

**WORKING GROUP ON ECONOMIC AND FISCAL REFORMS—DISCUSSION DRAFT
PHILIPPINES DEVELOPMENT FORUM 2006**

The Working Group (WG) on Economic and Fiscal Reforms congratulates the government on the progress made with fiscal reforms. It stresses that the key challenge is to sustain the reform momentum by meeting the public sector fiscal targets for 2006 and beyond. The WG supports the government's efforts towards continued strengthening of public sector revenues—through administrative reform and policy measures—which will facilitate balancing the budget while devoting more resources towards productive infrastructure and social services.

Taking Stock of Progress

- **Since assuming office in 2004, the administration has passed revenue measures worth around 2½ percent of GDP.** These include the increase in electricity generation tariffs by over 50 percent (worth around 1 percent of GDP) and the VAT reform law (estimated at 1.4 percent of GDP). The government also conducted a public information campaign to educate the public about the benefits of VAT reform as well as the mitigating measures designed to reduce the impact on the poor. This contributed to a smooth rollout of the two stages of the EVAT law.
- **These measures have facilitated a sharp reduction in the fiscal deficit and—for the first time in years—an improvement in the revenue-to-GDP ratio.** The national government deficit fell from 3.9 percent of GDP in 2004 to 2.7 percent of GDP in 2005. Meanwhile the broader deficit of the non financial public sector is estimated to have fallen over 2 percentage of points of GDP in 2005 to 2.7 percent of GDP.
- **Other reforms have also been undertaken.** These include the sales of about one-fifth of the stock of non-performing assets in the banking system through the Special Purpose Vehicle (SPV) framework which has recently been extended by Congress. The Bureau of Treasury conducted an exchange of domestic bonds to consolidate the number of outstanding tenors which would help to deepen the secondary market for government bonds. To support capital market development more broadly, the government has filed a number of bills in Congress including the Corporate Recovery Act and the Credit Information System Act.

Market Reaction and Remaining Vulnerabilities

- **Financial markets have rallied in response to the progress with reforms.** Sovereign spreads have tightened by close to 200 basis points since the middle of last year and the peso has strengthened against the US dollar to levels not seen since over three years ago. Part of this reflects regional and broader asset class trends. Nevertheless, Philippine assets have also rallied relative to the region and the asset class. Standard and Poor's and Fitch Ratings moved their sovereign outlook on the

Philippines from negative to stable in February and the largest US pension fund CalPERS raised its ratings for the Philippines.¹

- **Nevertheless, on account of the large stock of public debt and heavy reliance on external commercial borrowing, vulnerabilities remain.** Nonfinancial public sector debt is estimated at 90 percent of GDP at end-2005 and the public sector needs to borrow a little over \$3 billion from external financial markets to rollover existing obligations. The Philippines would be at risk should there be a reversal of the currently benign financing environment in emerging markets, perhaps reflecting higher risk aversion or a disorderly resolution of global imbalances. A sustained oil price shock poses another risk which would constrain the balance of payments, depress economic activity, raise inflation, and, through its impact on world growth, affect export growth. An Avian Flu pandemic also poses risks although there is yet to be a case in the Philippines. Political turmoil, which could potentially create uncertainty about the sustainability and direction of reforms, is another source of vulnerability.

Immediate Challenges

- **The primary challenge for the government is to sustain the reform momentum, including through realizing the EVAT revenues and achieving the fiscal targets for 2006.** With the realization of EVAT revenues, the national government budget deficit is expected to fall to 2.1 percent of GDP. At the same time EVAT revenues would allow for a welcome increase in infrastructure and social services expenditures. Key to achieving these targets is that the two main collection agencies (the Bureau of Internal Revenue and of Customs) are able to meet their respective collections targets. With markets keenly watching the monthly outturns and progress towards achieving this year's targets, the government could boost transparency by (i) breaking out revenues by revenue item, which would allow markets to follow whether the revenue yield from the EVAT package is as anticipated; and (ii) distinguishing between cash and non-cash revenues and expenditures.
- **Equally important are the broader fiscal targets of the public sector.** Based largely on the EVAT revenues, the deficit of the nonfinancial public sector is expected to fall further to 2.3 percent of GDP in 2006. It would be important to keep a close eye on the financial condition of the GOCCs and other parts of the public sector to avoid undermining the national government's consolidation efforts and a build-up in contingent liabilities. Developing medium term deficit targets for the important GOCCs would help in this regard. Any efforts towards "pump-priming" the economy outside the national government should not compromise the broader fiscal targets or transparency. Transparent rules/guidelines need to be adopted to set

¹ Moody's continues to have a negative outlook on the sovereign ratings, while Fitch has warned that "more significant fiscal adjustment" is needed "to avoid a recurrence of downward pressure on the sovereign ratings"

parameters on whether and to what extent contingent and guaranteed liabilities of GOCCs are to be assumed by the national government.

- **The WG strongly supports the government's plans to improve tax and customs collections efficiency.** A comprehensive and concentrated reform effort in these two agencies will help the government meet its medium term fiscal targets as well as help address the perceived social inequity between tax payers and tax evaders. As the government moves forward to seek donor assistance in this area it would be critical that the efforts form part of an overall reform strategy than piecemeal efforts. The WG endorses a series of steps which can be taken to improve collections efficiency at the bureaus of internal revenue and customs (see Attachment).
- **The WG supports the government's efforts to improve the quality of social spending and public sector investments.** Delays in the budget enactment or a reenactment of the 2005 budget can undermine efforts to improve service delivery and erodes the credibility of the government's budgeting process. In this context, the working group endorses the passage of a fiscal responsibility bill to discipline budget preparation and approval. To address delays in budget enactment, a number of projects worth P35 billion to pump prime the economy have been launched in five priority areas: public works, housing, food production, health and education. These measures are intended to mitigate the adverse impact on growth of the delayed passage of the 2006 budget. However, it is not yet clear how much of the targeted amount under these measures represents spending over and beyond the fiscal targets for 2006 for the public sector. The working group urges that these measures be implemented transparently and encourages the government to ensure comprehensiveness in fiscal reporting.
- **The WG expresses its support for accelerating reforms and privatization in the power sector.** The proposal for a new generation rate mechanism to recover fluctuations of fuel costs in a timely way is welcome. Privatization remains critical to ensure adequate investment in the power sector and thus avoiding future supply shortages. In particular a plan to restore the financial viability of PSALM as well as plans to strengthen financially weak power off takers would be critical. Finalizing universal consent agreements with creditors for the transfer of assets and liabilities from NPC to PSALM and Transco is important. The WG supports efforts by the DOE to resolve outstanding plant-specific issues related to privatization of generating assets such as land-titling, operation and maintenance of non-power component, and water rights. In addition, the WG also stresses that successful bidding of Transco could help to jump-start the privatization process.
- **More broadly, improving the investment climate is key to achieving high and sustainable growth and reducing poverty.** In addition to achieving fiscal sustainability, strengthening and deepening financial markets and improving governance are vital to improving the investment climate.
- **Balancing the budget over the medium-term will require tax policy measures.** Gains from improved tax administration and interest savings are unlikely to eliminate

the public sector deficit of 2 – 2½ percent of GDP that will remain after the VAT reform is implemented. In this regard, the WG supports the government’s efforts to significantly strengthen the rationalization of tax incentives bill that has passed the House of Representatives. Additionally, indexing specific excises would help to prevent a deterioration in their yield in the years ahead.

- **Reform efforts to improve the quality and efficiency of public spending also need to be maintained in other parts of the public sector.** Plans by the Social Security System to strengthen its investment strategy and improve collection efficiency are welcome. Reforms in the GSIS and AFP RSBS would also need to be accelerated. Stronger efforts to rationalize fiscal relations between the national and local governments need to be undertaken. Parallel reforms on the expenditure side (including implementation of recent procurement reforms, cuts in discretionary funds and special privileges) and related anti-graft and corruption campaigns are also important elements to strengthen the “*social contract*”
- **Passage of the amendments to the BSP charter is critical to a sustained strengthening of the financial sector.** The proposed amendments would strengthen the prompt corrective action framework and would strengthen the BSP’s ability to deal with distressed banks. Greater efforts to pass these amendments, as well as other pending financial sector legislation such as the Corporate Recovery Act, The Pre-Need Code Act and the Revised Investment Company Act, would be welcome. Timely adoption of Basle 2 standards would align prudential regulation with international standards and strengthen financial sector institutions’ ability to manage risks. Other reforms include strengthening corporate governance standards and enhancing the inter-bank payments system.

DRAFT

**PHILIPPINES DEVELOPMENT FORUM—WORKING GROUP ON ECONOMIC AND FISCAL REFORMS
ACTIONS TO ADDRESS CRITICAL ISSUES IN TAX AND CUSTOMS ADMINISTRATION**

A. BUREAU OF INTERNAL REVENUE

Registration and Filing

- Set up a taskforce to solve the registration and filing problem. Undertake a thorough investigation of the exact scope, nature, magnitude and cause for the problems.
- Develop a strategy for 1) cleaning up the registration database, 2) solving the encoding backlog, 3) and identifying the true stop filers.
- In this context: consider the establishment of a few dedicated processing centers for the whole country.
- Implement the strategy and allocate sufficient resources to guarantee proper implementation.
- Request stop filers to submit outstanding returns.
- For stop filers that do not comply with the reminder: Make an interim assessment of their tax liability for each outstanding return.
- Commence enforced collection activities for the interim assessed amounts.
- Allow that a BIR interim assessed amount be replaced by a self-assessed amount if the taxpayer submits the outstanding return.
- Initiate other tough enforcement measures - such as business closures - for taxpayers who continue not meeting their filing obligations.

Audit

- Develop the benchmarking methodology into a proper risk profiling system.
- Revise the audit manual to ensure that the identification of issues to be audited is based on substantial risks to revenue.
- Train auditors in risk profiling and risk based audit techniques.
- Revise the selection criteria for the inclusion of large taxpayers in the LTS.
- Allocate a sufficient number of highly qualified auditors to the LTS to be able handle all large taxpayers.
- Allocate to the LTS all taxpayers that fulfill the new criteria for large taxpayers.
- Develop a risk profile for each of the large and medium taxpayers.
- Select taxpayers for audit based on a risk assessment; the taxpayers' risk profiles should form the main basis for the selection.
- When auditing, apply risk technique for identifying issues to be audited.
- Continuously update and revise a taxpayer's risk profile.

Establish a performance management system

- Develop performance indicators for all major operational functions (taxpayer service, registration, returns processing, collection, audit, enforced collection, legal services including appeals processes).
- Measure performance.
- Analyze performance (including comparing the performance results of field offices).
- Communicate performance results to functional areas (including comparisons).
- Use the analysis of performance results to initiate changes to work processes and resource allocations.
- Over the medium to long term: Develop further the performance management system to also cover management indicators for customer efficiency, customer satisfaction, and transparency, etc.

Taxpayer Service

- Initiate information campaigns highlighting costs of evasion.
- Consolidate, rationalize and update regulations and rulings, etc.
- Review and streamline the management of the ruling program.

B. BUREAU OF CUSTOMS

Safeguarding revenue in the import clearance process

- Redesign clearance procedures, in consultation with private sector representatives and in close liaison with the Asycuda project.
- Design management controls, indicators and reports to monitor the proper operation of procedures and identify variances from requirements.
- Review “super green channel” and ensure that only importers with impeccable records qualify; reject all importers for material breaches, including any detected by post-clearance audit.
- Cleanse the list of accredited importers.
- Progressively review the profiles (track records) of importers, the most frequent/highest revenue liability group first, taking account also of factors like commodity type and country of origin, using ACOS records together with post-clearance audit results and seizure, penalty and claims data.
- Determine importer green/yellow/red risk status and feed this information into the risk management system; ensure that it directs entries to the appropriate channel.
- Adopt comprehensive risk management system and relocate the risk management unit to the group responsible for import clearances.
- Reinstate computer-driven assignment of entries to officers for document checks and physical inspection of consignments.

- Separate the document check and physical inspection functions.
- Conduct more rigorous physical inspections—full or partial unstuffing and the level of sampling of contents to be determined by an objective assessment of revenue risk independently of the inspecting officer.
- Improve the alert system to ensure that stopped cargo is kept under proper control.

Warehousing

- Establish a hand-picked team of officers to monitor the activities of the highest risk SEZs; introduce random spot-checks to verify operators' records and physical stock.
- Undertake a risk assessment of SEZs by reference to commodity types/levels of revenue at risk/prior track records, etc.
- Design and implement a simple, PC-based, spreadsheet recording details of movements into and out of warehouses and their processing officers or activate program in ASYCUDA.

Seized and abandoned cargo

- Establish a hand-picked team to police controls, up to and including the listing of consignments for auction.
- Design and implement a simple, PC-based, system of recording movements into and out of storage; introduce random stock-takes of goods in storage.
- Introduce more effective physical and entry/exit controls.

Post-clearance audit

- Give audit on-line access to ACOS database, or immediate paper reports from MISTG, to enable risk-based audit selection.
- Recruit and train more auditors.
- Ensure that verifying the correctness of declared values is included as a standard audit objective; train auditors to apply the valuation code.

Establish a performance management system

- Develop performance indicators for all major operational functions.
- Measure performance.
- Analyze performance (including comparing the performance results of field offices).
- Communicate performance results to functional areas (including comparisons).
- Use the analysis of performance results to initiate changes to work processes and resource allocations.
- Over the medium to long term: Develop further the performance management system to also cover management indicators for customer efficiency, customer satisfaction, and transparency, etc.