Fiscal and Monetary Policies as Constraints to Development

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"The formulation of fiscal policy lies at the dead center of democratic government." -- E. Pendleton Herring, 1938

As the Philippines moves towards the end of the second millennium and enters its third thousand years, it is beset with debates on how it must deal with the challenges and opportunities emerging on a global, as well as national scale.

Challenges have been raised, calling for the rethinking and reinvention of many dearly held beliefs about society, particularly on the state and the economy. Issues centering on public finance have been contentious and difficult. Related issues of monetary policy have been equally challenging.

The year 1994 was particularly difficult, with debates focusing on the oil levy, new taxes, including the expanded Value Added Tax (EVAT), and the 1995 budget, in addition to the running debate on the country's foreign and domestic debt.

We are now halfway through 1995. Public finance issues are once more emerging, what with new taxes, as well as oil price increases, looming in the horizon. The forthcoming legislative debates on the 1996 budget promise vigorous disagreements on revenue and expenditure priorities. In the meantime, the foreign debt issue is now more of a fiscal crisis than a foreign exchange dilemma.

Fiscal and Monetary Policies: A Clarification

While the phrase 'fiscal and monetary policy' is commonly used as a single concept, it actually refers to different aspects of economic policy which have different but related impacts.

Public finance refers to the income and outgo of governments in the pursuit of national objectives. It involves the inflow of financial resources in the form of taxes and other revenue, and the outflow of such resources in the form of expenditure to finance goods and services.

The public finance cycle involves five processes: (1) the formulation of fiscal policy; (2) the generation of revenue from taxation and other sources; (3) the expenditure of funds through the national budget; (4) public borrowing; and (5) accountability. It is recognized that these processes have effects on the economy which can either constrain or accelerate development.

In this paper, fiscal policy is understood to mean the mix of policies on taxation and other revenue, expenditure, and borrowing, which is intended to promote the stabilization and development of the economy.

The national budget embodies the development goals of the country. It explains how these goals can be attained through revenue raising, spending, and borrowing activities of the government. The national budget specifies the sources of revenue, including tax and non-tax revenues, as well as the proposed expenditure for government programs and projects.

The budget likewise indicates the level of borrowing which is expected to close the gap between revenues and expenditure. Thus, the budget articulates, in a very real sense, the fiscal policies of a country like the Philippines.

On the other hand, monetary policy is generally understood to be that which influences the level of money supply in the economy, again for the attainment of economic and development objectives.

While fiscal and monetary policies are different from each other, they are closely interrelated and need to be coordinated. This means that the attainment of fiscal policy goals can be wiped out by monetary policy effects and vice versa.

Fiscal Policy as Constraint

If there is any policy area which is dominated by orthodox theories, it would be that of fiscal policy. Much rethinking is necessary on government policies relating to taxes and revenue, expenditure, and borrowing.

Since the 1950s, fiscal and monetary policies have been crafted in response to requirements of stabilization, and subsequently, in accordance with the structural adjustment programs (SAPs) negotiated with the International Monetary Fund (IMF). Another major influence on fiscal policy is Presidential Decree No. 1177 (PD 1177) which prescribes the budget process and provides for the automatic appropriation of, among other things, the debt service. This decree, which was promulgated by the late President Ferdinand E. Marcos during his autocratic regime, continues to dictate fiscal processes even under the present democratic system.

Fiscal policies premised on these two major influences are the core objects of the continuing opposition being waged by the Freedom from Debt Coalition (FDC).

Is the debt crisis over?

The matter of debt, both domestic and external, and its management is a major arena of debate not only in the Philippines, but also across the globe.

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The government claims that the debt crisis is already over for the Philippines. Economists, however, are careful to note that while it may be true that debt as a foreign exchange problem is becoming manageable, debt as a critical part of a fiscal crisis is far from resolved. The debt issue remains a fiscal policy problem, in view of the fact that debt payments continue to be a terrible burden on the budget.

The government cites the following as indicators that the country's debt no longer poses a problem: (1) total debt stock as a percentage of the Gross National Product (GNP) and as a percentage of exports has been reduced; (2) the share of concessional debt to total debt stock has increased; and (3) foreign exchange reserves have reached a comfortable level.

The abovementioned indicators are the standard measures normally utilized by institutional lenders, particularly the IMF, in assessing foreign debt. If the numbers are favorable, it is assumed that debt is no longer a problem. This is the orthodox view. However, this favorable picture does not reveal the festering sore underneath the seemingly healthy sheen of debt management: the fiscal crisis.

Firstly, the ratios do not show the massive human and financial costs involved in attaining the favorable numbers. United Nations organizations like UNDP and UNICEF, as well as independent economists, have long pointed out that the human cost of paying the debt in full is too high. This is because economic and social development services are sacrificed for debts, a good amount of which have been shown to be fraudulent and non-productive.

Secondly, the process of paying the foreign debt in full has put pressure on the domestic debt which has ballooned to unmanageable proportions. Heavy domestic borrowing is resorted to in order to purchase dollars to service the foreign debt. At present, debt service continues to wreak havoc on the budget and throw development objectives into disarray. Even as the government claims that the debt crisis is over, at least 30 percent of the budget is still allocated for debt service. This explains why debt service is presently considered as more of a fiscal crisis than a foreign exchange problem. We may have enough dollars to pay the debt, thanks to remittances from overseas contract workers and heavy domestic borrowing; but we have a budget with an unmanageable debt service component which competes with and marginalizes urgent development needs.

Thanks to PD 1177, there is no rein either on borrowing or on the debt service. The estimates for debt service payments provided for in the budget are always exceeded. In 1993 for example, programmed debt service was pegged at P120.426 billion. This was debated bitterly in Congress. Actual debt service was 260 percent higher at P313.749 billion. And this is only for one year!

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In addition to the tremendous burden the debt service imposes on the budget, another clear indication of the continuing debt crisis is the fact that negative net resource transfers continue to be a problem. This means that remittances to creditors still exceed new loans or inflows from them to us. From 1986 to 1994, net negative transfers amount to -\$31.21 billion, that is, we have paid out to creditors some \$31 billion more than we have received in new loans.

"[H]ow was the 1994 'surplus' attained? This was achieved through large scale underspending for infrastructure and social services....[And] underspending for infrastructure and social services cannot be sustained by a country with ambitious development targets like the Philippines."

Finally, the persistence of the debt crisis is also seen when we consider the country's debt to Japan. International financial newspapers have been making much out of the fact that the continuing strength of the yen *vis-a-vis* the US dollar has the effect of pounding Asian debt to Japan with impunity.

Right now, Japan is our number one bilateral creditor. Nearly 70 percent of the total official debt of the country is owed to Japan. Philippine debt to Japan is growing rapidly not so much because of new loans, but because of revaluation.

As a summary of the issues on debt policy, the following observations are made:

1. the honorable debtor policy may have resulted in flattering debt ratios, but the costs to development are very high;

2. the prevailing debt policy has resulted in a fiscal crisis, with debt service continuing to be a major drain on the budget, thereby crowding out expenditure for economic and social development;

3. negative resource transfers continue unabated; and,

4. debt to Japan is uncontrolled and should pose serious problems unless measures are undertaken to reduce it.

What budget surplus?

The notion of a balanced budget, *i.e.*, with surpluses and not deficits, is standard in orthodox theories regarding the budget. If the budget of a developing country is balanced or reflects a surplus, this is considered a very good thing. However, attaining a surplus for its own sake is not necessarily a good prescription for a country raring to march to the third millennium. The process of attaining a surplus can entail high human and development costs.

To illustrate, the government claims that in 1994, a surplus of P12.3 billion was attained. This claim was considered worthy of front page newspaper coverage and praise from columnists and TV commentators. The claim has been repeated so often that many assumed it to be correct.

In a Senate hearing on the debt service for 1994, the FDC pointed out that the claimed surplus is a mirage. The purported surplus did not reflect the debt service payments for Central Bank (CB) liabilities which were assumed by the national government. The expenditure was treated as an 'off-budget' item. If these payments amounting to P21.3 billion were considered as a budget item, a deficit of P9 billion would have been incurred, instead of the much touted surplus.(FDC Memorandum to the Chairman, Senate sub-committee on the Debt Service, 1994)

A similar observation was made by Dr. Benjamin Diokno of the U.P. School of Economics, the former Undersecretary of the Department of Budget and Management (DBM). He described the situation as "failure masquerading as success." (Diokno, 1995)

Putting the debt service payments for CB liabilities aside, how was the 1994 'surplus' attained? This was achieved through large scale underspending for infrastructure and social services. At the same time, there was significant undercollection of taxes.(Diokno, 1995; De Dios, 1995) We, therefore, have a situation where a 'successful' fiscal policy, *i.e.*, the attainment of a surplus, was achieved at high development costs.

Underspending for infrastructure and social services cannot be sustained by a country with ambitious development targets like the Philippines. The claimed budget surplus was achieved at the expense of low public investment expenditure. The ratio of public investment to GNP for the Philippines is 4.5 percent, as compared to the NICs' 8.5 percent. It was estimated that in order to attain the NIC level, public investments would have to reach P40 billion for 1994 alone. (FDC Discussion Paper on Government Fiscal Policy, 1995) True, an accounting surplus was attained, but targets for public investment were not; thus, economic and social development objectives were negatively affected.

Budget priorities and the budget process

The real priorities of the government are declared not so much in rousing political speeches as in the national budget. The Philippines is already rushing towards the end of the millennium, and yet, its budget priorities are still dictated by PD 1177.

Debt service remains the number one priority item in the budget, consistently exceeding allocations for economic and social services since 1983.

While expenditure for social services have been rising, the social allocation ratio, *i.e.*, the share of the social services sector in the national budget, of 30.1 percent in 1993 is still low compared to the UNDP target of 40 percent and to the ratio of many Asian countries. Accomplishments in the area of health services are understandably a source of pride and satisfaction for the government. Nevertheless, the per capita general government expenditure of \$7.22 for health services, as of 1993, is still much lesser than the \$12.61 estimated by the World Bank to cover a minimum package of basic health interventions as of the same year. (Manasan and Llanto, 1994)

Government has recognized that there will be losers and winners with its entry into the World Trade Organization (WTO). GATT was ratified by the Senate on the assurance that P32 billion will be spent for GATT-related safety nets for those who will be negatively affected. In reality, only P2 billion of the total are new expenditure (Montemayor, 1995). Most of the so-called safety nets are either continuing projects or existing appropriations.

In fact, Senator Gloria Macapagal-Arroyo conceded that the sources for GATT-related spending are 'soft,' while Senator

Raul Roco, for his part, admitted that there has been double counting in the identification of sources for this munificent P32 billion fund. He also stated that the Countrywide Development Fund (CDF) of the legislators were counted as part of the funding for GATT safety nets.

Thus, we have a situation where economic and social expenditure are not given priority attention. Safety nets for sectors negatively affected by the GATT remain at the level of rhetoric, not finding much concrete expression in the budget.

Policies on tax and non-tax revenues

Government has two major sources of revenues: tax and non-tax. Taxes are generally classified into direct and indirect taxes. Direct taxes are based on income, wealth, and property, as exemplified by income and property taxes. Sales and excise taxes are the best-known examples of indirect taxes. Non-tax revenues include grants, user charges, income from government owned and controlled corporations (GOCCs), and proceeds from privatization. At present, privatization proceeds form the bulk of non-tax revenues.

As in the case of the budget and the debt, things on the revenue front are not necessarily what they seem. Much has been said about the fact that revenues of the government have been increasing. What is generally unnoticed, however, is that targeted tax revenues have not been actually attained. Reports from the Bureau of Treasury indicate a shortfall of P1.58 billion for 1994. (*Business World*, 14 February 1995) What accounts for the impressive increase in revenues is not taxes but non-tax revenues from privatization. While the tax effort in 1994 improved by only 2.6 percent in nominal terms, the

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increase in proceeds from privatization comprised 53.8 percent of the total revenues generated from new measures implemented by the government. (FDC Discussion paper on Government Fiscal Policy, 1995)

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As a policy, dependence on revenues from privatization is definitely not sustainable. The privatization program is winding up; once the government runs out of assets to sell, revenues from this source will subsequently dry up.

Let us now take a closer look at the government's tax policy. One aspect of tax policy which needs rethinking in a hurry is the traditional dependence on indirect taxes as the main source of tax revenues. As of 1994, indirect taxes account for 65.6 percent of total taxes collected, with 34.4 percent raised from direct taxes. (*Business World*, 1995) The issue raised here is that of equity. It is a policy which has been in force since the Marcos years, and even earlier; nevertheless, the government appears unable to enforce a progressive system of taxation, despite all the moving speeches about equity, justice, and democracy. No matter how attractive the government packages it, a regressive system of taxation will never gain popular support and commitment.

Tiger economies idolized by our policymakers all have progressive systems of taxation. The trend in these countries to increase revenue from indirect taxes is based on the framework of a tax system which is already progressive. In the case of the Philippines, a VAT and EVAT system is being imposed on a tax system which is already dominated by indirect taxes, thus enhancing the regressiveness of the system.

Monetary Policy as Constraint

Like fiscal policy, monetary policy is tailored to the orthodox requirements of the IMF. Under stabilization programs and SAPs inked with the IMF, money supply is zealously monitored. The rate of inflation is continuously watched. Deviations from money supply targets are considered major sins. The constant fear is that if money supply is not rigidly controlled, inflation might spiral.

The rigid imposition of monetary ceilings or limits on money supply exacts an upward pressure on interest rates. As a result, productive investments contract, thereby hampering development and growth in the process.

Recent studies show that the correlation between high money supply and high inflation does not exist. In 1992, when money supply was restricted to 11 percent growth, inflation was high at 8.9 percent. On the other hand, when money supply was allowed to grow by 24.6 percent in 1993, inflation was only 7.6 percent.

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Rethinking Fiscal and Monetary Policies: Challenges to the Government

The government incessantly reminds Filipinos to rise to the challenges of the year 2000 and beyond. Yet, its orthodox fiscal and monetary policies date back to the 1950s and 1970s.

The major challenge to government is to extricate fiscal and monetary policies from the vise-like grip of stabilization programs and SAPs presided over by the IMF and other multilateral institutions. For the past two years, the FDC has challenged the government to do

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just this. We have consistently maintained that the Philippines does not need the IMF and its orthodox policies. The global, regional, and national economies are experiencing rapid changes. Flexibility in policies will allow innovation and creativity in meeting the challenges of the 21st century.

The second major challenge to government is to do away with an anachronistic fiscal policy structure which traces its roots in Marcos' PD 1177. The provision on automatic appropriation for debt service is just one of the 'jurassic' features of this decree.

The third major challenge is for government to recognize that the formulation and implementation of fiscal and monetary policies is an indispensable part of the democratic process. It is not the exclusive domain of technocrats. The process of agreeing on objectives and choosing among alternative policy measures is essentially political. Until recently, fiscal policy-making was dominated by technocrats, multilaterals, Congress, and the business sector. Citizens had to demand that they be heard.

Fifty-seven years ago, the writer of a classic work on fiscal policy stated that "the formulation of fiscal policy lies at the dead center of democratic government." (E. Pendleton Herring, 1938) It can be said that this proposition is even more valid at this time than it was before. One of the global trends in governance is citizen participation. All over the world, more and more people are demanding that they participate in the making of decisions on what taxes they are to pay, the services they are to get, and the debt burden they are to assume.

Rethinking fiscal policy options

Assuming that government repeals PD 1177 and tells the

IMF to get off its back, the following fiscal policy options are advanced.

Go beyond the debt cap and debt moratorium alternatives. First, policies intended to lower domestic interest rates have to be adopted. Since the government is the largest domestic debtor in the economy, a reduction in interest rates will result in the lowering of the debt service. As of the first quarter of 1994, domestic debt stood at over P661 billion. Lowering interest rates by one percent will result in a reduction of P6.6 billion in debt service.

There are other ways of reducing the debt service burden than the debt cap. The debt cap alternative is no longer tenable because the composition of the external debt has profoundly changed since 1988.

Second, the government must take steps to restructure the huge domestic debt. It has already been pointed out that the domestic debt grew as a consequence of the foreign debt crisis. At present, the government is also funding development projects in the budget through domestic borrowing.

Restructuring the domestic debt can be done by the governmentsince the bulk of domestic creditors are government financial institutions themselves.

Third, negotiate for the reduction of Philippine debt to Japan. However, reduction should be limited only to the increase in the debt stock brought about by revaluation. It should not affect the original debt stock. Two Japanese senators who visited the Philippines and had talks with Finance and CB officials endorsed the idea.

A reduction in debt to Japan will have a big effect on the total foreign debt stock, considering the fact that Japan is the number one creditor country of the Philippines.

Fourth, relax tight fiscal targets in terms of the magnitude of expenditure and the level of deficit. Development expenditure are crowded out of the budget by the monstrous debt service burden. Expenditure for economic and social services should be judiciously expanded to respond to the needs of our rapidly growing population and meet minimum standards suggested by the United Nations.

Finally, the issue of behest loans must be pursued relentlessly. Sanctions must be imposed on responsible parties. The government must send a strong signal that it will penalize those responsible for the terrible burden of fraudulent debt now being borne by Filipino taxpayers.

Orient priorities of public spending toward development. First, the urban bias of growth must be corrected through budget and expenditure policy. While the government boasts of its countrywide development policies, actual public spending negates such a claim. Severe underspending in infrastructure has already been mentioned before. Still, much of this limited spending go to the National Capital Region (NCR). For example, under the 1995 GATT-Safety Nets Fund, the NCR captured the largest appropriation for highway projects.

The situation is ironical, considering the fact that sectors negatively affected by the GATT are from the agricultural sector. To add insult to injury, the infrastructure backlog is more serious in the agriculture sector.

Another instance of urban-rural disparity in public spending is deficient rural electrification, as well as the lack of access to health and other basic services in the rural areas.

Second, development should not only be brought to the rural areas through deliberate public spending; it can be sourced from the rural areas too. This can be done by (1) building mass transportation and telecommunications infrastructure; (2) increasing access to credit by strengthening rural banks through added capitalization; (3) encouraging the formation of cooperatives; and (4) overcoming the irrigation backlog.

Rethink the current tax policy. First, the government must build the trust and confidence of the taxpayers in its capacity to collect existing taxes. Economists note that "vast opportunities exist for collecting more taxes without raising the rate of existing taxes or imposing new taxes." (Manasan and Llanto, 1994). They estimate that if only half of the amount of taxes evaded can be collected, about P17.6 billion can be raised yearly from income taxes and the mother VAT.

Second, in implementing tax reform, priority should be given to the correction of the regressive character of the tax system. New indirect taxes such as the EVAT will not fly so long as the public knows that not enough direct taxes are being collected.

Third, the following measures and direct taxes on income, wealth, and property should be in the government's tax reform agenda:

1. expansion of the 20 percent excise tax on non-essential goods;

2. the two-percent affluent consumption tax as specifically applied to the sale of residential buildings, townhouses, and condominium units worth P5 million or higher, as well as memberships in golf and other exclusive clubs;

3. the land conversion tax on every conversion of agricultural land to non-agricultural use at 25 percent of the fair market value;

4. increase in the tax imposed on high-priced private motor vehicles; and,

5. improvement of real property tax collections through improvements in property valuation.

Relate tax policy to environmental objectives. A fresh option to tax policy is to link it with environmental objectives. On one hand, higher rates of taxes can be imposed on industries which depend excessively on limited natural resources. Moreover, penalties can be imposed on industries which are inefficient in

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the use of power and energy, or on those which pollute the environment. On the other hand, tax incentives can be granted to those who use resources efficiently, reduce power consumption, and use pollution-free technology. Such approaches to tax policy have been adopted before and successfully implemented in Europe.

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Rethinking monetary policy

As in fiscal policy, the government does not need the IMF to set its monetary targets. A restrictive monetary policy is incompatible with the demands of rapid growth and development. Monetary targets must be relaxed to allow expanded expenditure for economic and social development. Such a policy tack will likewise give monetary authorities leeway in influencing foreign exchange rates.

Rethinking Alternatives to Fiscal and Monetary Policy: Challenges to Progressive Groups

Even as government needs to reinvent fiscal and monetary policies to cope with the drive towards social and economic transformation, progressive groups must also reexamine alternative proposals.

First, there is a need for progressive groups to take a second look at dearly held theories about budget deficits and surpluses, money supply and inflation, foreign exchange rates and devaluation. Deficits may not necessarily be bad; surpluses may not necessarily be good. High money supply does not necessarily correlate with high inflation. Low or zero inflation may not necessarily indicate growth; it might even indicate a moribund economy. The context within which alternatives are formulated has changed tremendously since the 1960s and 1970s.

Second, alternative debt policies need to be continually reexamined in the light of rapid changes in the debt profile of the country and global developments. For example, in its 1993-1995 Strategic Plan, the FDC broadened its analytical framework to include not only a narrow study of the external debt, but also an analysis of SAPs and related development issues. This led to changes in policy alternatives and campaign thrusts. The shift was accomplished amid vigorous debates among the member organizations.

Third, rigorous discussion and debate need to be continued is the area of monetary and foreign exchange policy. Many progressives, particularly the working classes, cannot forget the country's traumatic experience with devaluation during the 1960s. The lessons of past experience are undoubtedly valuable. Nevertheless, there is a need to look closely at the present complexities of the monetary and foreign exchange debate.

One angle which must be considered is the fact that we have a large OCW sector whose dependents are affected by foreign exchange policy. Another area of reexamination is the role of the export sector *vis-a-vis* the forex rate. Is a large export sector necessarily bad for the economy? Does a 'strong' currency necessarily denote a strong economy? How come Japan's economy is in trouble as a consequence of its 'strong' currency?

Again, progressive groups must continue to hold dialogues with other organizations and experts on the technical, as well as social, implications of this critical issue. New insights and knowledge should be gained from these exercises.

Finally, progressive groups must keep a continuing balance between analytical rigor and pro-people objectives; between what is technically feasible and what is politically correct.

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As the Philippines moves onto the third millennium, debates on the directions it must take will not be lacking. For sure, one area of debate will be public finance, particularly fiscal policy. Monetary and foreign exchange policy will be another area of contention. The debates will not, and must not, be limited to the policy-makers and their technocrats. The people who will bear the massive costs of financing development need to be heard – and listened to.

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