0
2000	13.9	10.9	3.0
2001	13.3	10.6	2.7
2002	12.5	10.0	2.5
2003	12.5	9.9	2.6
Net change	(4.5)	(3.1)	(1.4)

18. The fundamental divergence between revenue growth of 5.41% and the nominal GNP growth of 11% is at the core of the crisis. And such revenue underperformance is more structural, less administrative. While tax collection inefficiency is an accomplice to the crime, the following factors play more significantly in causing the shortfall: (a) economic growth from 1997 to 2003 was driven by non-revenue sectors – agriculture, OFWs and exports. While nominal GNP grew by 10.56%, revenues grew by only 4.82%; (b) the bigger fall in total revenues to GNP of 4.9% versus tax revenues to GNP of 4.5% can be traced to the exhaustion of privatization options that aided the fiscal balances during the Ramos boom years as the Estrada and Arroyo administrations were left with few crown jewels left at decimated asset prices; (c) the tariff reduction program over the past ten years have eroded our revenue base with BOC Revenue-to-GNP falling from 4.0% in 1997 to only 2.6% in 2002 or roughly P78billion in annual revenues foregone; (d) the much-vaunted Comprehensive Tax Reform Program turned out to be a major tax cut as the income tax rate was reduced from 35% to 32%, taxable personal income thresholds were raised and capital gains tax similarly reduced while specific taxes on liquor and cigarettes (as well as petroleum) did not grow with inflation (see BIR Tax Effort Ratio);

(e) since 1997, not a single major revenue measure was passed that could make a dent on the deficit except for the minor adjustment on SUVs and the earmarked Road Users Charges; (f) legislated leakages have reached P174billion in 2003, principally for investment incentives by BOI and PEZA.

Growth Rates at constant 1985 Prices

	1999	2000	2001	2002	2003	Average
Agriculture	6.6	4.3	3.7	3.8	3.8	4.4
Exports	3.6	17.1	(3.4)	3.6	4.4	5.0
Net Factor Income from Abroad (OFWs)	10.1	26.8	10.0	3.8	17.9	13.7
GDP	3.4	4.4	3.0	3.1	4.7	3.7
GNP	3.7	4.8	3.4	3.2	5.6	4.1

BIR Tax Effort Ratio

Source and Cause of Fall
(1997 to 2002)

Percentage Point Decrease

Total	-3.16
Tax on Income and Profit	-1.13
Excise Tax	-1.18
VAT	-0.31
Percentage Tax	-0.24
Other Taxes	-0.29

19. Investment incentives (P174billion) and tariff liberalization (P78billion) are among our big revenue losers. Import liberalization via aggressive tariff reductions not only reduced our permanent base for revenues. Import competition also reduced the profit margins of domestic manufacturers which meant lower income taxes. But, these policy directions were well-intended to induce economic growth; in fact they enabled us to suffer the least from the Asian financial crisis. We were gambling that the fiscal revenues foregone from these two policies will be more than recovered in future years from robust economic growth. Unfortunately for the Philippines, while we planted the seeds of incentives and tariff reductions in 1990s, the harvest was aborted by the Asian financial crisis.

20. *Post hoc, ergo propter hoc.* Among economic events since 1986, the Asian financial crisis remains to be the principal trigger to the current fiscal crisis. 80% of the total deficit in nominal terms was realized between 1997 to 2003. P2.011 trillion of the increase in the P3.355 trillion National Government debt also sprang during this period. Aside from preventing the fiscal harvest from tariff liberalization and investment incentives, the Asian financial crisis also damaged our existing tax base with corporate taxes declining from 3.4% of GDP in 1997 to only 2.5% in 2002.

21. After Clinton popularized confessional politics with great success in effecting policy turnarounds, the Arroyo administration is bold enough to own up to its share of big-time policy-driven revenue losers. Admission of guilt, big and small, is a necessary step towards clearing the air for greater public forbearance of the painful remedies to the fiscal crisis. Public outcry was growing against rising purchased power adjustments (PPA) as expensive IPPs contracted during Ramos were now mostly commissioned during the administrations of Estrada and Arroyo. Thus, in May 8, 2002, the President ordered a P0.40 cap on the PPA (excluding capacity fee payments). This was supposed to be a cute tactical maneuver whose costs were to be shortly underwritten by the universal charges to be set by ERC, spreading out the stranded costs over a longer period as envisioned in the EPIRA law.

IMPACT OF THE P0.40 CAP ON PPA

	LUZON		VISAYAS		MINDANAO		PHILIPPINES	
	In Pesos	In P/kWh	In Pesos	In P/kWh	In Pesos	In P/kWh	In Pesos	In P/kWh
May 2002 to Sept 2002	8,681,806,832	0.8502	569,609,838	0.3909	311,995,407	0.1409	9,563,412,076	0.6888
Oct 2002 to Dec 2002	1,440,166,145	0.2533	398,176,102	0.4398	567,910,832	0.3988	2,406,253,080	0.3003
Jan 2003 to Dec 2003	4,510,256,672	0.1962	1,899,368,950	0.5046	1,581,282,103	0.2676	7,990,907,725	0.2447
Jan 2004 to June 2004, (estimated)	3,047,530,255	0.2640	982,021,267	0.4872	150,475,170	0.0478	4,180,026,692	0.2502
TOTAL	17,679,759,904	0.3506	3,849,176,157	0.4727	2,611,663,512	0.2057	24,140,599,573	0.3388

Adjustments per ERC's Resolutions to MRs

(Included in the 3rd GRAM DAA)

April 13,
2004 Order
(Add'l PPC
Recovery -
1st GRAM)

(1,606,811,793)	(0.2146)	(240,971,102)	(0.2000)	(658,718,343)	(0.3464)	(2,506,501,239)	(0.3464)
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April 14,
2004 Order
(Add'l PPC
Recovery -
2nd GRAM)

(3,499,097,235) (0.2241) (562,685,690) (0.2253) (1,245,987,805) (0.3186) (5,307,770,731) (0.2410)

**Unbilled
Purchased
Power Cost
(PPC)**

12,573,850,876 0.2493 3,045,519,365 0.3740 706,957,364 0.0557 16,326,327,603 0.2291

22. Officially, PSALM calculates that PPA cap has cost government only P16billion in foregone revenues from May 2002 to June 2004. Our own estimate of the direct revenue losses is a much larger P38billion in the same period or P19billion per year. In 2004, Napocor was initially projected to lose P114billion -- P61billion from financial expense and P63billion from cost underrecoveries selling at P2.58 but producing at P3.514 on the generation volume of 36.269billion and other expenses of P25billion, basically forex differential on capacity fee payments. All-in unit cost of production is really P4.31.
23. While it may be argued that the main culprit for the operating losses of Napocor is the failure of management to secure tariff adjustments, the PPA cap certainly made it difficult for Napocor management to justify such increases as it would contradict the administration line as in effect, the left hand is getting back what the right hand has given. Napocor eventually applied for increases on the basic rate on June 24, 2004 when rising prices of oil and coal provided the pretext. The other major fiscal impact of the PPA cap is that it delayed the privatisation of gencos whose proceeds are earmarked for maturing principal.
24. However, it was only after two years that the ERC finally granted Napocor GRAMs 1 to 3 amounting to P0.58/kwhr on April 2004 and tariff adjustments of an average P0.93 per kwhr on September 3, 2004 – P1.23 for Luzon, P0.2202 for Visayas and P0.2665 for Mindanao. Luckily, while past administrations can only admit to their mistakes once out of power, the Arroyo was given a chance to rectify them, and even before admitting. But, why is it that the power sector invites much of our major fiscal follies from Marcos' nuke plant (1 for the price of 2) pushing Aquino to mothball it which then triggers the power crisis that justified Ramos' lopsided IPPs that then forces Arroyo to cap the PPA?

ESTIMATED LOSSES DUE TO PPA CAP

	2002	2003	2004	Total
PPA pmts (P)	2,065	37,354	40,978	
Volume (kwhr)	32,264	37,729	41,528	
Ave. PPA/kwhr	0.99	0.99	0.99	
less P0.40	0.40	0.40	0.40	
Uncollected PPA	0.59	0.59	0.59	
x Adj. Volume	18,821	37,729	20,764	
Total Loss (P)	11,176	22,262	12,183	45,622
less GRAM (P0.58)	0	0	(7,800)	(7,800)
Net Loss				37,822

Note: May-Dec Fullyear Jan-Jun
 Note: GRAMS 1 to 3 granted in April 2004

25. The moral of the PPA cap story is: the people eventually pay for such populist decisions of the government. Actually, they pay so much more than what they got it for especially if we include the cost of fiscal cum energy crisis it has helped to spawn. Worse, the poor gets so much less than the rich as families whose incomes are above P60,000 actually account for 90% of total consumption of electricity. Conversely, the bigger positive impact of the tariff adjustment is that it rectifies one of the most egregious anomalies in the history of Philippine social policy. The P116billion yearly financial support of NG to Napocor represents the biggest public subsidy to the rich in our fiscal history. Aside from net losses of P34billion in 2002, P113billion in 2003, P114billion in 2004 and P116billion in 2005 (without the increase), maturing principal were also to be serviced by the government with P35billion in 2003, P28billion in 2004 and P48billion in 2005 for a total of P488billion in four years added to the debt stock of the National Government benefiting mostly the rich. Such huge amount could have funded social services directly targeted at the poor and vital infrastructure that could have expanded the productive capacity of the economy for growth.

CONSUMPTION OF ELECTRICITY BY INCOME DECILE (FIES 2000)

Income Decile	Amount	% to Total
Under 20000	180	0.34%
20,000-29,999	663	1.26%
30,000-39,999	1,247	2.37%
40,000-49,999	1,842	3.51%

50,000-59,999	1,869	3.56%
60,000-79,999	3,790	7.22%
80,000-99,999	3,562	6.78%
100,000-249,999	18,630	35.47%
250,000 - over	20,741	39.49%

26. Parenthetically, this equity distortion is replicated by the Supreme Court decision on the Meralco rebate with only P7billion of the P31billion going to households with monthly consumption below 300kwhrs while those above 300kwhr, commercial and industrial will get P24billion.

27. Nevertheless, the P0.93/kwhr tariff adjustment on top of GRAM 1 – 3 of P0.58kwhr represents a substantial downpayment of the Arroyo administration on its fiscal reform program as it would cut the deficit by around P36billion. However, to close the P116billion Napocor deficit projected for 2004 would have required an adjustment of P3.11 assuming consumers fully pay for the service they use. However, this would make the country's industries uncompetitive with Napocor effective rate rising to P5.69/kwhr. Thus, since global competitiveness of domestic industries is a valid social goal, part of the burden needs to be shouldered by taxpayers. The strategy of the Arroyo administration was to make taxpayers pay for the financial charges by assuming Napocor debt of P620billion while consumers pay for the operating losses. Given the operating loss of P63billion in 2004, this would have required a tariff increase of P1.69/kwhr versus the grant of P0.94. The P0.16 balance of the requested P1.85 would have gone to modest RORB. For long-term sustainability, Napocor needs to pursue the balance as ERC decision effectively staggers the consumer impact of the original P1.85 petition. We reckon P0.45 in 2005 and P0.40 in 2006 to be reasonable assumptions. These may be obviated if coal and oil prices correct to 2003 levels.

28. Increasing the tax-to-GNP ratio to its 1997 level of 17% should, therefore, do the job. The solution is easy, almost effortless in thought. However, the deterioration in tax efficiency unraveled in six years and it is arguable whether we can reverse it soon enough to produce the revenues in time to pay our increasingly fidgety creditors. Aside from timing, there is actually not enough to be collected through better tax collections. In a congressional hearing in 2003, Rep. Prospero Pichay asked the National Tax Research

Center or NTRC to conduct a study on how much more can really be collected if there are no corrupt BIR and BOC officials and all businessmen are honest. The NTRC came back with a paper concluding that tax gap stands at an average of P127billion. Given that this embraces the hard-to-tax sectors or activities, then it would be difficult for the government to plug the P312billion public sector deficit unless one is prepared to withdraw incentives afforded to senior citizens, labor unions, cooperatives and some 150 more preferred sectors.

29. The P4.9trillion GNP in 2003 appears huge and most people wonder where all of those taxes have gone. But, of this GNP base, the NTRC estimates only P1.78trillion is taxable considering the incredible spread of legislated exemptions. Thus, our policy options for expanding the revenue base are quite sparse. After careful screening of several measures by the government's economic managers under the informal setup of the Economic Managers Group, only three were found to yield substantial revenues, fulfill with the standards of good tax policy (progressivity, uniformity, simplicity) and enjoy reasonable prospects of approval – (1) sin taxes – P14billion, (2) P2 petroleum tax – P20billion and (3) two-step EVAT from 10% to 14% - P30billion. Except for sin taxes, even petroleum and VAT hike face vocal resistance. The others in the 10-point tax reform package involve contentious policy (sales tax, gross income tax, incentives rationalization), are highly unpopular (tax on text), or are difficult to quantify (lateral attrition, tax amnesty).
30. The fourth, and the largest, source of additional revenues would be the tariff adjustments for Napocor. The recent P0.93/kwhr increase would reduce the CPSD by P34billion and boost the prospects for privatizing Napocor-owned power plants - 16billion kwhr out of total 42billion generation and 26billion represent expensive IPPs which would be retained till their contract expire. This should accelerate the reduction in debt servicing being absorbed by the National Government. In the medium-term, the financial benefit to residual Napocor is estimated at of P22.71billion, which will still reduce consolidated public sector deficit. Interestingly, the average IPP cost is P4.50/kwhr while the new tariff would be P3.17/kwhr (i.e. P2.20 + P0.97) still resulting in net loss to the National Government. As mandated by the EPIRA law, Napocor had to sell its owned plants that are producing at only P1.96/kwhr and are the earning assets of Napocor.

31. With revenue options few, and mostly unpopular, we must also confront the issue that because of the IRA formula, if we were to close the current P312billion gap through new taxes, then we need P520billion in new taxes. That is impossible! The P80billion tax package of PGMA will yield only P48billion for deficit reduction as 40% or P32billion will be set aside for IRA. In 1991, the country passed RA 7160 otherwise known as the Local Government Code providing that LGUs shall get 40% of tax revenues three years preceding the current fiscal year. Second, IRA payments have zoomed to P151billion from only P20.3billion in 1992; the national budget grew from P259billion to P907billion. It grew from 7.8% share of the budget and 1.5% of GDP in 1992 to 18% and 3.5% of GDP, respectively, in 2002. Third, while the government downloaded 40% of tax revenues to LGUs in 1992, it has not been able to download the corresponding activities, which would have curtailed its own expenditure. The national government could not even fully devolve agriculture and health services due to opposition of national government employees. Fourth, the national government conveniently forgot that to earn those revenues, it had to heavily borrow to invest in infrastructure. But having decided to assign 40% of its revenues, it would have looked silly or impractical, if not unpopular with presidential elections one year away, to download debt then at the same time. But, then, it should have calibrated the IRA share of taxes to a more reasonable level.

32. IRA, wages and interest payments (P151billion, P288billion and P302billion, respectively) make 82% of the 2005 expenditures compulsory leaving only 18% for social services and capital outlays. With an inflexible cost structure facing a restrictive revenue stream, the government has few policy options, nay little room for error, to balance the budget. Interest payments and formula-based IRA alone would cause a growth in expenditures of 4.7% in 2005, 7% in 2006 and 3% per annum until 2010 even if we held other expenditures at constant and interest rate is assumed at current rate of 8.67%.

IMPACT OF IRA AND INTEREST

	2005	2006	2007	2008	2009	2010
IRA	10,465,716	21,178,795	18,304,260	18,920,087	25,363,555	27,729,585
Interest	30,161,000	39,582,968	13,827,777	11,104,511	7,467,812	3,427,964
Total	40,626,716	60,761,763	32,132,037	30,024,598	32,831,367	31,157,549
Total Budget	907,589,726	968,351,489	1,000,483,526	1,030,508,124	1,063,339,491	1,094,497,040
% increase	4.69%	6.69%	3.32%	3.00%	3.19%	2.93%

33. As the simulation exercise below shows, even if we assume zero growth in public sector wages, capital outlays and social services, revenues grow by 8% (vs. 5.41% in the past 7 years) and the current interest rates obtain (Scenario 1); we will still have a deficit of P61billion in 2009 mainly due to the formula allocations to LGUs and interest payments on our debt stock.

SIMULATION OF FISCAL SCENARIOS

Assumptions		Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
Revenue GR		8%	8%	8%	8%	8%
Personal Service GR		0%	5%	10%	10%	0%
Maintenance GR		0%	5%	10%	10%	0%
Capital Outlay GR		0%	5%	10%	10%	0%
IRA		Formula	Formula	Formula	Formula	Formula
Interest Rate		8.60%	8.60%	8.60%	9.60%	9.60%
Outcomes						
	Baseline 2004	2009	2009	2009	2009	2009
Budget Balance	-184,500,000	-60,745,554	-98,873,985	-142,511,690	-240,804,985	-157,565,377
Deficit to GNP	-3.66	-0.73	-1.19	-1.72	-2.9	-1.9
Debt	3,540,326,593	4,668,091,684	4,432,080,840	4,576,194,395	4,911,490,477	4,668,091,684
Debt to GNP	70.21	56.2	53.36	55.09	59.13	56.2

34. Under Scenario 5, if the average interest rate increase by only one percent, assuming revenues grow by 8% and the rest held constant at 2004 levels, the deficit will remain substantial at P157billion in 2009. Our fiscal balance is clearly most sensitive to changes in interest rates due to our huge debt stock.

35. Our revenue projection would even come much lower as exploding deficit and debt will lead to an interest rate shock. If we do nothing, and creditors slaps us with additional 100bps interest rate only, the projected outcomes are already unacceptable as NG debt will almost double in six years and the deficit will explode to P388billion by 2010. This assumes revenues could grow at a secular average of 5.4% (1997-2004 average), IRA increases based on formula, wages at 3% pa while capex and maintenance grow with inflation. Our revenue projections could even come lower if the deficit and debt lead to economic slowdown due to interest rate shock.

ASSUMPTIONS		OUTCOMES		
Variables	Basis		Resulting Deficit	Resulting Debt
Tax Revenue	5.41% growth	Base-2004	197,500,000	3,673,326,593
Non-tax Revenue	4.2% growth	Base-2005	185,400,000	3,991,726,593
Wages	3% growth	2005	240,013,803	4,046,340,396
LGU IRA	Formula	2006	317,357,965	4,496,698,361
Maintenance	Inflation	2007	351,600,628	4,981,298,989
Capex	Inflation	2008	387,909,081	5,502,208,070
Interest	100bps higher at 9.67%	2009	430,859,886	6,066,067,956
Napocor	P116bn loss pa	2010	476,848,390	6,675,916,346

36. The UPSE's policy recommendations were focused essentially to keep the debt-to-GNP from further deteriorating. The package of proposed measures were intended to prevent the crisis from exploding by raising revenues and capping costs in order to produce an incremental primary surplus of P125billion, which is close to the President's SONA package of P100billion, P80billion in new taxes and P20billion in savings. In short, it was only for survival.

37. In most government projections, the country is not expected to reduce the debt stock by a single cent till 2009 as debt would merely fall as percentage of GNP. In the current state of play, fiscal policy has a defensive role, i.e. to prevent an economic blowup that could have devastating effects on national welfare. The fiscal tradeoff is being proposed as a choice between pain now or more pain later. Businesses and individuals can choose to pay higher taxes now or pay higher interest rates together with the consequent volatile disruptions in demand and supply later. While pork cuts would hurt our poorer districts by starving them of vital infrastructure, a fiscal crisis will hurt them more. The whole country, whether districts or provinces, towns or cities, producers or consumers, workers or employers, will be worse off if the fiscal crisis breaks out into a financial crisis.

38. Debt and deficits are the collected consequence of flawed policies, bad judgment calls and poor political choices. The fiscal balance is a manifestation of our bad habits. The public debt stock is no more than a repository of our many dysfunctional values – lack of work ethic, crab mentality, lack of sense of national interest, lack of rule of law, lack of political will, *bahala na* mentality, *mañana habit*. This is the primary source of philosophical agitation of the new administration. We must slay the two-headed monster

of debt and deficit. But, we believed that this also presents us that one single and simple cause that we can rally around and that could evoke our long dormant positive aspects and harness them for nation building. Fiscal policy was to become a new religion with the President as the high priestess. It was also the domain where she could create or enlarge the mandate for her presidency particularly as she was principally favored over other candidates for her solid economic background in the academe and in the technocracy.

39. As a first step, by pronouncing that *the country is in the midst of a fiscal crisis*, President Gloria Macapagal-Arroyo puts everyone on notice that every peso counts and every government official and worker must justify every peso of its budget and make it work for the people's benefit. It was not just proportional but also the only fundamentally correct response that the administration could immediately make to the release of the UPSE white paper which called it a deepening crisis. Not only do we tell our creditors that we will do something about their concerns, it was also to become a signal that we are pursuing fiscal reforms with more than political will but with missionary zeal in order to make a difference and prompt positive consequences in the everyday lives of common people. We need to do the economic equivalent of self-actualization in Maslow's hierarchy of values in our fiscal policy.

40. Indeed, the government should do more than put its fiscal house in order. Its business is more than just to survive a crisis. While a fiscal crisis declaration could have the momentary benefit of leveling expectations, it should not be an excuse for mediocre performance through the expedient of suppressing aspirations. The fiscal proposition must be reconstructed from "pain now, more pain later" to "pain now, gain later". We need to raise the current policy ethos of fiscal conservatism that merely seeks to restore stability in public finances to one of fiscal activism that seeks a healthy balance sheet and vigorous cashflows as an instrument for socio-economic goals and as a tool for competitiveness in global markets. We can even go the extra mile by shooting for more pain now, more gain later. But, that is asking too much at this point of our national lifecycle.

41. Furthermore, in asking the people for sacrifice, the government needed to be morally and empirically certain that it is fundamentally the right thing to do and that it has reasonable

chances of success. Thus, as additional guidance, the pain must be carefully imposed on those who can afford it and that the gain will be skillfully targeted to those who need it more. This is the basis for the burden-sharing. Thus, aggregate cuts in the discretionary funds of NG agencies, special privileges of GOCCs, the intelligence and social funds of the President and the congressional allocations of the House and Senate look puny against a P312billion problem. However, they play a catalytic role in the total solution by rebuilding public confidence and expanding people's forbearance for pain.

42. Thus, the second order of business for the Arroyo administration is to secure credit upgrades within 18 months. And to do that, we have to implement painful reforms that would fix the budget earlier than and reduce the debt-to-GNP ratio more rapidly to more comfortable levels. The country is currently rated at three notches below investment grade and its spreads over T-notes are about 440bps compared to 97 bps for Thailand, 103 bps for Malaysia and 330bps for Indonesia. The recent downgrade resulted in an increase of 90bps translating to a P19billion in additional interest costs. Conversely, the country could aspire for a three-step upgrade which would result in an early harvest of P60billion in interest savings on its burgeoning foreign debt stock which could free up resources for infrastructure (growth) and for social services (equity).
43. Strong fiscal fundamentals should become an added incentive for domestic and foreign investments by reducing the risk premium required for capital exposure to the Philippines. Why would investors locate in the Philippines and pay 440bps over T-notes when they pay only a spread of 100bps for the same business activity, same technology, same product and same market? Moreover, government will invest in basic infrastructure to reduce costs of doing business and balance the budget to keep interest rates and inflation down.
44. The third goal in our fiscal hierarchy is to secure a strong financial platform in making meaningful strides in our six-point anti-poverty program within the next three years through a substantial growth in social services. The fourth goal is to mobilize resources for the 10-point legacy program that first seeks to balance budget by 2009 but whose nine other items require massive investments in infrastructure that needed to be financed.

45. The fifth is closer to the Maslow's value of self-actualization where the budget would play a forward role in driving a 7% GDP growth that would create jobs beyond the organic capacity of the economy of about 450,000 jobs per year and reduce poverty from 32% to 17%. While we could choose less painful options that would keep government afloat, we also have the choice of difficult structural reforms that could lead to a more bountiful economic harvest.

46. As rubber meets the road, such fiscal activism must, nevertheless, contend with political realities in carving a road from rehabilitation to recovery. We feel that we could hold the line and sustain the momentum of fiscal consolidation for only two years. The second goal of credit upgrades can then be achieved by 2006. This would provide a more fertile base for substantial achievement in social services (3rd goal – anti-poverty) and infrastructure (4th goal – 10 point legacy) for the rest of the term of President Gloria Macapagal Arroyo. This roadmap to fiscal recovery and its underlying design are presented in the following spreadsheets so that analysts could scrutinize its assumptions and dispute its outcomes.

FISCAL ROADMAP

	2005	2006	2007	2008	2009	2010
Revenue Measures						
	Sin tax of P14bn	VAT hike to 12% for P14bn	VAT hike to 14% for P16bn	na	na	na
		P2 petro tax for P20bn				
	P1.00 Napocor tariff increase	P0.45 Napocor tariff increase	P0.40 Napocor tariff increase			
Cost Measures						
	IRA freeze at 2004 for P10bn savings	IRA freeze for P16bn savings	IRA reversion of P21bn addl	IRA reversion of P18bn addl	IRA reversion of P19bn addl	IRA reversion of P25bn addl
	Pork cut of P10bn					
	Add interest pmt of P31bn as assumed	Addl interest pmt of P26bn instead of P39bn	Reduction of int. by P1bn instd of addl P14bn	Reduction of int. by P6bn instd of addl P11bn	Reduction of int. by P6bn instd of addl P7bn	Reduction of int. by P2bn instd of addl P3bn
Deficit	151,681,270	125,649,965	89,293,276	30,996,418	-43,238,319	-109,731,527
Privatisation	-50,000,000	-74,000,000	-50,000,000	-50,000,000	0	0
Napocor debt assumption	200,000,000	0	0	0	0	0
NG debt	3,975,007,863	4,100,657,828	4,189,951,104	4,220,947,521	4,177,709,202	4,067,977,675
Primary Surplus	150,010,730	202,846,000	239,202,689	305,758,842	372,945,545	438,958,871

FISCAL ROADMAP

	2005	2006	2007	2008	2009	2010
Macro Assumptions						
GNP	5,571,530	6,212,256	6,895,604	7,688,599	8,572,787	9,558,658
GNP growth	5.5	5.5	6	6.5	6.5	6.5
Inflation	6.5	6	5	5	5	5
Expenditure Forecasts						
Wages	289,259,112	297,936,885	306,874,992	316,081,242	325,563,679	335,330,589
LGU IRA	145,403,425	145,403,425	166,582,220	184,886,480	203,806,567	229,170,122
Interest	301,692,000	328,495,965	336,755,259	335,355,131	329,707,226	329,227,344
Maintenance	88,707,090	96,690,728	103,942,533	111,738,223	120,118,589	129,127,484
Capital Outlays	72,062,383	93,183,839	110,329,666	130,706,176	154,310,173	191,173,159
Total	897,124,010	961,710,843	1,024,484,670	1,078,767,251	1,133,506,235	1,214,028,698
Revenue Forecasts						
Revenues	745,442,740	836,060,878	935,191,393	1,047,770,834	1,176,744,555	1,323,760,225
Tax Revenues	657,440,540	739,258,458	828,708,731	930,639,905	1,047,900,534	1,182,031,802
Non-tax	88,002,200	96,802,420	106,482,662	117,130,928	128,844,021	141,728,423
Revenue Assumptions						
Revenue Base	596,408,000	641,848,540	739,258,458	828,708,731	930,639,905	1,047,900,534
Organic Growth in %	4.77%	7.00%	8.50%	9.00%	9.50%	10.00%
Organic Growth in Pm	28,440,540	44,929,398	62,836,969	74,583,786	88,410,791	104,790,053
New Taxes Required	17,000,000	52,480,520	26,613,304	27,347,388	28,849,837	29,341,215
Tax Revenues	641,848,540	739,258,458	828,708,731	930,639,905	1,047,900,534	1,182,031,802
Tax Revenue/GNP	11.80%	11.90%	12.02%	12.10%	12.22%	12.37%

47. Our model uses the National Government as unit of analysis with off-budget items merely impacting on the NG debt and consequently on interest costs. The general strategy can be summed up as (1) new revenue streams through new taxes (2) improved organic growth through tax efficiency measures (3) reduction of off-budget surprises through Napocor tariff adjustments and (4) asset sales through privatisation of Napocor earmarked for debt stock reduction or servicing of its maturing principal.

Impact on Consolidated Deficit

	2005	2006	2007	Total
New Taxes	14,000	34,000	16,000	64,000
Sin Taxes	14,000			14,000
Petroleum tax	0	20,000		20,000
EVAT		14,000	16,000	30,000
Napocor Tariff Adj.(*)	31,941	12,355	12,355	56,652
Interest savings from Napocor privatisation	4,335	10,751	15,086	30,172
Incremental Organic Growth over 5.41% secular	0	10,205	22,843	33,048
Congressional cuts	10,000			10,000

IRA freeze	10,000	6,000		16,000
Agency cuts	5,000			5,000
Total	75,276	73,311	66,284	214,872
less interest savings from Napocor privatisation	(4,335)	(10,751)	(15,086)	(30,172)
add back tariff on volume on privatized capacity	4,689	5,242	4,659	14,589
Total Pain	75,630	57,597	33,014	166,241

**Privatisation: capacity reduced by 3.36bn kwhr in 2005, 7.84bn in 2006
with remaining own capacity at only 4.8bn in 2007*

***Privatisation proceeds: P50bn in 2005, P74bn in 2006 and P50bn in 2007*

48. The total package is estimated at P215billion consisting of (1) P166-billion pain package from new taxes, tariff hikes and spending cuts, (2) P32billion from tax efficiency measures and (3) P30billion interest savings from Napocor privatization.
49. The P166billion pain package consists of: (1) P64billion in new tax measures - P14billion (sin taxes) in 2005 and P50billion (VAT plus petroleum tax) in 2006 (2) spending cuts through a two-year IRA freeze that would yield P10billion in 2005 and P6billion in 2006, reductions in discretionary allocations saving P10billion yearly for the next three years and P5billion contribution from NG agencies and GOCCs thru the implementation of AO 83 and 103, (3) Napocor tariff adjustments of P1/kwhr in 2006, P0.45 in 2006 and P0.40 in 2007.
50. P30billion in interest payments are targeted to be saved in the next three years from the P224billion privatization proceeds from Napocor will be spread over five years P50billion in 2005 and P75billion in 2006 that would be used for debt stock reduction instead of financing the deficit. Organic growth on existing revenue streams is estimated at 7-8% p.a. versus the secular 5.4% p.a. over the past six years. This would be the contribution from collection efficiency.
51. In the financial model, the impact of Napocor is reflected through its impact on debt service and the debt stock of the NG - privatisation proceeds reducing them and absorbed debt servicing of residual Napocor increasing them. Since they are not tax revenues, we can not apply or rely on their organic growth particularly as Napocor is privatizing its

own plants with capacity for sales volume of 3.36bn kwhr and 7.84bn kwhr sold in 2006 and 2007 respectively. This would leave Napocor with 30% of its own capacity. Moreover, we expect Transco to be sold within the next three years. Proceeds of sales are expected to reach P224billion but are assumed to be staggered at P50billion in 2005, P74billion in 2006, P50billion in 2007 and P50billion in 2008.

52. Our initial roadmap targets an early fiscal harvest with an earlier budget balance by 2008 and modest surplus in 2009. To do this, P133billion of the P166billion painful measures must be invested in the first two years – P75billion in 2005 and P58billion in 2006. Thus far, P52billion of the P76billion for 2005 has already been accomplished with only the P10billion IRA freeze and the P14billion sin taxes still to be firmed up. Prospects for passing the indexation of taxes on liquor and cigarettes are quite good.

53. All told, this P166billion pain package should deliver the credibility shock needed to secure credit upgrades within the next twelve months. With P52billion in place, plus possibly sin taxes by October, we could easily convince foreign creditors to refinance maturing US\$4.5billion obligations in 2005. In the financial model, we are assuming a more gradual reduction in interest rates of 50bps in 2005 and 25bps annually from 2006 onwards. However, the package could potentially secure 200bps reduction from upgrades in two years – 100bps in 2005 and 100bps in 2006. On the foreign debt side, the government saves P40billion annually while the rest of the economy P25billion for total savings of P65billion. On the domestic credit front, the initial savings are likely to be constructive since interest rates are still low and the package would only stave potential increase of 200bps in the 91-day T-bill computed based on the difference between current inflation of 5% and projected inflation of 7%. For the government, it means annual savings of P37billion. Total financial savings to the economy are estimated at P102billion. In short, the payback period for the fiscal adjustment package is only two years.

54. The fiscal harvest would come, therefore, as early as 2007 when sustained deficit reduction causes interest rates to taper off as a result of targeted credit upgrades (lower spreads on foreign issuances and lower T-bill rates). The modest harvest in fiscal balance would have been a bumper were it not for the fact that 2007 is an election year which may

demand a reversion to the IRA formula and we could tolerate modest wage adjustments after two years of freeze. IRA allocations will increase by P21billion toning down the projected interest savings in 2007.

55. The public's direct share of pain is proposed at P135billion: P64billion in new taxes spread over two years and P71billion in Napocor tariff hikes spread over 2 - 3 years. This may be compared to government's share by way of cuts in public spending of P31billion (P10billion – pork barrel, P10billion in 2005 and incrementally P6billion in 2007 – IRA freeze and P5billion – intelligence and social fund cuts plus dividends of A.O 83 and A.O. 103). Since the public ultimately bears the impact of reduced government services, the total sacrifice is estimated at P166billion.

56. Tax collection efficiency will have substantial role in the fiscal adjustment. The strategies on this front include the legislation of lateral attrition and possibly tax amnesty with statement of assets and liabilities. Nevertheless, given the historical difficulties in tax effort, we expect this to start contributing only by 2006 with P10.2billion and P22billion in 2007, computed based on the extra organic growth in the existing portfolio of taxes over the secular growth of 5.41%.

57. In our estimation, the pain package is well-spread with higher income classes taking bigger hits as % of their income as the tax package is mostly progressive except for VAT which is only slightly regressive. In aggregate amount, however, it will principally be borne by the mass middle class (households with annual incomes above P60,000) since in reality there are very few rich families. Moreover, the negative impact on consumption is staggered with Napocor adjustments spread at P1 in 2005, P0.45 in 2006 and P0.40 in 2007 while VAT will be increased from 10 to 12% in 2006 and from 12 to 14% in 2007.

58. In terms of sequencing of reforms, cuts in entitlements will initiate the consolidation process to create a more conducive environment for engaging the public in sharing the burden. New taxes which would also be sequenced from measures where progressivity is not critical and a viable consensus already exists (sin taxes) to the more progressive measures (Napocor tariff increases and petroleum tax) to the more regressive (VAT) being last. Thus, in 2005, the package would include P25billion expenditure reforms, sin

taxes and P1 rate hike in Napocor. In 2006, the package would include the P0.40 Napocor rate hike, petroleum tax of P2/liter and VAT increase from 10% to 12%. And in 2007, it would include VAT hike from 12% to 14% and P0.40 hike in Napocor rates. In aggregate terms, this means new revenue stream of P14billion in 2005, P34billion in 2006 and P16billion in 2007.

59. The basic risk to the sequencing and the staggering is that our appetite for pain or the political will to pursue reforms could wane as the pressure ease with the incremental improvements, thereby undermining the long-term cohesion of the program. With Napocor tariff increase amounting to P34billion plus the P15billion cut in spending yielding P49billion in the evolving tally of fiscal adjustments, the need for new taxes and further spending cuts may be undercut instead of gaining momentum.
60. On the revenue side, the more critical risk is that creditors, however, may find the package of new taxes amounting to P64billion not substantial enough to make them roll maturing loans or to give us lower rates. Given that spending cuts are easier to restore with elections scheduled in 2007, they could demand higher recurring revenue streams to provide a buffer for possible spending surprises or for delays in privatisation. However, our finance officials should argue quite validly that this should be placed in the context of the whole package, particularly tariff increases for Napocor.
61. On the expenditure side, the spending cuts are unlikely to result in major loss of productivity in government. Admittedly, one of the risks to the strategy is that the current ethos of austerity could provide the stubborn bureaucracy with the pretext for inefficiency and worse for failure in meeting even the minimum targets. Its greater impact would be on income distribution and countryside development as poorer LGUs and districts are likely to suffer more from the spending cuts as % of their economic base. Investments in these areas need to be prioritized during the recovery period starting 2007.
62. A safety net program clearly needed to be built into the program to anticipate and countervail the unhealthy yet unintended side effects of the program on the poor and also to enhance its public acceptability. There were three elements. First, on the energy front, the impact of the tariff increases on the poor thru direct consumption of electricity and

partly on account of the 12% energy content of consumer products will be mitigated by directly targeted mechanisms. These include the lifeline rates in the Meralco franchise with those consuming 50kwhr getting a 50% discount on the final rate, below 75kwhr – 25%, and below 100kwhr – 15%. Outside the Meralco franchise area where cooperatives are dominant, the increases will be mitigated by condonation of NEA loans with savings of up to P1/kwhr. Second, the impact of new taxes will be mitigated by carefully choosing tax measures on products least consumed by the poor, by staggering the increases and by the sequencing them from those where progressivity was least important and prioritizing the more progressive to the less regressive. Third, on the spending side, social services will be the first item to be allowed modest recovery and shall be targeted to grow at 1.5x inflation for the rest of the program. While the IRA freeze will be lifted in 2007, social services will be allowed to grow by 2006 and government wages at the latter part of 2006.

	2005	2006	2007	2008	2009	2010
Wage Growth	0.66%	3.00%	3.00%	3.00%	3.00%	3.00%
Maintenance Growth	0.13%	9.00%	7.50%	7.50%	7.50%	7.50%
Infra as %GNP	1.59%	1.50%	1.60%	1.70%	1.80%	2.00%

63. In terms of impact on economic growth, the Philippines is unlikely to suffer the same fate of Argentina where new taxes and spending cuts only served to deepen the economic depression from 1998-2002. Unlike Argentina which was already experiencing GDP recession of -4.7% and -7.1%, the Philippines is implementing fiscal consolidation when GDP is robust and has nice momentum with +6.4% in 1Q and +6.2% in 2Q. Moreover, our financial sector is healthier with NPLs at 13.7% and loan-to-deposit ratio of 80% affording excess capacity to finance private investments.

64. The short-term contractionary impact of lower government spending on consumption and investment combined with the drag of higher taxes on personal consumption could easily be mitigated if the private sector take up the slack and creditors reward us with lower spreads sooner. Thus, increased business confidence is critical to a successful execution of the fiscal plan. Aside from healthier government balance sheet, in the long term, the economy benefits dramatically from a downward shift in our interest rate curve. In fact, one of the salutary effects of the fiscal consolidation is that it would provoke the

structural transition from a consumption-led to an investment-led economic expansion. The proposed fiscal strategy includes that, after near-zero growth in 2005, capital outlays will be gradually increased to 2% of GNP by 2010. From the 2005 situation where maintenance cost of P88billion exceeds capital outlays of P72billion, we target that by 2010 capital outlays will reach P191billion while maintenance will be P129billion.

Contractionary Impact (as % of GNP)

	2005	2006	2007
<i>Spending Cuts + New Revenues</i>	70,941	52,355	28,355
GNP	5,571,530	6,212,256	6,895,604
% to GNP	1.27%	0.84%	0.41%

65. Higher taxes and Napocor tariff hikes could add 1.5% to the base line projection of 5-6%. Thus, even assuming global commodity prices, particularly oil, do not correct, 2005 inflation could reach an average 7.2% (5.5% + 1.5%). The additional 1.5% projection sufficiently considers possible cascading as new taxes and Napocor tariff hikes account for only 0.82% and 0.75% of GNP in the first two years of fiscal consolidation. Financial markets are likely to be more forgiving of such policy-induced inflation since it is merely a residual impact of strategies designed to fix the deficit, the root cause of inflationary expectations. The fiscal plan is more likely to reduce long-term inflationary trends.

Inflationary Impact

	2005	2006	2007
<i>New taxes + Napocor tariff</i>	45,941	46,355	28,355
GNP	5,571,530	6,212,256	6,895,604
% to GNP	0.82%	0.75%	0.41%

66. Three simple threads underlie the seeming complex weave of our fiscal strategy. These partly draw upon the key lessons from the mistakes of Argentina during the crisis of 1998-2002. First, the national leadership must consciously build the people's trust in our public institutions and expand the **public's forbearance** for the pain of increased tax impositions and reduced government services. Moreover, the government must be able to articulate and advocate that the immediate pain would result in future gains and that such gains will be equitably shared, to persuade them to sustain the needed effort in two years. Our people must embrace the principle of expanded and enlightened self-interest- that it

is in their best interest that the government succeed with this fiscal roadmap. Second, it must also always seek to maintain **business confidence** in the political leadership and in the wisdom of its economic strategy. Aside from mitigating the unintended negative impacts of its strategic decisions, the government should communicate policy cohesion, consistency and predictability in executive pronouncements and congressional actions. To sustain public forbearance and business confidence, **government credibility** must be rebuilt and sustained. Leadership by example is clearly imperative. And such passion for fiscal discipline must stream down to the bottom of the bureaucracy. Even petty missteps like the mishandling of tax credit scam as well as every small deviation from policy inflict a very high toll on our total effort. So, we repeat that now-famous quote – A thousand needles on thyself before a single one on thy patient.

67. The Philippines faces an opportunity to overcome a fiscal crisis and move forward on its goals of faster economic expansion and rapid reductions in poverty. In the current robust policy dialogues, the long dormant positive impulses of our national life are finally coming out with the National Liga ng Barangays (ABC) initiating a proposal for an IRA freeze that was to be followed by a substantial and proportional self-sacrifice of pork barrel from the House and the Senate, with even the Church admonishing its followers to assist the government and even outright donations by rich individuals.

68. Yet, while investors are heartened by the resurgence in redeeming conduct among our public institutions, it remains to be seen whether the public will finally be convinced to take up their share in the sacrifice by way of new taxes. While the current surge in personal patriotism is a good start, nevertheless, it should not sidetrack us from the more substantial tasks ahead. Such renewed sense of national interest should graduate to a more structural worldview from giving up pork barrel to passing unpopular taxes for Congress and for rich businessman from donating P1m to paying the right taxes. Our fingers are crossed.

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