

Manasan, Rosario G.

Working Paper

Public Sector Governance and the Medium-Term National Action Agenda for Productivity (MNAAP)

PIDS Discussion Paper Series, No. 2000-24

Provided in Cooperation with:

Philippine Institute for Development Studies (PIDS), Philippines

Suggested Citation: Manasan, Rosario G. (2000) : Public Sector Governance and the Medium-Term National Action Agenda for Productivity (MNAAP), PIDS Discussion Paper Series, No. 2000-24, Philippine Institute for Development Studies (PIDS), Makati City

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Public Sector Governance and the Medium-Term National Action Agenda for Productivity (MNAAP)

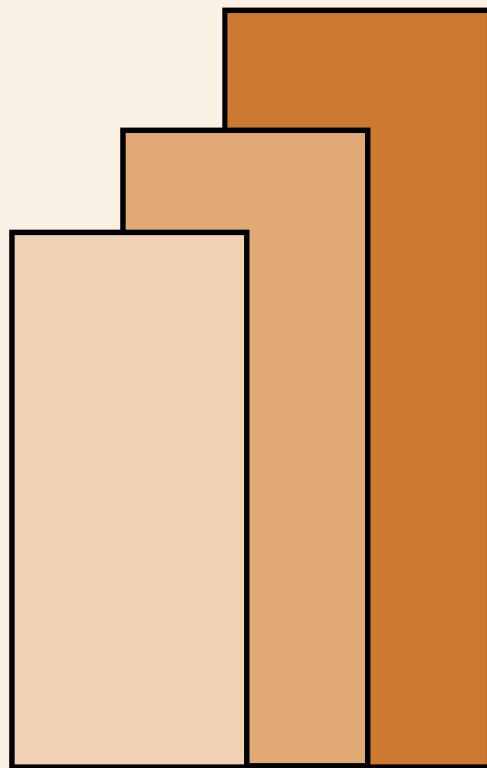
Rosario G. Manasan

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June 2000

For comments, suggestions or further inquiries please contact:

The Research Information Staff, Philippine Institute for Development Studies
3rd Floor, NEDA sa Makati Building, 106 Amorsolo Street, Legaspi Village, Makati City, Philippines
Tel Nos: 8924059 and 8935705; Fax No: 8939589; E-mail: publications@pidsnet.pids.gov.ph
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ABSTRACT

This short note provides a framework for looking at public sector governance and productivity improvements. It argues that the role of government in enhancing productivity growth is two-fold. First, government should provide an environment that is conducive to improving total factor productivity in private sector production. Second, government should work to increase the productivity of the public sector itself.

In terms of providing the appropriate economic setting that is favorable to private-sector-led development, government needs (1) to provide the macroeconomic and the microeconomic environment that will establish incentives for firms/individuals to act in accordance with the invisible hand had there been no market imperfection, (2) to provide the institutional infrastructure (i.e., property rights, law and order, rules and even application and enforcement of the same) that markets need to work efficiently; and (3) to ensure the financing/provision of adequate basic health care and education, and basic physical infrastructure (World Bank 1992). In particular, the instruments that government may use in this regard are include (1) direct government interventions in the product markets as defined by the regulatory structure in strategic sectors, and (2) economy-wide policies like financial liberalization, trade liberalization, and foreign investments liberalization.

On the other hand, (1) budget reform (2) the installation of a system of performance measurement and incentive in the public sector, (3) the re-engineering of the bureaucracy, (4) the combating of corruption, and (5) decentralization are the key features of a program that will increase the productivity of government operations.

PUBLIC SECTOR GOVERNANCE AND THE MNAAP

*Rosario G. Manasan*¹

1. INTRODUCTION

Over the years, mainstream economic development strategy has shifted its definition of the role of the public sector in the economy from one which puts emphasis on the superiority of markets in bringing about efficient resource allocation to one which focuses on market failure and then to one which highlights government failure. More recently, however, many policy analysts increasingly view government and markets as complements rather than substitutes (Stiglitz 1998). Thus, it is no longer a question of the state versus markets but one of public-private partnership. This view “takes as dogma neither that markets by themselves will ensure desirable outcomes nor that the absence of a market, or some related market failure, requires government to assume responsibility for the activity. It often does not even ask whether a particular activity should be in the public or the private sector. Rather, in some circumstances the new agenda sees government as helping to create markets..... In other circumstances, it sees the government and private sector working together as partners, each with its own responsibilities. And in still others, it sees government as providing the essential regulation without which markets cannot function” (Stiglitz 1998).

In the same vein, “governance is defined as manner in which power is exercised in the management of a country’s economic and social resources for development. Governance is not simply about how government conducts business in its own sphere. It is also about how government interacts with civil society. It tells how well government has encouraged and facilitated people participation not only in service delivery but also in the evaluation and monitoring of government performance itself” (Manasan *et al.* 1999)

¹ Research Fellow, Philippine Institute for Development Studies

Given this perspective, the role of government in enhancing productivity growth is two-fold. First, government should provide an environment that is conducive to improving total factor productivity in private sector production. Second, government should work to increase the productivity of the public sector per se.

In terms of providing the appropriate economic setting that is favorable to private-sector-led development, government needs (1) to provide the macroeconomic and the microeconomic environment that will establish incentives for firms/individuals to act in accordance with the invisible hand had there been no market imperfection, (2) to provide the institutional infrastructure (i.e., property rights, law and order, rules and even application and enforcement of the same) that markets need to work efficiently; and (3) to ensure the financing/provision of adequate basic health care and education, and basic physical infrastructure² (World Bank 1992).

On the other hand, (1) budget reform (2) the installation of a system of performance measurement and incentive in the public sector, (3) the re-engineering of the bureaucracy, (4) the combating of corruption, and (5) decentralization are the key features of a program that will increase the productivity of government operations.

2. SUPPORT FOR PRIVATE-SECTOR-LED DEVELOPMENT

Government rules that influence how the private sector performs fall under two types: (1) direct government interventions in the product markets as defined by the legal and administrative framework and (2) economy-wide policies. While the first set of rules are addressed to specific industries and the second one cuts across sectors.

2.1. Deregulation

Deregulation is one of the favorite buzzwords in the 1980s and 1990s. Although deregulation is sometimes used to refer to the naïve stripping away of regulations, more recent thinking highlights the need for regulatory redesign (Stiglitz

² A healthy and well-educated labor force and adequate essential infrastructure are critical complements to productive private investments.

1998). Advances in technology have put in question the existence of natural monopolies in the electricity and telecommunications industries, for instance. Also, without suitable regulation, privatization may simply transform a state monopoly to a private monopoly. This development then implies the need for appropriate regulatory structures.

In the Philippines, significant strides have been taken in the relaxation of direct government intervention in specific sectors and activities. These include: (1) the deregulation of the agriculture sector, (2) the liberalization of bank entry and branching, (3) the deregulation of inter-island shipping, (4) the deregulation of the telecommunication industry, and (5) the deregulation of the oil industry.

It should be emphasized that the deregulation initiatives described in the following section are not necessarily the only instances where government regulations have slackened in the recent past. However, their impact on the economy is significant either because the sector where deregulation has occurred is large like agriculture or because the forward/backward linkage of the sector with the rest of the economy is high as in banking, shipping and telecommunication.

Deregulation in the Agriculture Sector

The history of government intervention in the agriculture sector is best described as one of “rent-seeking.” Thus, it is not surprising that the important reforms in the sector involve deregulation in the following forms: (1) the abolition of monopsonistic arrangements in the trading of sugar and coconut; (2) the liberalization of fertilizer importation and distribution; and (3) the opening of import trade in wheat to the private sector.

Sugar and Coconut Trading. In 1974, the government established a monopoly in sugar trading. Philippine exchange (PHILEX), a subsidiary of the PNB, was mandated to be the sole buyer of sugar from sugar mills and to be the sole exporter of sugar, too. (The PNB was the major financial institution providing credit to the sugar industry at that time). After the PHILEX sustained considerable losses because of poor

sugar price in the world market in the mid-seventies, the government considerable to its monopoly powers. In 1977, the government expanded the powers of the Philippine Sugar Commission (PHILSUCOM) as the principal policy making body for the industry and the National Sugar Trading Corporation (NASUTRA) was created as its subsidiary to take over the functions of the PHILEX. The government intensified its grip on the industry by acquiring and operating the major transport and bulk storage facilities for sugar and sugarcane. PHILSUCOM also established new sugar refineries and sugar centrals.

The effects of government interventions in the sugar industry were: (1) a loss to producers of P11 billion or P14 billion; (2) the introduction of an additional layer in the marketing chain resulting in either more mark-ups, a redistribution of income from actual traders to favored “paper traders”, or both; (3) no increase in trading efficiency and no increase in foreign exchange earnings; (4) a loss to the economy because of the operating losses of NASUTRA (De Dios 1984).

In the case of coconut, the government through the Philippine Coconut Authority (PHILCOA) imposed a coconut levy (legally defined as private contributions to a stabilization fund) on coconut farmers starting in 1973. This was done in the guise of rationalizing the industry. The fund was subsequently used for the vertical integration program, replanting and other development activities in the sector. The vertical integration program was ostensible planned to make the farmers owners of coconut trading and processing mills. As part of this grand design, proceeds from the coconut levy was used to purchase a bank, the United Coconut Planters Bank (UCPB) and to establish a private milling and marketing company for coconut products, the United Coconut Mills, Inc. (UNICOM). The UNICOM eventually dominated the industry and became the major buyer of coconut from farmers. It also controlled the coconut milling sub-sector and the export of coconut oil. As a result of these interventions UNICOM paid farmers a price 9%-15% less than what they would have received under a more competitive environment (Clarete and Roumasset 1983). Intal and Power (1990) estimated nominal protection rates in 1974-1986. In 1974-1978, the negative protection to coconut (-19%) was attributed to the export tax and the coconut

levy; in the 1979-1986, it (-24%) was traced to the export tax, the coconut levy and the monopsony power of the UNICOM.

Because of the above mentioned problems related to the heavy government intervention in sugar and coconut industry, there was great pressure from both internal and external groups to deregulate these industries in the early 1980s. In 1985, the government dissolved domestic trading to the private sector, and abolished the UNICOM. However, sugar trading remains highly regulated.

Fertilizer Industry. In 1977, the Fertilizer Industry Authority (FIA) was reorganized into the Fertilizer and Pesticide Authority (FPA) for the purpose of regulating prices, inputs, domestic production and marketing of fertilizers and farm chemicals. To ensure that the fertilizer prices it sets are enforced, the FPA decides on the level of imports necessary to complement local production of fertilizer. The FPA then allocates allowable imports to authorized importers (some of whom were also domestic producers of fertilizer). Fertilizer imports were exempted from tariffs and the 50% margin of deposit on the value of import letter of credits. Furthermore, raw material imports of domestic producers of fertilizer were also exempted from tariff and the 50% margin of deposit. When fertilizer prices went up in 1973-1975, the government imposed a ceiling on fertilizer prices. It then subsidized domestic producers of fertilizer for the losses they incurred in having to sell their products below cost because of the price control.

While government intervention in the fertilizer industry was allegedly designed to help farmers by lowering its price, the domestic price of fertilizer is higher than world price since 1976. David and Balisacan (1981) showed that the regulatory framework for fertilizer enforced by the FPA has resulted in an increase in the protection of the domestic producers/importers while farmers were penalized.

In 1986, the Aquino government liberalized the importation of urea and non-phosphatic fertilizer and eliminated tariff on these products. These has resulted in an increase in the number of fertilizer importers and a near equalization of domestic prices with border prices (Intal and Power 1990).

Opening of Trade in Wheat. In the 1975, the authority to import wheat was made an exclusive privilege of the National Grains Authority, which was later reorganized as the National Food Authority (NFA). Its imports were then allocated to the eight members of the Philippine Association of Flour Millers (PAFMIL). “Allocation decisions were done cooperatively (i.e., by agreement) rather than by market forces. The NGA tolerated and accommodated the lobby of flour millers for regulated flour prices and reduced duties mainly because of a vested interest – it was then sole importer of wheat. Because of excess capacities then prevailing, the NGA also restricted entry into the industry” (SGV Consulting 1992). Flour millers operated substantially below capacity and earned profits in excess of what is normal by pricing their output high. Consequently, hoarding, overpricing and blackmarketing became the order of the day.

In March 1986, the government abolished NFA’s monopoly on the importation of wheat and deregulated the flour industry. Since then, flour prices declined. The PAFMIL members increased their capacities and there were four new entrants in the market. However, due to certain rigidities in the distribution system, consumers did not fully capture the gains from the changes thus far. The real gainers are the distributors and the bakers (SGV Consulting 1992).

Although government intervention in vital areas in agriculture has been dismantled as described above, the sector still has to surmount other problems. David, Ponce, and Intal (1992) attributed the poor performance of the Philippine agriculture relative to that other Asian countries in the last decade to the slow growth in the productivity of the crop sector. In turn, declining crop productivity growth is traced to low levels of government expenditures on the maintenance, rehabilitation and construction of irrigation facilities, under-investment in agricultural research that could have given rise to needed technological innovations, and inadequate agricultural extension services. In addition, direct government intervention in the market for rice and corn has tended to dampen agricultural prices, lower incentives to farmers and impact negatively on downstream industries.

Outstanding issues in the agriculture sector are discussed in more detail in Inocencio and David (2000). In particular, it noted that while quantitative restrictions (QRs) on agricultural products were abolished in 1996, they were replaced by tariff rates that were typically higher than the nominal protection rates implied by the QRs. Also, the tariff rates on close substitutes of commodities that used to be subject to QRs were increased. Lastly, the administration of the minimum access volume (MAV) provision of the WTO has given rise to rent-seeking activities and has been associated with high bureaucratic costs.³ On the whole, a drift towards increasing protection for Philippine agriculture was observed. (See related story under trade liberalization below.)

Deregulation of Bank Entry and Branching

As part of the financial reforms introduced in the early eighties, universal banks, which were allowed to engage in some functions previously reserved for investment houses, were created. The functional differentiation among different types of financial institutions was reduced introducing greater competition in the system. However, banks were also encouraged to consolidate through the build-up of internal capital or to merge with other banks ostensibly to exploit economies of scale and scope although studies showed that these already been exhausted (Lamberte 1982). As a result, no new commercial bank was established in 1980-1988.

Tan (1989) demonstrated that the share of the five largest commercial banks in total assets of the banking system increased from 33% to 54% between 1982 and 1988. This indicates the growing concentration of the banking system during the period. Lamberte (1991) showed that this increasing concentration is associated with a widening of the bank spread (difference between lending rate and deposit rate), adjusted for intermediation taxes during the same period. In other words, because of the oligopolistic character of the sector as interest rate on loans and deposits were liberalized during the period, banks did not deposit rates as much as expected but

³ EO 313 provided for a two-tiered tariff scheme for each of the deregulated agricultural products such that a lower tariff rate is applied for imports under the minimum access requirement of the WTO and a higher tariff rate is applied for imports in excess of this quota.

simply captured the gains implicit from an increase in the lending rates through larger bank spreads.

In 1989, the licensing of new banks was deregulated. However, minimum capital requirement for different types of banks was raised somehow dampening the liberating effect of the first measure. The opening of new branches in rural areas was liberalized in full. On the other hand, the Central Bank continued to regulate branching in urban areas.

These actions are expected to encourage bank entry and branching and to weak the cartel-like behavior of the banking system. In turn, this is expected to lead to a lowering of intermediation costs and an increase interest rate on savings. These issues will be discussed further in the next sub-section on financial liberalization.

To date, the entry of foreign banks has also been liberalized.

Deregulation of Inter-island Shipping

The inter-island shipping industry is regulated by the Maritime Industry Authority (MARINA) which enforces rules on route capacity and pricing of liner shipping services.

Under MARINA's route franchising system the existing operator is given first option to provide additional capacity in situations where it is deemed needed. MARINA protects a new operator by disallowing other operators from serving the route within a period of five years from the date of issuance of the former's franchise. This rule is meant to give the first operator time to recover is investment. MARINA maintains the sole right to determine the capacity required in all routes. Existing operators may not increase their existing capacity by more than 20% without prior MARINA approval.

Nathan Associates (1991) pointed out that "low official rates on agricultural commodities lead to the shutting out of these commodities from the liners' preferential cargoes. The pricing policy has prevented operators from obtaining and offering

appropriate, specialized capacity for some commodities. Government regulations have protected inefficient operation and encouraged over-tonnaging on specific routes by disregarding these considerations when identifying needs for rate adjustments. The route franchising system not only limits competition. It also fails to take into account service standards, further promoting inefficient operation and limiting inducements to the provision of standard services. The regulatory framework has encouraged passenger overloading and low passenger service standards by (a) preventing flexibility of service schedules to better meet demand in peak periods, and (b) holding third class passage rates at levels which have not generally kept pace with inflation” (as cited in SGV Consulting 1992).

In 1991, the government implemented a fork-tariff system. This scheme gives operators the discretion to vary their tariffs within a 10% band of the reference rates set by the MARINA. Cargo rates for livestock, transit cargoes and reefer boxes were freed as well as those for first and second class passage. Entry was liberalized somewhat in that the MARINA has allowed the entry of a second operator in most routes. Undeniably further deregulation is needed but the above measures are steps in the right direction. Full deregulation of inter-island shipping is projected to enhance marketing activities particular of agricultural commodities. Cabanilla (1987) reported that it is more than twice as expensive to transport corn from Mindanao to Manila than from Bangkok to Manila.

The deregulation of the inter-island shipping is generally considered as effective (Halcrow Fox 1997). However, ports services continue to be a problem in key cities as indicated by high berth capacity. Moreover, increased private sector participation is constrained by institutional problems in the regulation and management of port operations.

Deregulation of the Telecommunication Industry

The government regulates the telecommunication industry primarily through its franchising and licensing functions. Before any firm can participate in the market, it must first obtain a franchise via a legislative act of Congress. The franchised operator should then secure a Certificate of Public Convenience and Necessity (CPCN) from the National Telecommunications Commission (NTC) before it can actually start its operations. Before NTC issues the CPCN, it conducts public hearings where the public and the competitors may support or oppose the application. At the same time, the government limits rates that telecommunication operators charge based on a ceiling of 12% on the rate of return (computed based on net book operating expenses).

Over the years, government regulations in the sector have followed the natural monopoly principle. Thus, the government has restricted entry of firms in the sector so as to avoid the “wasteful duplication of services and unnecessary competition” (SGV Consulting 1992). In 1973, the NTC, through a memorandum circular, encouraged the merger and consolidation of domestic common carriers. In 1981, Presidential Decree 1756 was issued granting incentives for the merger and consolidation of public utilities. During this period, the Philippine Long Distance Company, the first private firm given a franchise to operate in the sector, strengthened its position in the market by acquiring a number of smaller operators. The PLDT was granted the monopoly to operate an international gateway in 1983. In 1986, the PLDT was again given priority in acquiring existing systems in the name of further rationalizing the sector’s development. Consequently, PLDT was able to consolidate its position such that it now has monopoly on the nationwide transmission network or backbone.

As a result of this regulatory regime, the market structure of the sector is highly concentrated where PLDT accounts for 94% of all phones in service and 86% of total line capacity. SGV Consulting (1992) pointed out that the lack of competition in the sector and failure of the NTC to enforce service commitments have resulted in the following. First, the supply of telephone facilities has lagged behind demand. At present, there are some 400,000 pending telephone applications with the PLDT. Second, the distribution of telephone services is heavily skewed towards the urban sector. Metro Manila accounts for 70% of all telephones in service. Third, the quality of service is generally perceived to be poor.

Some deregulation promoting greater competition in the provision telecommunication services has occurred since 1987. The NTC directed the mandatory interconnection of the public communication carriers. It also put in place a new revenue sharing arrangement that is more favorable to local operators (as against the PLDT which owns the backbone). Entry into the provision of international toll services, cellular telephone systems and customer premises equipment was also liberalized. Since then, the NTC has approved the CPCNs of two other firms (Philippine Global Communication, Inc. [Philcom] and Eastern Telecommunications Philippines, Inc. [ETPI]) to operate international gateways. Consequently, toll rates for international calls were reduced by 20% by those for domestic calls were increased. However, the Supreme Court annulled the CPCN of ETPI following PLDT's complaint that the NTC's grant of a CPCN to ETPI to operate a gateway is invalid because the latter does not hold a legislative franchise providing the same.

At present, the Philippine telecommunications industry is considered to be one of the most dynamic in the region with at least two local exchange operators and several cellular operators. As noted above, tariffs have declined. However, telephone penetration remains highly skewed in favor of urban areas.

Other proposals made by SGV Consulting (1992) earlier are still applicable. These include the reexamination of the natural monopoly rationale in the presence of technological advances like value-added network services; the strict enforcement of mandatory interconnection of facilities in areas where the natural monopoly argument holds (as in basic telephone services in specific geographical areas); re-assessment of schemes other than the net rate of return ceiling in regulating tariffs charged by the industry, (e.g., price cap regulation); and strengthening of the NTC (technically and institutionally) for it to be able to regulate the telecommunication industry effectively. In line with this, Serafica (2000) pointed out that the present regulatory environment is not equipped to demands of increased competition, particularly in the areas of interconnection and rate setting. Definitely, this is an area that requires further work.

Deregulation of the Oil Industry

Prior to 1996, the government fixes wholesale and retail prices of different petroleum products based on the petitions of oil companies and after public hearings. As such, upward adjustments in petroleum product prices become highly politicized. In the months leading to the 1990 Gulf crisis, for instance, the government failed to adjust petroleum product prices in a timely manner, in step with rising world price of crude oil, because strong populist protest. As result, the national treasury became P4.5 billion poorer as it had to prop up the bankrupt Oil Price Stabilization Fund. Thus, the national government ended up effectively subsidizing domestic consumption of petroleum products during that period.

In 1996, the OPSF was abolished and the petroleum/oil industry was deregulated. The importation and domestic distribution of refined petroleum products were liberalized, domestic price of petroleum was deregulated, and taxes and tariffs on crude oil and refined petroleum products were restructured. Moreover, PETRON was privatized.

Undoubtedly, the deregulation of the oil industry is effective in shielding the fiscal position of the government from being eroded by subsidies. Under the old regime, the recent round of crude oil price increases in the world market would have resulted in increasing transfers from the national treasury to the OPSF.

Although domestic petroleum product prices are amongst the lowest in the world, the wisdom of the deregulation of the oil industry continues to be questioned. Following the deregulation of the oil industry, a small number of new firms have entered the market. However, the structure of the market remains largely oligopolistic. From this perspective, there is need for an assessment of the adequacy of the regulatory environment in protecting domestic consumers from possible collusion of the big players in the petroleum product market.

Deregulation of Power Sector

Prior to EO 215, the National Power Corporation has a monopoly of power generation and transmission. EO 215 changed that by allowing the private sector to participate in power generation. Thus, there are now several existing independent power producers.

Nevertheless, electricity tariffs in the country are amongst the highest in the Asian region and the country suffers from a low level of electrification (Seráfica 2000). The proposed restructuring of the power sector is designed to address this. Refer to the work of Seráfica (2000) for the various elements of the said restructuring.

A Summing Up

A review of the various deregulation experiences in the country all point to the need to design more appropriate regulatory structures in response to changing technologies and changing market structure in specific sectors. In particular, there is a need for government to provide a regulatory structure that ensures private provision of utilities at reasonable prices.

Also, there appears to be a continuing need for governments to review and assess the rationale as well as the cost and benefits of the regulations they have imposed. In line with this, there is need for an inventory and review of the costs of various kinds of process regulations in the area of business registration, investment promotion, customs administration and tax administration so as to minimize the implicit cost of doing business in the country. Moreover, the experience in other countries demonstrates that regulations tend to be more effective if they use market and market-like mechanisms like auctions and market-based instruments.

2.2. Economy-wide Liberalization

The principal elements of the liberalization program that has been instituted since the early eighties are: financial liberalization, trade and industrial policy reform, foreign investment liberalization and foreign exchange market liberalization.

Financial Liberalization

In the seventies, the financial sector was unable to mobilize sufficient resources for the needs of a growing economy. The shortage of long-term was even more acute. The period saw the rapid expansion of the money market sector as savers were attracted by the relatively higher returns it offered. Unlike the banking sector, it was not subject to the interest rate ceilings that were then in force. Many firms also resorted to the international market to finance their capital needs since real interest rate abroad was low guarantees were obtainable from the government.

The financial reform of the early 1980s was an attempt to increase the availability of long-term funds in the system by bolstering financial intermediation. This was then expected to lead to greater savings flowing through the financial sector and consequently, made available to investors. In 1981, the Central Bank (CB) abolished the interest ceilings on all types of deposits and loans except short-term loans. The ceiling on short-term loan rates was lifted in 1983. In 1985, the CB adopted a uniform, market-oriented discount rate. Special credit programs that lend at sub-market rates were rationalized to align their rates with the market. The Central Bank transferred to government financial institutions certain credit programs it used to manage directly.

Lamberte (1991) showed that the ratio of money supply (M3) to GDP, which is an indicator of the flow of loanable funds, increased from 1980 to 1983, dropped dramatically in 1984 and increased slowly through 1989. However, it has not recovered to its 1983 level yet. This, he argues, implies that financial reforms has not been able to promote financial intermediation as it was expected to achieve. Lamberte then attributed this phenomenon to the low or negative interest rates on deposits between 1980-1989. During this period, interest rate on savings deposits was negative in most years while that on time deposits was positive but generally low. He argued that because of freeing of interest rates coincided with increasing bank concentration as a result of the government policy on merger/consolidation, banks, acting in cartel-like fashion, failed to increase interest rates on deposits even as they jacked up interest on loans. As a result, bank spreads widened during the period. The recent moves to liberalize bank branching and entry is, thus, expected to correct this situation.

Trade Liberalization and Industrial Policy Reform

In the fifties, the Philippines embarked on an industrialization strategy based on import substitution. Controls on imports and foreign exchange were then the primary policy instruments used to implement this program. The dismantling of the imports and foreign exchange restrictions in 1962 did not significantly alter the overall incentive structure since import and foreign exchange controls were simply replaced by a highly protective tariff structure. Moreover, the overvaluation of the peso persisted. In the seventies, the government attempted to promote exports without revising its tariff system by providing fiscal incentives to investments in the export sector through the Board of Investments (BOI). While incentives counteracted the bias against exports, they were not generally adequate to provide full compensation. The policy distortions induced by these modified import substitution strategy are well documented. First, there was a bias in favor of manufacturing over other sectors; second, exports are penalized; third, the finishing stage of consumption goods production was favored intermediate and capital goods production (Bautista, Power and Associates 1979) The tariff structure together with the investments incentive scheme favored large over small/medium enterprises, capital intensive over labor intensive techniques and projects, and the geographical concentration of industries in the National Capital Region (NCR).

Trends in the industrial performance in the last 30 years reflect these policy-induced distortions. Philippine exports did not grow as fast as its neighbors'. The structure of production in manufacturing is heavily biased in favor of consumer goods (average of 50% in 1970-1980) with capital goods accounting for about a fifth of manufacturing GVA. The average rate of growth of Philippine exports lagged behind its competitors (Bautista 1991). Total factor productivity in industry declined by 1.2% yearly on the average in 1971-1980 (Hooley 1985). Overall employment growth in the manufacturing sector has lagged behind the rest of the economy. Thus, its share in total employment has declined from 12.1% in 1960 to 10.6% in 1980. Small/medium

industries accounted for about 10% of output of all firms with 10c or more workers in 1983 (Tecson et al. 1989).⁴ The capital labor ratio in most of the manufacturing (three-digit) sub-sectors went up from 1960-1980 without corresponding increase in labor productivity (World Bank 1987). forty percent of all firms with 10 or more workers in 1983 were located in NCR.

Against this backdrop, the government initiated a trade reform program in 1981. It was a three-pronged program that included the phased reduction of tariffs, the realignment of indirect taxes and the lifting of non-tariff restrictions. While the first two components were pushed through, the removal of quantitative restrictions was derailed because of the 1983-1985 economic crisis. In 1983, the investments incentive system managed by the Board of Investments (BOI) was revised. There was a shift from capital cheapening incentives were replaced by performance based incentives (e.g., tax credit on value added). The incentives were also more geared towards compensating the export sector for the prevailing penalties against it. In 1985-1990, import restrictions on a significant number of previously regulated items were eliminated. The number of regulated items as a proportion of total PSSC lines was reduced from 34% to 8%. Also, export taxes on all commodities were eliminated. In 1987, the investment incentives law as again repealed. The performance-based incentives were dropped in favor of the income tax holiday. In 1991, the government launched another five-year tariff reform program under Executive Order 470.

The average effective protection rate (EPR) declined from 64.7% in 1979, to 49.0% in 1985 and 36.5 in 1988 (**Table 1**). The EPR for exportables increased from 6.9% in 1979-1985 to 4.1% in 1988 while that for importables dropped from 117.6% in 1979 to 102.3% in 1985 and 75.1% in 1988. The EPR for manufacturing decreased

⁴ Tecson et al. (1989) attributed the bias against small/medium enterprises (SMEs) to a number of policies. First, until 1985, EPRs were found to be negatively associated with share of SMEs to total sectoral employment or total sectoral value added. The implication is that industries dominated by large firms were in a better position to bargain for higher tariff protection. Second, the administrative arrangements in the grant of BOI incentives was also biased against SMEs. This arise because the transactions cost associated with the documentation and procedural requirements for the availment of incentives from BOI (which is to a large extent invariable to firm size) is too high relative to the benefits derived from the incentives (which is positively related to firm size in nominal terms) by SMEs. Third, the effective rationing of credit as a result of interest rate controls tends to work against SMEs since they are perceived by banks to be less bankable and more risky.

from 93.3% in 1979 to 73.3% in 1985 and 55.5% in 1988 while that of agriculture also declined by 12.3% in 1979 to 9.0% in 1985 and 5.2% in 1988 (Medalla and Power 1986; Medalla 1990). The gap between the exportable and importable sectors and that between agriculture and manufacturing narrowed down considerably. Moreover, the intra-as well as inter-sectoral disparities in EPRs was also reduced as indicated by the decline in the standard deviation in EPRs of all sectors from 116.5 to 70.8 in 1985-1988. However, the basic character of the protection structure remained (Medalla 1990).

The decline to 24.8% by 1995 in the EPR for all sectors was accelerated with the implementation of EO 470 starting in 1991. At the same time, the standard deviation slipped to 23.0% (Manasan and Pineda 1999). Also, it further narrowed the gap between agriculture and manufacturing. Thus, the trade liberalization program implies a shift to a near uniform tariff structure that is less distortionary and, as such, is expected to foster greater competitiveness of domestic industry.

Table 1
Average EPR and Standard Deviation by Major Groups
Using Price Comparison
(in percent)

| Sector Group | 1979 | 1985 | SD | 1988 | SD | 1990 | SD | 1995 | SD | 2000 | SD |
|--|--------|--------|--------|-------|--------|-------|-------|-------|-------|-------|-------|
| 1.2. ALL SECTORS | 64.70 | 49.04 | 116.55 | 36.49 | 70.84 | 29.39 | 22.07 | 24.83 | 22.96 | 14.86 | 19.04 |
| Exportables | -6.90 | -6.91 | 5.94 | -4.14 | 3.27 | | | | | | |
| Importables | 117.56 | 102.26 | 145.07 | 75.14 | 88.06 | | | | | | |
| 1.3. AGRICULTURE, FISHERY & FORESTRY | 12.29 | 9.00 | 37.37 | 5.21 | 26.32 | 27.10 | 23.04 | 28.51 | 30.28 | 17.26 | 21.17 |
| Exportables | NA | -8.49 | 9.67 | -5.70 | 9.67 | | | | | | |
| Importables | NA | 79.62 | 20.88 | 49.28 | 26.27 | | | | | | |
| 1.4. MANUFACTURING | 93.30 | 73.35 | 158.95 | 55.49 | 100.80 | 31.93 | 20.96 | 24.83 | 19.20 | 14.81 | 18.34 |
| Exportables | -4.45 | -4.45 | 11.13 | -1.28 | 9.94 | | | | | | |
| Importables | 27.10 | 107.27 | 180.10 | 80.24 | 111.94 | | | | | | |

Source: 1979-1988 EPR estimates from Medalla, Erlinda M. "An Assessment of Trade and Industrial Policy, 1986-1988"

1990-2000 EPR estimates from Manasan, Rosario G. and Virginia S. Pineda. "Assessment of Philippine Tariff Reform: A 1998 Update"

Further tariff reform in the late 1990s re-enforced the gains made in the earlier years. Thus, the overall average EPR was cut down to 14.9% in 2000. Sector-wise, the reductions in the mean EPRs are greater for the manufacturing group than for agriculture, fishery and forestry group, particularly for the agriculture sub-group. Agriculture, which was penalized in the previous decades, became more favored starting in 1995. This reflects the more sluggish tariff cuts in agriculture compared to manufacturing.

The more recent reform initiatives did result in a more even pattern of protection across sectors. While the overall standard deviation of EPRs declined from 1995 to 2000, the overall coefficient of variation of EPRs rose significantly. Worsening dispersion was particularly evident in agriculture sub-group and the food processing sub-group. The increasing coefficient of variation is caused by the stickiness in tariff adjustments in these two sub-groups.

On the other hand, Manasan (1990) demonstrated that the 1987 changes in the investment incentives system has resulted in (1) an increase in the capital intensity of BOI registered projects and (2) an effective reduction in the benefits provided exporters such the under-compensation for the implicit penalties against exports rose. Moreover, SGV Consulting (1992) has highlighted the arbitrariness in the listing and delisting of

industries under the Investment Priorities Plan (IPP).⁵ They cite cases (e.g., steel industry and aerospace engineering) where the BOI include specific activities in the IPP to accommodate requests by industry participants.

Foreign Investments Liberalization

In 1991, the Foreign Investments Act (FIA) was enacted into law. This law repealed the highly discretionary and uneven treatment of foreign investments under the Omnibus Investments Act of 1987. In principle, the FIA greatly simplifies the registration procedures for foreign investments entering the country. Provided their activities are not included in the negative list, foreign investors may come in without prior approval from the Board of Investments. Moreover, firms exporting at least 60% of their product may not be owned 100% by foreigners. Prior the 1991 FIA export-oriented firms are defined to be those that are exporting at least 70% of their output. On the whole, the FIA liberalized entry of foreign capital.

Foreign Exchange Market Liberalization

Although the Philippines officially adopted a floating exchange rate system in the 1970s, there is a general consensus that the CB manages the system and tended to artificially prop up the peso in the guise of stabilizing the exchange rate. Restrictions on foreign exchange trade and use were extensive. Export proceeds and foreign exchange earnings of overseas workers had to be surrendered to authorized agent banks. There were controls on the repatriation of certain forms of foreign investment income. Interbank trading was extremely restricted. Sale of foreign exchange for travel, medical, educational expenses abroad were limited.

Starting in 1991, the foreign exchange market was liberalized at a spectacular pace. The limit on the amount of foreign exchange receipts exporters are allowed to keep was increased from 2% to 40% initially to then to 100%. The requirement on the remittance of overseas workers was lifted. Loans that may be obtained by exporters

⁵ Industries/activities included in this list may avail of incentives from the BOI.

from Foreign Currency Deposit Units (CDFUs) were increased from 50% to 70% of the value of their L/Cs. Full and immediate repatriation of principal, dividends and interest of foreign investments is now allowed by the CB. Controls on the buying and selling of foreign exchange and the entry and exit of foreign exchange were relaxed. Restrictions on off-floor trading of foreign exchange by commercial banks were abolished.

Assessing the initial impact of the deregulation of the foreign exchange market, Bertrand et al. (1992) reported that:

“Deregulation seems to have the unintended effect of contributing to a sharp appreciation of the peso. In recent months, a recession-induced slowing down of imports, portfolio inflows attracted by relatively high domestic money market interest rates and attractive stock prices, and certain other inflows related to the May 1992 elections have been major sources of an avalanche of dollars in the local foreign exchange market. The deregulation has contributed to this condition by easing the way for portfolio inflows and inducing additional inflows in the form of a massive increase in overseas workers’ remittances.... As a consequence, the peso strengthened dramatically against major currencies. This has been moderated by the purchases of foreign by the CB from the bourse. However, to meet monetary targets under the present IMF standby, the CB fully sterilized its dollar purchases by issuing its interest bearing short-term instruments. This has effect of raising money market rates.”

2.3. Macroeconomic Stability

A stable macroeconomic environment is another critical ingredient in promoting the efficient allocation of resources, in increasing productivity and in encouraging innovations in the private sector activities. In this regard, the role of aggregate fiscal discipline cannot be overemphasized. In the Philippines, the

government's fiscal position is largely driven by gains in the government's revenue performance although expenditure control is also part of the equation.⁶

The government undertook an extensive restructuring of the tax system in 1986 and then again in 1996-1999. While the previous efforts to change tax policy were piecemeal in nature, the 1986 Tax Reform Package represented the first attempt at a comprehensive reform of the country's tax system. In line with articulated policy, the measures comprising the tax reform package were not solely dictated by the need for government revenues. Equity and efficiency objectives also received considerable weight in the design of this package.

The following were the major components of the Tax Reform Package: (1) a shift from the schedular to a more global approach in taxing individual income from compensation, business, trade and exercise of profession;⁷ (2) increase in personal and additional exemptions; (3) separate treatment of income of spouses; (4) an increase in the final withholding tax rate on interest income (from 17.5 percent) and royalties (from 15 percent) to a uniform rate of 20 percent; (5) the phase-out of the final withholding tax previously levied on dividends; (6) the unification of the earlier dual tax rate (of 25 and 35 percent) levied on corporate income to 35 percent; (7) the introduction of the value added tax (VAT) in place of the sales/turnover tax and a host of other taxes; (8) the conversion of unit rates formerly used for excise taxes to *ad valorem* rates; (9) the abolition of export taxes; and (10) further reduction in tariff rates.⁸

From 1987 onwards, the government had to introduce more tax changes primarily to respond to the need to raise more revenues within the context of a series of

⁶ Although the improvement in government revenue collection may be viewed as part and parcel of improvements in the performance/productivity of government agencies which are the topic of the next section, the author decided to include it under the present section because it also impinges in a significant manner on the sustainability of productivity improvements in the private sector. This is so because higher tax effort promotes macroeconomic stability to the extent that it tends to reduce the fiscal deficit. Moreover, the ability of government to finance investments on basic health, basic education and basic infrastructure (key inputs to productivity improvements in the private sector) are primarily driven by improvements in tax effort.

⁷ However, passive income (i.e., interest income, royalties, capital gains and the like) was still subjected to final withholding tax.

⁸ The last item is not usually viewed as part of the TxRP but as the main element of the Tariff Reform Program (TfRP).

fiscal adjustment programs. But not all were consistent with the spirit of the 1986 reform package. Some, like the import levy imposed in 1991, were put in place because they were administratively and politically convenient. However, they were generally seen as highly distortionary and having a perverse effect on long-term growth.

The Simplified Net Income Taxation Scheme (SNITS) was introduced in 1992. The SNITS (1) restricted deductions that can be claimed against gross income; (2) reverted the individual income tax system to the schedular approach by imposing differential rate schedules on compensation income and business/professional income; (3) increased the lowest marginal tax rate applicable to business/professional income from 0 percent to 3 percent while reducing the highest marginal tax rate from 35 percent to 30 percent. In that year, the BIR also expanded the coverage of the withholding tax system and increased the level of personal exemptions.

In 1998, the Comprehensive Tax Reform Package (CTRP) was passed into law. With its enactment, the pendulum is once again nearer the global system of income taxation. It imposes a unified rate schedule for both compensation and business/professional income of individuals. The rate schedule under CTRP has 7 brackets in contrast to the old schedule for compensation income which had 11 brackets and the old schedule for business/professional income which had 5 brackets. The 1998 individual income tax legislation also increased personal and additional exemptions even as it allowed the deduction of premium payments for health and/or hospitalization insurance from gross income.⁹

The flip-flopping character of tax legislation over the years is also evident for indirect taxes. For instance, the coverage of the VAT was broadened to include services in 1996 with the passage of the Expanded Value Added Tax (EVAT) but Republic Act 8241 (which took effect in January 1997) expanded the list of items that are expanded under the EVAT. Similarly, Republic Act 8240 (which became effective

⁹ The deduction of premium payments for health/hospitalization insurance from gross income may not exceed P2,400 per year, per family. Moreover, such deduction is applicable only if the total gross income of the taxpayer is P250,000 or less.

January 1997) reverted the *ad valorem* excise tax on fermented liquor, distilled spirits and cigarettes to the specific scheme.¹⁰

Tax revenue is the most important source of income of the national government. It accounted for 86.2 percent of total central government revenue in 1992-1996 compared to 82.2 percent in 1986-1991 (**Figure 1**). Conversely, the share of non-tax revenue to total central government revenue declined from 17.8 percent in 1986-1991 to 13.8 percent on the average in 1992-1996. This occurred as grant as well as fees and charges collected by various government agencies contracted even as privatization proceeds expanded.

Significant improvements in tax effort have been achieved since 1986. Thus, the ratio of total tax revenue to GNP climbed from an average of 11.3 percent of GNP in 1975-1985 to 16.2 percent in 1996 (**Figure 2**). However, the improvement in Philippine tax effort appears to have tapered off in more recent years. For instance, while the tax effort increased by a hefty 3 percentage points in the 4-year period between 1986 and 1990, it rose by a mere 1 percentage point in the 4-year period between 1992 and 1996.

Figure 1

¹⁰ Prior to this, cigarettes were taxed on an *ad valorem* basis. This change was made in response to tax avoidance/evasion practices of manufacturers under the old system (e.g., transfer pricing and misclassification of brands).

Distribution of National Government Revenue by Source, 1975-1996

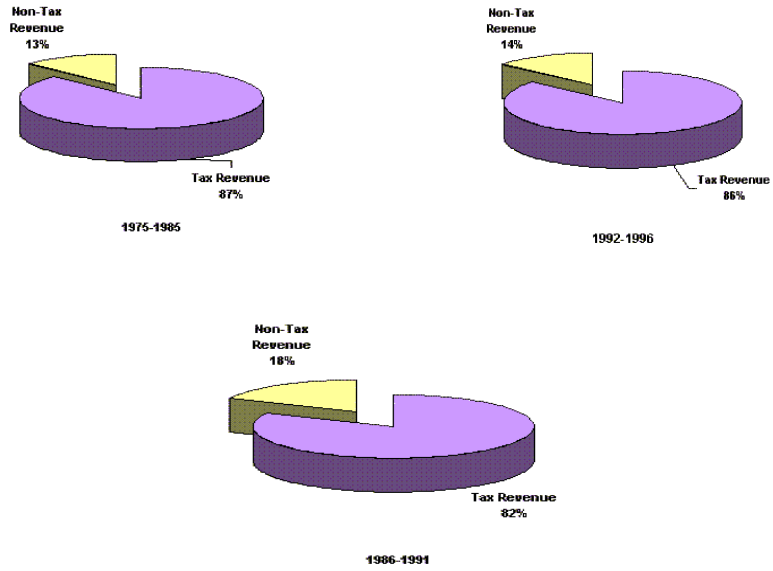
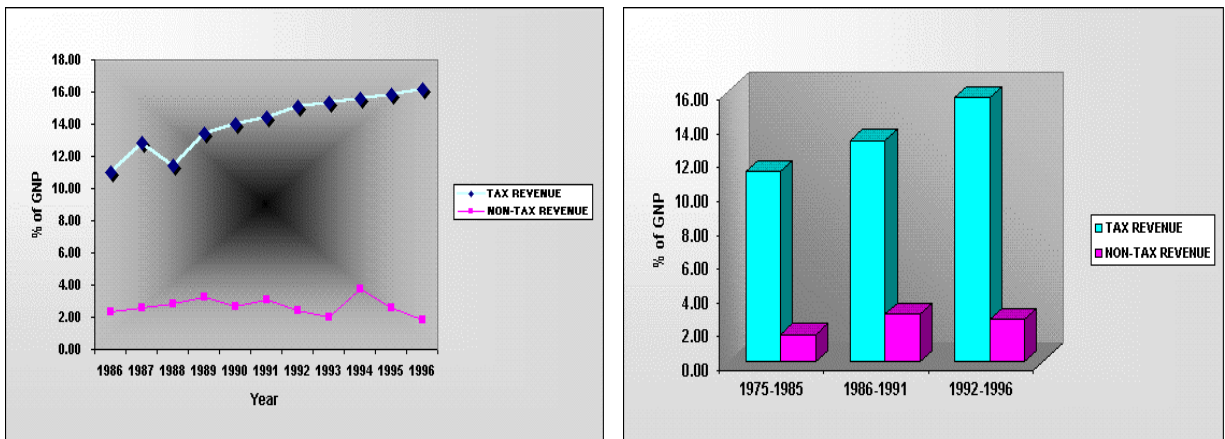


Figure 2
Tax and Non-Tax Effort, 1975-1996



Nonetheless, these developments allowed the Philippines to catch up with the tax effort of other Asian countries. Despite this progress the country continued to lag behind the performance of Malaysia, Singapore, South Korea and Thailand (**Table 2**). It is noteworthy, however, that the Philippine was able to overtake the tax effort of Indonesia in 1994.¹¹

Table 2
Tax Effort in Selected Asian Countries, 1991/1994
(in percent of GDP)

| | 1991 | 1994 |
|--------------------|-------------|-------------|
| Indonesia | 17.2 | 15.5 |
| Malaysia | 21.2 | 21.4 |
| Philippines | 14.6 | 16.0 |
| Singapore | 15.8 | 16.9 |
| Thailand | 17.6 | 16.8 |
| South Korea | 14.9 | 16.9 |

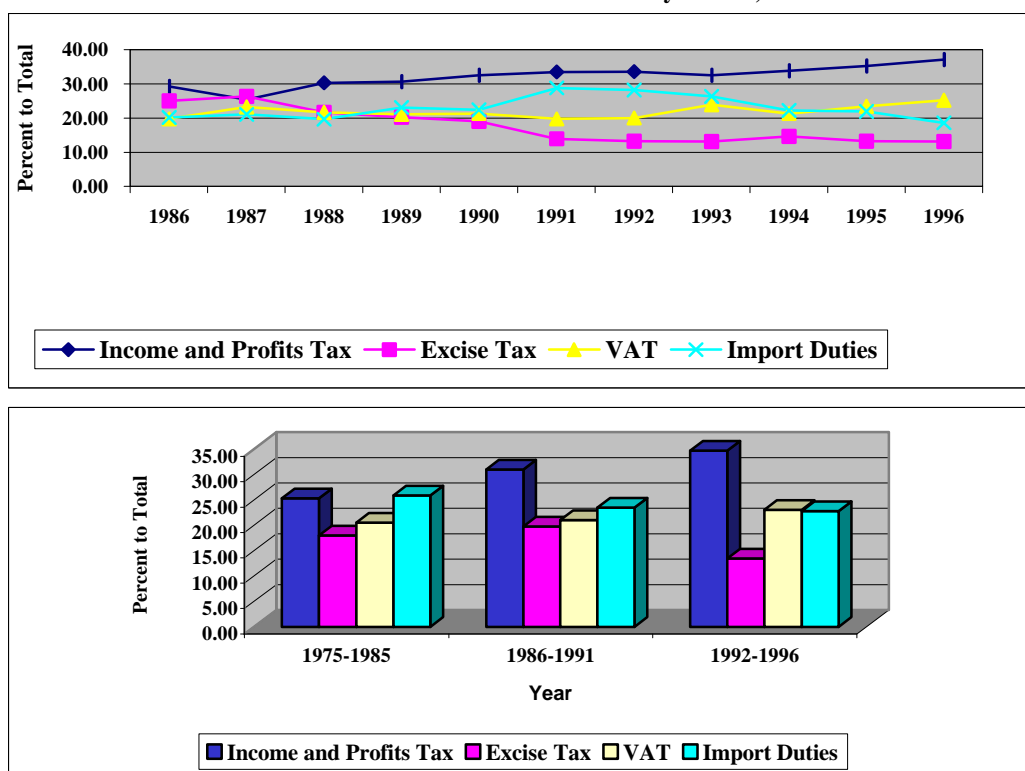
Source of basic data: Author's estimates using revenue data from the Government Finance Statistics and GDP data from the International Finance Statistics

Concomitant with the gains in the revenue performance of the tax system, a marked change in the composition of national government taxes took place in the last decade. The share of taxes on income and profits (which account for about 95 percent of direct taxes in the aggregate) registered a substantial expansion, from 25.2 percent on the average in 1975-1985 to 37.1 percent in 1996 (**Figure 3**). The increasing contribution of direct taxes to the national government's total tax take constitutes a positive development from the equity perspective.

However, tax effort started to deteriorate starting in 1997 as the tax-to-GNP ratio plummeted to 14.9 percent in 1998 from a peak of 16.4 percent in 1996. Undeniably, the Asian financial crisis contributed to this situation. However, it is alarming that the decline sustained in an unabated fashion in 1999 even as the economy post some recovery. In this light, a study that will attribute this deterioration in the tax effort into its various causes will be helpful. Also, a disaggregated sectoral and geographical analysis of tax revenue effort will guide further improvement in tax administration.

¹¹ It should be emphasized that this occurred partly because the Philippine tax effort improved and partly because that of Indonesia deteriorated in the 1990s as a result of the soft market for oil exports which adversely affected the yield of its corporate income tax. It is also interesting to note that Thailand appeared to have relaxed in the early 1990s in terms of tax effort.

Figure 3
Distribution of National Government Taxes by Source, 1975-1996



In spite of the gains earlier referred to, tax evasion remains high. In 1996, the evasion rate was 39 percent for the corporate income tax (Table 3), 51 percent for the VAT (Table 4) and 53 percent for the individual income tax (Table 5).

Table 3
Potential Revenue from the Corporate Income Tax
and the Level of Tax Evasion, 1992-1996

| Year | Actual Revenue (Pmillion) | Potential Revenue (Pmillion) | Evaded Taxes (Pmillion) | Collection Rate % | Evasion Rate % |
|------|---------------------------|------------------------------|-------------------------|-------------------|----------------|
| 1991 | 24081.30 | 36788.15 | 12706.85 | 65.46 | 34.54 |
| 1992 | 30645.38 | 50888.95 | 20243.57 | 60.22 | 39.78 |
| 1993 | 35702.54 | 62714.05 | 27011.51 | 56.93 | 43.07 |
| 1994 | 45183.15 | 76245.40 | 31062.25 | 59.26 | 40.74 |
| 1995 | 52772.17 | 87901.10 | 35128.93 | 60.04 | 39.96 |
| 1996 | 68053.41 | 111177.85 | 43124.44 | 61.21 | 38.79 |

Source: Potential revenue, author's estimates
Actual revenue, BIR Annual Reports

Table 4
Level of Tax Evasion from VAT, 1985-1996

| Year | Evaded Taxes | | | Collection Rate | | | Evasion Rate | | |
|------|--------------|---------------------|-----------------------|-----------------|--------------|--------------|--------------|--------------|--------------|
| | Total | Fr. Domestic | Fr. | Total | Fr. Domestic | Fr. | Total | Fr. Domestic | Fr. |
| | (Pmillion) | Sales (Pmillion) | Imports (Pmillion) | % | Sales % | Imports % | % | Sales % | Imports % |
| 1985 | 6432.00 | | | 31.80 | | | 68.20 | | |
| 1989 | 26279.50 | | | 27.80 | | | 72.20 | | |
| 1990 | 26315.70 | | | 33.20 | | | 66.80 | | |
| 1991 | 30347.30 | | | 33.20 | | | 66.80 | | |
| 1992 | 46574.91 | 30995.58 | 15579.33 | 40.80 | 36.88 | 47.30 | 59.20 | 63.12 | 52.70 |
| 1993 | 46708.10 | 28569.58 | 18138.52 | 47.11 | 41.41 | 54.14 | 52.89 | 58.59 | 45.86 |
| 1994 | 55299.97 | 28769.91 | 26530.06 | 45.81 | 46.95 | 44.52 | 54.19 | 53.05 | 55.48 |
| 1995 | 61623.49 | 33778.38 | 27845.11 | 48.94 | 46.68 | 51.43 | 51.06 | 53.32 | 48.57 |
| 1996 | 79710.98 | 45802.31 | 33908.67 | 49.17 | 47.19 | 51.62 | 50.83 | 52.81 | 48.38 |

Source: Author's Estimate

Table 5
Level of Tax Evasion from the Individual Income Tax, 1985-1996

| Year | Evaded Taxes | | | Collection Rate | | | Evasion Rate | | |
|------|--------------|--------------|---------------------|-----------------|--------------|---------------------|--------------|--------------|---------------------|
| | Total | Fr. Salaries | Fr Bus/ Prof Inc | Total | Fr. Salaries | Fr Bus/ Prof Inc | Total | Fr. Salaries | Fr Bus/ Prof Inc |
| | (Pmillion) | (Pmillion) | (Pmillion) | % | % | % | % | % | % |
| 1985 | 16,037.60 | | | 26.90 | | | 73.1 | | |
| 1986 | 9,564.70 | | | 38.30 | | | 61.7 | | |
| 1988 | 19,940.30 | | | 28.50 | | | 71.5 | | |
| 1990 | 29,994.30 | | | 35.10 | | | 64.9 | | |
| 1991 | 29,599.46 | 9342.60 | 20256.86 | 39.96 | 62.78 | 16.28 | 60.04 | 37.22 | 83.72 |
| 1992 | 37,108.14 | 5239.58 | 31868.56 | 36.29 | 75.84 | 12.82 | 63.71 | 24.16 | 87.18 |
| 1993 | 31,743.61 | 9382.64 | 22360.97 | 42.38 | 65.32 | 20.24 | 57.62 | 34.68 | 79.76 |
| 1994 | 24,529.98 | 6412.14 | 18117.84 | 53.80 | 77.05 | 27.95 | 46.20 | 22.95 | 72.05 |
| 1995 | 35,651.09 | 18584.65 | 17066.44 | 48.26 | 56.76 | 34.19 | 51.74 | 43.24 | 65.81 |
| 1996 | 48,510.09 | 19748.39 | 28761.70 | 47.38 | 64.23 | 22.23 | 52.62 | 35.77 | 77.77 |

Source : Actual Revenue from Bureau of Internal Revenue

Potential Revenue, author's estimates

note: nia income distributed according to breakdown between wages and nos in fies

In assessing the Philippine experience on tax reform, Das-Gupta and Mookherjee (1998) noted the emphasis on reforms in tax legislation and tax structure in the general direction of base broadening and simplification. Together with the expansion of the withholding tax system, these changes have contributed to the

improvement in taxpayer compliance. However, the continued prevalence of tax evasion suggests serious problems in tax administration and indicates that one cannot rely on modifications in tax structure alone to correct shortcomings in tax administration.

At the same time, the level of computerization in the Bureau of Internal Revenue remains limited despite initiatives in this area having started as early as 1992.¹² Manpower incentives and audit strategy continues to be backward (Das-Gupta and Mookherjee 1998). The Salary Standardization Law and the Civil Service Law continues to govern the tax collection agencies although some scope for giving rewards is available. The audit selection strategy remains largely undefined. Monitoring of tax-filers continue to be a problem. Increasing decentralization was not accompanied by the reform of the supervision system (Manasan 1994).

The theoretical literature on tax evasion (Allingham and Sandmo 1972; Yitzhaki 1974; Das-Gupta and Mookherjee 1998) demonstrates that taxpayer compliance is sensitive to economic incentives. As such, they suggest that a mechanical approach to tax administration that is based entirely on the logistics of tax administration but which excludes the effects on taxpayer and tax collector motivations is unlikely to be useful. In this sense, these models may provide some practical guide to the reform of the tax administration system.¹³

The classic model of tax evasion¹⁴ (Allingham and Sandmo 1972; Yitzhaki 1974) starts with a single utility maximizing taxpayer deciding on how much of his income to declare for tax purposes given some constant probability that evasion is detected and penalized and a given fine or penalty rate. Thus, the taxpayer chooses the level of income he will report (or, alternatively, the amount of income he will hide from the taxman) by taking into account in his own personal calculus that if he is successful

¹² The Bureau of Customs, in contrast, appeared to have made some headway in this area.

¹³ It is worth noting that the first-generation models of tax evasion focus only on the taxpayer and the variables that affect his behavior. In contrast, the second-generation models of tax evasion brings in another player in addition to the taxpayer: the tax collector. Furthermore, the tax collector himself is viewed as being corruptible. These second-generation models then analyzes the joint behavior of taxpayers and tax collectors as key variables like tax rates, probability of detection, penalty rate, tax collector bonuses and the like are varied in the context of tax evasion with bribery.

in concealing some of his income from the tax collector then he will increase the amount of income he retains. On the other hand, if his action is detected and if he is punished then his retained income will be reduced by the amount of the fine. How the taxpayer decides to act is, then, largely dependent on the relative magnitude of the “temptation” and the “punishment” attendant to tax evasion (Das Gupta and Mookherjee 1998).

Given this perspective, it becomes clear that a high penalty rate and a high probability of detection (i.e., stricter enforcement) can deter evasion.¹⁵ Furthermore, the results of these models affirm that an increase in the tax rate will increase the temptation to cheat but it will also increase the penalty for cheating as long as the fines are imposed on an *ad valorem* basis. If the taxpayer exhibits non-increasing absolute risk aversion, the punishment effect dominates and an increase in the tax rate leads to better compliance (Yitzhaki 1974). This finding runs counter to the conventional wisdom that follows from the so-called Laffer curve.

These models also point to the possibility that maximal penalties for small amounts of evasion may induce taxpayers to evade by large amounts. In turn, this suggests that penalties as well as the effort to prosecute must be graduated with the scale of evasion (Mookherjee and Png 1994).

While the models discussed above essentially view the probability of detection and the penalty rate as exogenous, the basic models of tax evasion have also been extended to make the probability of detection endogenous essentially by taking into account the presence of corruptible officials. In effect, tax evasion does not only depend on the incentives to the taxpayer but also on the incentives to the tax collector and the interaction between the two players (Das Gupta and Mookherjee 1998).

¹⁴ This model is also referred to as a model of voluntary tax compliance.

¹⁵ Given this perspective, the introduction of stiffer penalties and the creation of special tax courts in the early 1990s are, therefore, steps in the right direction. However, the resoluteness of the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC) to enforce the legal sanctions continues to be a concern. It should be noted that there was some attempt to step up prosecution of tax offenders during the Ramos administration. It is not clear that this effort is being sustained with the same vigor under the present administration.

In these newer models, the probability of evasion being detected is viewed as a function of costs to the taxpayer of under-reporting income which, in turn, depend on the penalty rate and the amount of effort put in tax enforcement. When evasion is discovered, the tax collector decides whether to report it and impose penalties. His decision depends on the incentive structure that the tax collector faces. Thus, if the tax collector under-reports evasion successfully, he will get a bribe in addition to his government salary. On the other hand, if he gets caught he will be punished in the form of a fine, transfer to another assignment or, at worst, dismissal from office. (To simplify, let the punishment be translated to the equivalent of a fine or a loss in income.) The probability that the erring tax collector gets caught, in turn, is dependent on the quality of supervision over tax examiners and third-party audit. In some cases, the tax collector may also be allowed to retain some portion of the additional revenue that is generated because of his vigilance as a reward or bonus. In the final analysis, the tax collector's decision is then dependent on the relative strength of the carrot and the stick: the amount of the bribe, the amount of the reward/bonus, the amount of the fine/penalty and the probability of being caught.

In the situation where a taxpayer evades taxes by some amount, corruption will occur if the collective benefit of the taxpayer and the tax collector (i.e., the expected benefits to the taxpayer in terms of additional retained income less the bribe he has to pay minus the expected cost to the taxman in terms of the penalties for bribery and foregone bonus pay) is positive. Moreover, in the corrupt regime, the taxpayer will select the amount of tax to evade while the tax collector will simultaneously select the effort devoted to monitoring and, thus, the probability of detecting evasion (Mookherjee 1998).

These newer models have then been used to evaluate alternative practical measures in improving tax enforcement that are to a large extent embodied in the probability of detection. In particular, the original Allingham-Sandmo model has been extended to evaluate how audit frequency should vary with declared income (Das Gupta and Mookherjee 1998). The results of this work show that for a given class of taxpayers (clustered around specific characteristics), audit frequency and declared income ought to be negatively related. Intuitively what this implies is that a tax

administration system that unduly focuses on high income tax returns may be encouraging taxpayers to evade by large amounts precisely because doing so reduces the probability that they will be subjected to the scrutiny of tax examiners. Conversely, the tax administration system may deter taxpayers from evading “too much” by threatening to audit low income tax returns just as intensively as high income tax returns. Moreover, although the productivity of each audited case may indeed be greater for large taxpayers, the growth in total tax receipts may be higher if small/medium taxpayers are not neglected owing to the persuasive effect of this policy on overall tax compliance (Silvani 1992). Note that this result is not entirely consistent with the emphasis currently being given to large taxpayers per se without any clear audit selection strategy being defined. Also, the prevailing audit rate of less than 1.5 percent per year is low when compared with other developing countries (Das Gupta and Mookherjee 1998).

Lastly, other extensions of the Allingham-Sandmo model focused on the alternative compensation provisions for tax collectors. First, the payment of salaries that are higher than the market rate combined with the authority to fire culpable tax collectors is found to increase corruption either because it increases the bribe level or reduces the willingness of tax officials to report evaders with strong political connections. Second, instituting a pay-for-performance scheme for the tax collector is found to induce the tax collector to intensify his monitoring efforts and to increase the probability of detecting tax evasion. In turn, the bribe level increases which also increases the cost to the taxpayer of evading taxes. However, if the reform is not large enough to fully eradicate corruption, corruption will continue but on a larger scale. That is, “the bribe level rises to compensate the tax collector for the added cost imposed by the reform.” Another drawback of bonus-based incentives is the possibility that they may increase taxpayer harassment based on threats by the tax collector to over-assess the obligations of taxpayers. Mookherjee (1998) noted that the higher is the bonus rate and the cost of taxpayer appeal and the lower is the rate of success of taxpayer appeal, the greater is the likelihood of taxpayer harassment.

Mookherjee (1998), thus, argues that piecemeal incentive reform may actually increase corruption. “Because reforms in incentive systems and organizational

procedures are complementary, reforms are more likely to succeed if they are comprehensive rather than incremental.” In this regard, the list of organizational reforms includes: (1) improving personnel quality; (2) institutionalizing independent third-party audits; (3) limiting discretionary authority of tax examiners; (4) introducing functional specialization in tax administration; (5) increasing computerization; (6) improving the appeal mechanism; and (7) reducing high-level political interference.

Increasing the compensation of tax collectors and examiners will be for naught if it is not accompanied by the greater flexibility on the part of the tax administration agency to hire and fire personnel. More stringent criteria for screening new recruits and for promoting existing personnel will greatly enhance the quality of tax administration. Moreover, clear procedures for dealing with reports of corrupt behavior and even-handed application of sanctions for the same should be strictly observed at all times.

Meanwhile, independent third-party audits are necessary in evaluating the audits undertaken by tax examiners. This system will tend to increase the probability of detecting corruption. Mexico’s experience in this area has been positive. There, if an audit yields no additional assessment, the case cannot be closed by the original tax examiner but must be referred to an officer in a different department. If *x days* pass without any result, the original audit team is replaced by a new one. Audit results are reported to a representative of the industry to which the taxpayer belongs. If the industry group disagrees with the assessment, the case is referred to the vigilance department. Any auditor guilty of harassment is subject to prosecution.

On the other hand, a centralized audit selection system could reduce the scope for the discretionary authority of tax examiners. Such a scheme requires a centralized information base for audit selection or a strict procedure for audit selection. Related to this, organizing the tax administration agency along functional lines will tend to reduce collusion of taxpayers and tax collectors as it minimizes the possibility of the tax payer having to deal with the same tax officer for diverse tax functions as filing of returns, obtaining refunds, responding to audits, and lodging appeals.

At the same time, it is difficult to exaggerate the benefits from increased tax computerization. Greater computerization improves the tax collection agencies' access to internal as well as external sources of information making possible matching of tax returns with third-party information. It also enhances the ability of the tax collection agency to automate the generation of overdue notices which enhances voluntary compliance. Moreover, it also makes it more difficult to tamper with records. Furthermore, it facilitates automated audit selection, thus reducing the discretion of tax examiners.

On the other hand, the appeals process can be enhanced by improving the procedures for the filing of complaints, setting of time limits for judgments, and establishing appropriate burden of proof. Lastly, it has been noted that efforts to eliminate bureaucratic corruption are quixotic at best in systems with strongly entrenched political corruption (Mookherjee 1998). Thus, if tax evaders have recourse to political influence such that tax audit exposes the tax examiner to disciplinary action from higher-ups, then no reform of the incentive structure will work.

Given these background, there is a need to re-assess existing tax administration practices within the context of how the prevailing institutional arrangements create economic incentives that affect the behavior of both taxpayers and tax collectors.

Epilogue: There is a widespread consensus that the simplification of the tax structure (in the direction fewer exemptions, less differentiation of tax rates across sectors and activities) will ease tax administration (Gillis 1989). Many of the tax laws enacted in the Philippines in the last 15 years were justified on this ground. However, reviewing the experience also gives one a sense that the tax structure has also been the subject of unnecessary fine-tuning, at best, and to excessive flip-flopping, at worst, oftentimes without having addressed the complexities that naturally accompany economic development. In this case, frequent changes in the tax code necessarily impose an additional burden on tax administration.

3. INCREASING PRODUCTIVITY WITHIN THE PUBLIC SECTOR

Increasing the effectiveness of the public sector involves: setting hard budget limits (i.e., attaining aggregate fiscal discipline), allocating resources strategically (i.e., allocating resources consistent with policy priorities), and delivering services in an efficient and effective manner.

3.1. Budget Reform – MTEF

The Budget Call for year 2000 signals the implementation of the Medium Term Expenditure Framework (MTEF). The MTEF calls for greater integration of the planning and budgeting system involving the National Economic and Development Authority (NEDA), the Department of Budget and Management (DBM), and the Department of Finance (DOF). The framework has two principal features: a consistent set of macroeconomic and revenue forecasts and forward estimates of existing programs for two years. Although the budget will still be enacted on an annual basis, proposed appropriations will be defined within the context of a 6-year macroeconomic plan, a 3-year prioritized public investment plan and a 3-year costing of agency programs, projects and activities (DBM 2000).

The MTEF also divides an agency's budget into two parts: the baseline (or operating) budget and claims over and above the baseline budget for funding of new programs and projects. The baseline budget refers to the minimum level of expenditure at which the agency will continue to operate at the current year's level and be able to perform its basic mandate and functions. On the other hand, sectoral and sub-sectoral budget ceilings for the non-baseline portion of the government budget are first determined by the Development Budget Coordinating Committee (DBCC). Next, a two-track process is followed whereby department ceilings for agencies under the Economic and Social Sectors are determined by the Planning Committee preparing the NEDA Medium-Term Development Plan and where departments under the General Public Services and Defense Sectors are determined by the DBM.

At the same time, the regional/spatial dimension of the budget will take into account the inputs of the Regional Development Councils to ensure the consistency of the proposals with Regional Development Investment Programs.

These moves are expected to ensure increased transparency, predictability and certainty in the financing of multi-year projects. They will also promote the restructuring of the budget to support the priorities of the administration.

These initiatives to reform the budget process are all in the right direction. However, a number of weaknesses continue to plague the system. First, revenue targets in the budget documents persist to be unrealistic and unachievable. Although overall fiscal discipline is typically not breached because expenditure controls (e.g., across-the-board budget cuts or imposition of reserves) are put into play during budget implementation, resort to these mechanisms necessarily weaken the link between planning and budgeting. The recent move to include expected receipts from new revenue measures under un-programmed appropriations which can only be spent when the said revenue materializes will help solve part of the problem. Nonetheless, this approach will not address problem arising from poor tax forecasting models.

Second, the system also elicits the penchant for creative accounting. Thus, one observes the use of arrearages (or the build-up of accounts payable) as an instrument to finance the fiscal deficit in recent years. In turn, this practice makes the budget documents less transparent. A shift to accrual accounting will largely address this problem.

Third, in line with its ten-point agenda, the Estrada administration did not include an allocation for pork-barrel in the 1999 budget it proposed to Congress. However, it failed to forge an agreement with the legislative branch to make the 1999 budget truly pork-free. In fact, the General Appropriations Act (GAA) of 1999 provided for 3 funds which have pork-barrel-like provisions.¹⁶ What appears to be

¹⁶ These are the Lingap para sa Mahirap Fund, the Food Security Fund, and the Rural/Urban Infrastructure Development Fund.

missing at this point are specific mechanisms that will ensure greater participation of Congress in the investment programming exercise. Such participation should be in the early part rather than towards the end of the budget process. At present, Congressmen may provide inputs in the identification of projects at the regional level through their participation in the Regional Development Councils. Apparently, this arrangement does not sufficiently address Congressmen's desire to have a bigger role in the identification and prioritization of projects at the sub-national level. Thus, there is a need to design a more effective venue/forum wherein Congressmen may fully participate in investment planning and programming. Without such a mechanism, the issue of pork-barrel and Congressional initiatives (whereby some programs/projects/activities in the President's budget are replaced by projects identified by the legislators right during the Congressional deliberation on the budget) will continue to fester.

3.2. Performance Indicators, Standards and System of Incentives

The Estrada administration has also set the stage for the installation of a government performance measurement system for the purpose of encouraging higher productivity, greater effectiveness and more efficient allocation of resources at the agency level. It is envisioned that the performance measurement will approximate market discipline in the operation of the core public sector.

The DBM will put in place a performance indicator system that will pass judgment not only on managerial performance but also organizational performance of agencies. The performance measures that are being considered are classified into: (1) indicators of outcomes and outputs, (2) indicators of fiscal responsibility including indicators of productivity, (3) achievement of specific milestones in the implementation of the medium-term strategic framework, (4) indicators of the management process and (5) indicators of compliance with rules (de Vera 1999).¹⁷

¹⁷ While all 5 types of indicators may be used to measure the managerial performance of an agency's head, only the first 3 are applicable in measuring organizational performance.

The implementation of the performance measurement system implicitly assumes a number of upstream and downstream activities. First, each government agency will have to prepare a medium term plan that specifies its mission in relation to national interests, targeted outcomes, strategies to attain outcomes, and outputs that are identified on the basis of strategic links with outcomes. Second, an incentive system that will reward good performance will have to be put in place.

In the Budget Call for the year 2000, the DBM required the various agencies to formulate their mission, determine target outcomes, and identify strategies. The next steps would involve (1) the pilot testing of the system in a few agencies, (2) simplification of the proposed set of performance indicators, and (3) benchmarking in order to develop performance standards against which agency performance will be gauged. In implementing the system, Schick (1998) offers the following cautionary note: “No country should move directly from an informal public sector to one in which managers are accorded enormous discretion to hire and spend as they see fit. Informality is a mixed blessing. On the one hand, it cuts through red tape, unresponsive bureaucracies, and bad policies; on the other hand, it opens the door to (and sometimes institutionalizes) corruption and inefficiency.”

3.3. Combating Corruption

The Philippines is often cited in business surveys as a country where corruption is on the rise and is impeding the flow of foreign and domestic investments (World Bank 1999). There is also a widespread perception in government, nongovernment, and international circles that corruption in the country is pervasive and deep-rooted.

For instance, a former Secretary of the DBM estimated that kickbacks from public works projects make up, on the average, 30 percent of total project cost (Coronel 1998). Similarly, it is estimated that in the case of textbooks and supplementary instructional materials, the bribe money that suppliers pay vary within a range of 20 percent to 65 percent of total cost (Chua 1999).

The World Bank study (1998) proposes a seven-point approach to fighting corruption. The key elements of such a program include: (1) simplifying the regulatory environment; (2) reforming the campaign finance system; (3) increasing public oversight of government and transparency in its operations including the conduct of regular client feedback and the development of a governance-appraisal system; (4) reforming the budget process including the simplification of (and the elimination of non-competitive aspects in) public procurement and putting limits on congressional discretion over detailed budget line items; (5) reforming civil service including its depolitization, the grant of competitive salaries to senior level civil servants; (6) enhancing sanctions for corrupt behavior; and (7) supporting judicial reform.

3.4. Re-engineering the Bureaucracy

The government re-engineering program aims to evolve an efficient, focused and innovative government bureaucracy. The program is designed to follow a two-track process. The first track seeks legislative authorization for the re-structuring of the bureaucracy. The proposed “Re-engineering Bill” will define the scope, level, quality, and focus of government interventions in the various sectors; properly distribute functions among levels of government; and develop an administrative structure that will improve the internal operating efficiency and effectiveness of government agencies. On the other hand, the second track will accelerate the streamlining of agency organizations and operations within the constraints imposed by existing laws (DBM 1999).

In line with this policy direction, the attrition policy has been resurrected and the filling of vacant positions is restricted. The Estrada administration is also pursuing the “scrap-and-build” policy by allowing the creation of agencies and positions only upon the abolition of equivalent organizational unit/positions. In addition, the proposed President’s Budget for 2000 encourages agencies in the Executive Branch to review their respective mandates, functions, programs and operating systems and procedures in order to phase out those which are no longer essential in the delivery of public services and to adopt measures that will streamline their organization and cut red tape. The savings that will thus be generated may then be used by said agencies to fund new priorities.

3.5. Quality in Public Governance

The Philippine Quality Award (PQA) is a specific strategy adopted to promote quality and productivity excellence in both private and public sector organizations. It is aimed at providing a framework for assessing organizational performance and recognizing quality and productivity excellence.

The establishment of the PQA was mandated by Executive Order (EO) No. 448 in 1997. The Development Academy of the Philippines (DAP) is the PQA administrator of the Philippines. As early as 1997, the DAP has conducted training for assessors/judges and seminars on PQA application development.

Prospectively, the MTNAAP Action Plan for 2000-2004 calls for the adoption of the “total quality management” (TQM) concept in all government offices. In this regard, the DAP is mandated to continually develop materials and conduct trainings on TQM for adoption and replication by government agencies. The DBM is also ordained to adopt and circulate to the agencies management-related TQM concepts, specifically on structural and fiscal aspects of governance. In like manner, the Civil Service Commission (CSC) will systematize the implementation of TQM in personnel-related areas, with emphasis on training, selection, and promotion of employees, ethics, and accountability in the civil service.

3.6. Decentralization

Decentralization brings government closer to the people. It enables the government to match public services more closely with local demand and preferences and to provide a more responsive and accountable government. As such, it may be viewed as part of a broad range of participatory mechanisms (World Bank 1997).

The passage in 1991 of the new Local Government Code represents a shift in local governance in the Philippines. The Code included far-reaching provisions affecting the assignment of functions across different levels of government, the revenue sharing between the central and local governments, the resource generation/utilization

authorities of LGUs and the participation of civil society in various aspects of local governance.

The Code mandates the devolution of many functions previously discharged by central government agencies to LGUs. The devolution of expenditure responsibilities to LGUs, with a few exceptions, is consistent with the decentralization theorem. For the most part, these are activities that can be provided at low levels of government. The activities identified have few important spillovers to a broader community to indicate that they should be provided by higher levels of government.

At the same time, the Code prescribes a higher LGU share in internal revenue taxes of the central government. Moreover, it expanded the tax base of LGUs to include products, activities and sectors that used to be outside the reach of local taxation. It also increased the maximum allowable rates at which most local taxes may be levied.

Despite improvements in local tax effort following the implementation of the Code, the contribution of LGUs to total tax revenue of the general government remains low. Also, the gains in local tax effort have essentially leveled off after significant improvements in the early post-Code years.

The general picture that emerges is one where LGUs have relatively greater expenditure responsibilities, yet those expenditures were covered mainly by transfers from the central government. Locally raised revenue pays for a very small part of total LGU expenditures and LGU reliance on the shared revenue from the central government has increased substantially.

A comparison of aggregate IRA levels with LGU expenditure responsibilities (including both devolved functions and so-called unfunded mandates) shows that LGUs were taken together were net gainers from fiscal decentralization even if one adjusts for inflation and population growth. However, there is a serious mismatch at the level of individual LGUs between the financial resources and the expenditure responsibilities that were transferred to them. In 1999, 44 out of 79 provinces, 729 out of 1,525

municipalities and 9 out of 83 cities suffered negative net resource transfers (Manasan 1999). It cannot be denied that this situation has adversely affected the ability of many LGUs to provide basic services to their constituents and is likely to widen disparities in service provision. Thus, this situation highlights the need for fiscal equalization grants.

On the one hand, expenditure assignments are generally clear and well understood by LGUs. The Code actually provides an explicit and clear delineation of functions across levels of governments, except perhaps in the area of environment and natural resource management. On the other hand, Sec 17 of the Code allows for central government augmentation or direct provisioning of basic services assigned to lower levels of governments. Also, EO 53 mandates that national government agencies retain management control over all foreign assisted projects and/or nationally funded projects even if the same involve devolved functions. At the same time, many of the so-called devolved agencies are made accountable for the overall outcome in their respective sectoral areas and as such they deem it their responsibility to direct LGU behavior in support of national objectives. Consequently, the existing regulatory framework effectively permits, nay encourages, the existence of a two-track delivery system where both central government agencies and LGUs can initiate devolved activities.

Cost sharing arrangements have been put in place as a way of harmonizing national objectives with local needs (in the case of devolved activities that may have some spillover benefits and economies of scale) and almost all of the devolved agencies implement some form of matching grant. However, there is a need to further rationalize the system across sectors to ensure that unnecessary shirking and/or funding duplication is avoided.

Lastly, it should be emphasized that there is considerable evidence that LGUs do it better and/or cheaper. This has been documented in the area of school building construction, road construction, and day care center construction (Manasan 1999). In this regard, initiatives to cut the IRA share of LGUs would tend to be counterproductive. It is critical that the IRA remains to be a predictable source of income for LGUs. In addition to this, LGU capability in planning and fiscal management needs to be upgraded to further enhance their operations.

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