2 Philippines

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I. Introduction

Over a hundred ethnic groups, a mixture of foreign influences and a fusion of culture and arts have enhanced the uniqueness of the Filipino race and the wonder that is the Philippines - an archipelago abundant in nature, rich in culture, and filled with pleasant discoveries.

The Philippines enjoys a diversity of destinations, activities and events which every explorer experiences in this archipelago of wonders. Vast mountains and volcanoes tell of great legends. Old cities share stories of the past. Caves excite. Shimmering waters and a tropical climate lure travelers all year round.

A. Government Information

Officially, the ***Republic of the Philippines (****Pilipino* ***- Republika ñg Pilipinas)*** is a country that is the only predominantly Christian nation in Asia and has a unique heritage of Malay, Spanish, and American cultures. Ruled by Spain for nearly 330 years until 1898, its cultural characteristics are today in some ways more like those of the nations of Latin America than those of Southeast Asia, the ten-nation geographic region to which it belongs.

Filipino politics is dominated by personally clashes and closely-knit networks of political patronage at both the national and local level. All political major parties have broadly similar platforms, based on the combination of nationalism, economic liberalism, social conservatism and populist gestures. Parties tend to eschew ideological positions or long-term development agendas for fear of highlighting ethnic or economic division, focusing instead on personality-based campaigning and political graft.

In the 2004 poll, which saw elections to both houses of congress as well as for the presidency, President Gloria Macapagal-Arroyo and her supporters consolidated their position. The president herself was reelected, albeit relatively narrow. The elections to the senate – in which half the twenty-four seats were contested – saw government supporters holding a majority of the seats. Elections to the lower house saw President Arroyo’s principal Christian Democrat (Lakas) supporters take just over 40% of the seats. The main opposition parties took around 30%.

B. Population Demographics

The people of the Philippines are known as Filipinos. Throughout the colonial eral the term “Filipino” originally referred to only the Spanish and the Spanish-mestizo minority. The definition, however, was later changed to include the entire population of the Philippines regardless of ethnic origin. Ironically, the term now somewhat excludes the Spanish-mestizo minority who are perceived by some Filipinos, and by many Spanish-mestizos themselves, to be foreign.

The overwhelming majority of the population, known as the ethnic Filipinos, is made up of various ethno-linguistic groups descended from Austronesian-speaking migrants who arrived in successive waves to the archipelago millennia ago. The most significant foreign ethnic minority are the Chinese, who have played an important role in commerce since the 9th century when they first arrived in the Philippines for trade. Mestizos, those of mixed race, form a tiny but economically and politically important minority. As of 01 July 2005, the population in the Philippines is estimated to be 87,857,473 with a growth rate of 1.8%.

A total of one hundred seventy-two native languages and dialects are spoken, all belonging to the Austronesian linguistic family. Since 1939, in an effort to develop national unity, the government has promoted the use of the official national language, the most widely spoken language is Filipino, which is based on Tagalog, although thirteen regional languages are spoken as vernaculars throughout the Philippines. English serves as the primary lingua franca and as the language of commerce and the professions.

Christianity is the main religion in the archipelago, with Roman Catholicism (83%) making up the majority. Protestant ranked the second (9%) while a small but significant minority profess Islam (5%), particularly in the southern Philippines. Remaining 3% comprises Buddhist and other.

C. Geographic Information

The Republic of the Philippines is an archipelago consisting of some 7,107 islands and islets lying about 500 miles off the coast, 805 kilometers off the southeast coast of Asia. The overall land area is 115,830 square miles (300,000 square kilometers) slightly larger than Arizona. It is bounded by the Philippine Sea to the east, the Celebes Sea to the south, and the South China Sea to the west and north. Only about 7% of the islands are larger than one square mile, and only one-third have names. The largest are Luzon in the north (40,420 sq. miles; 104,687 sq. kilometers), Mindanao in the south (36,537 sq. miles; 94,631 sq. kilometers), and Samar (5,124 sq. miles; 13,271 sq. kilometers). The islands are of volcanic origin, with the larger ones crossed by mountain ranges. The highest peak is Mount Apo (9,690 ft; 2,954 m) on Mindanao.

Other fast facts:

Capital and largest city: Manila, 13,790,900 (metro. area), 10,232,900 (city proper)

Other large cities: Quezon City 1,669,776 (part of Metro Manila Area) Cebu, 761,900

Independence: Attained independence from Spain on 12 June 1898, and from the United States of America on 04 July 1946

Monetary Unit: Philippine Peso (₱)

Transportation:

Railways – 897 km
Highways – 201,994 km
Paved – 42,419 km
Unpaved – 159,575 km
Ports and Harbors – Batangas, Cagayan de Oro, Cebu, Davao, Guimaras Island, Iligan, Iloilo, Jolo, Legaspi, Manila, Masao, Puerto Princesa, San Fernando, Subic Bay, Zamboanga.
Airports – 257

Climate: March to May is hot and dry. June to October is rainy. November to February is cool. Average Temperatures: 78ºF/32ºC. Humidity: 77%

Environment: The Philippines is rich in biodiversity, with around 12,000, plant species, 1100 land vertebrate species, and at least 500 species of coral. Total forest area is around 18%; coastal ecosystem reaches almost 20,000km.

Time: GMT + 8 hours

D. History

Spanish Control. Indo-Malays and Chinese merchants inhabited the islands before the discovery in 1521 by Spanish travelers led by Portuguese service navigator Ferdinand Magellan. Twenty-one years later, a Spanish exploration party named the group of islands Felipinas in honor of Prince Philip, who was later to become Philip II of Spain. The Spanish conquistadors introduced Christianity to the Philippines. They saw the islands an ideal hub for commerce with Manila and Cebu as strategic trading ports. The seat of government was first established in Cebu and later moved to Manila in 1571. Spanish colonization lasted from the 16th to the 19th century or retained possession of the islands for the next 350 years, and was marked by a series of uprisings. The Filipinos waged Asia's first nationalist revolution in 1896 and won their independence from Spain on 12 June 1898.

United States Rule. The Philippines were ceded to the U.S. in 1899 by the Treaty of Paris after the Spanish-American War. The Americans introduced their educational and legal systems as well as their democratic form of government. Meanwhile, the Filipinos, led by Emilio Aguinaldo, had declared their independence. They initiated guerrilla warfare against U.S. troops that persisted until the capture of Aguinaldo in 1901. By 1902, peace was established except among the Islamic Moros on the southern island of Mindanao.

The first U.S. civilian governor-general was William Howard Taft (1901–1904). The Jones Law (1916) provided for the establishment of a Philippine legislature composed of an elective Senate and House of Representatives. The Tydings-McDuffie Act (1934) provided for a transitional period until 1946, at which time the Philippines would become completely independent. Under a constitution approved by the people of the Philippines in 1935, the Commonwealth of the Philippines came into being with Manuel Quezon y Molina as president.

The Americans ruled for 48 years until World War II broke out in 1941. On December 8, 1941, the islands were invaded by Japanese troops for 4 years. Following the fall of Gen. Douglas MacArthur's forces at Bataan and Corregidor, Quezon established a government-in-exile that he headed until his death in 1944. He was succeeded by Vice President Sergio Osmeña. U.S. forces under MacArthur reinvaded the Philippines in October 1944 and, after the liberation of Manila in February 1945, Osmeña reestablished the government.

Early Independence Period. The US forces returned to liberate and on 04 July 1946, the Americans finally recognized Philippines full independence. Manuel A. Roxas y Acuña was elected its first president, succeeded by Elpidio Quirino (1948–1953), Ramón Magsaysay (1953–1957), Carlos P. García (1957–1961), Diosdado Macapagal (1961–1965), and Ferdinand E. Marcos (1965–1986).

The Marcos Era. Under Marcos, civil unrest broke out in opposition to the leader's despotic rule. Martial law was declared on September 21, 1972, and Marcos proclaimed a new constitution that ensconced himself as president. Martial law was officially lifted on January 17, 1981, but Marcos and his wife, Imelda, retained broad powers.

In an attempt to resecure American support, Marcos set presidential elections for February 7, 1986. With the support of the Catholic Church, Corazon Aquino declared her candidacy. Marcos was declared the official winner, but independent observers reported widespread election fraud and vote rigging. Anti-Marcos protests exploded in Manila, Defense Minister Juan Enrile and Lt. Gen. Fidel Ramos defected to the opposition, and Marcos lost virtually all support; he was forced to flee into exile and entered the U.S. on February 25, 1986.

The Aquino Years and Beyond. The Aquino government survived coup attempts by Marcos supporters and other right-wing elements, including one in November by Enrile. Legislative elections on May 11, 1987, gave pro-Aquino candidates a large majority. Negotiations on renewal of leases for U.S. military bases threatened to sour relations between the two countries. Volcanic eruptions from Mount Pinatubo, however, severely damaged Clark Air Base, and in July 1991, the U.S. decided simply to abandon it.

In elections in May 1992, Gen. Fidel Ramos, who had the support of the outgoing Aquino, won the presidency in a seven-way race. In September 1992, the U.S. Navy turned over the Subic Bay naval base to the Philippines, ending its long-standing U.S. military presence.

Meanwhile, the separatist Moro National Liberation Front was fighting a protracted war for an Islamic homeland on Mindanao, the southernmost of the two main islands. The Philippine army also battled another rebel group, the Moro Islamic Liberation Front. In August 2001, both rebel groups signed unity agreements with the Philippine government. Frequent and violent clashes with these and other terrorist groups have continued, however. Abu Sayyaf, a small group of guerrillas that has been fighting since the 1970s for an independent Islamic state and reportedly has links to Osama bin Laden, gained international notoriety throughout 2000 and 2001 with its spree of kidnappings and murders. The Philippine military has also battled the New People's Army, a group of Communist guerrillas that have targeted Philippine security forces since 1969. International officials reported in June 2003 that Jemaah Islamiyah, an affiliate of al-Qaeda, was training recruits in Mindanao, in the southern Philippines. About 120,000 people have died in the conflicts with rebel groups, and more than 3 million have been displaced.

In May 1998, 61-year-old former action film star Joseph Estrada was elected president of the Philippines. Within two years, however, the Philippine Senate began to impeach Estrada on corruption charges. Massive street demonstrations and the loss of political support eventually forced Estrada from office. Vice President Gloria Macapagal Arroyo, daughter of former president Diosdado Macapagal, became president in January 2001.

In July 2003, dozens of mutinous soldiers took over a Manila shopping complex, protesting low pay and demanding the resignation of President Arroyo and the defense secretary. The demonstration ended peacefully.

In May 2004 elections, President Arroyo narrowly defeated film star Fernando Poe. Poe alleged voter fraud and warned of a revolt by his supporters.

Police killed three top members of Abu Sayyaf while quelling a March 2005 prison uprising in Manila. In all, 22 people, including 20 prisoners and two guards, died in the violence.

President Gloria Macapagal Arroyo faced a political crisis in the summer of 2005, after admitting to calling an election official during 2004's presidential race. A taped phone conversation between Arroyo and the official seemed to suggest that she had tried to use her power to influence the outcome. Several members of her cabinet quit and joined the opposition and tens of thousands of protesters in calling for her resignation. In a televised address, Arroyo apologized for the “lapse of judgment” and said, “my intent was not to influence the outcome of the election and it did not.” The opposition filed an impeachment motion in July. In addition, Arroyo's husband, who had been accused of taking bribes from a gambling syndicate, said in July that he was moving abroad indefinitely.

In her state of the nation address in July, Arroyo proposed replacing the country's presidential system of government with a parliamentary one. Aside from that pronouncement, she aimed to achieve the following 10-point development agenda during her term of office:

1. creation of six to ten million jobs by
   a. tripling loans for small business owners, and
   b. development of one to two million hectares of land for agricultural business
2. education for all, thru
   a. the construction of new school buildings, and classrooms,
   b. provision of books and computers for students, and
   c. scholarships for families
3. balance the national budget in view of the country’s debilitating deficit woes;
4. decentralization of progress and development across the country through the development of transportation networks like the roll-on, roll-off ferries and digital infrastructure;
5. provision of power and water supply to all barangays;
6. decongestion of Metro Manila by forming new cores of government and housing centers in Luzon, Visayas and Mindanao;
7. development of Clark and Subic as the logistics center in Asia;
8. automation of the electoral process;

9. peace agreement with the rebel groups; and,
10. “closure of wounds” caused by divisions due to EDSA 1,2 and 3.

II. Overview of the Macroeconomic Activity and Fiscal Position

Summary

Reflecting its varied resource endowment, physical and human, the economy is diversified. The economy is marked by great disparities: in ownership of assets, in income, in levels of technology in production and in the geographical concentration of activity. The National Capital Region (NCR), the region centered on Manila, contains 14% of the population and produces one-third of GDP. Income per head in 2004 in the NCR, the richest region, was almost nine times that in the poorest region (the four provinces then forming the Muslim autonomous region in Mindanao). A wide gap also exists on the human development measure (which takes into account other indicators), with the index score for Sulu, one of the Muslim provinces, about one-half of the national average in 1997 and just over one-third that for the NCR. An even greater disparity is evident nationwide between the richest and poorest households. In 2004, the richest 10% of the population had an income 23 times that of the poorest 10%. Those living in poverty were estimated at 39.4% of the population in the same year, with the rate in rural areas put at 46.9%, whereas the poverty rate in the NCR was only 12.7%.

The Philippine economy performed relatively strong in the first half of the 1990s on the back of a robust export performance. However, the regional financial crisis of 1997-98 led to a sharp growth slowdown and left banks’ balance sheets in a precarious state. Although growth bounced back to reasonable levels from 1999-2003, the financial system remains hamstrung by a significant volume of bad debt, whilst unemployment has remained high in the wake of the crisis.

In 2001, the growth fell back slightly as a result of fallout from the country’s political crisis and the global tech-sector slowdown. The economy showed renewed strength in 2002 through 2004, although some commentators doubt whether the bounce-back – which was helped by a relatively loose fiscal stance – can be sustained into 2005, particularly given mounting investor concerns over fiscal sustainability. Over the long term, the economy’s growing presence in high-growth export sectors should guarantee continued development. However, problems related to political corruption and the slow pace of structural and – particularly – fiscal reform will probably keep growth below its potential for some time to come.

A. Macroeconomic Activity

In 2004, the global economic environment remained threatened by a host of factors. Foremost among them was the prolonged US-led war in Iraq that contributed to the spiraling in the prices of oil in the world market. The concomitant increase in the prices of energy and materials tempered world industrial production growth, squeezed profit margins and even resulted to a loss of jobs.

These external threats spilled over to the domestic front, rendering investors to remain cautious while the Philippine government opted to ban the deployment of Filipino contract workers bound for Iraq. Aside from these, however, there was no major disturbance in the global financial system, while trade among countries and regions remained robust during the year.

1) International Environment

a. External Accounts

The country's current account surplus remained strong based on figures for the first nine months of 2004 with a surplus of US$2.9 billion or about 4.7% of GDP. This was largely due to remittances of *overseas Filipino workers* (OFWs), which is expected to top US$8.0 billion for the whole of 2004. This level already exceeds expectation of a 6 percent growth for the whole of 2004.

Meanwhile, the country's January-December 2004 overall BOP position yielded a deficit of US$282 million, a reversal from the surplus of US$111 million in the same period in 2003. The full-year BOP deficit was 45.3 percent lower than the projected deficit of US$516 million. This development was on account of the improvement in both current and capital and financial accounts following strong global economic activity, reflecting the upturn in industrialized countries and the continued strength in global IT demand.

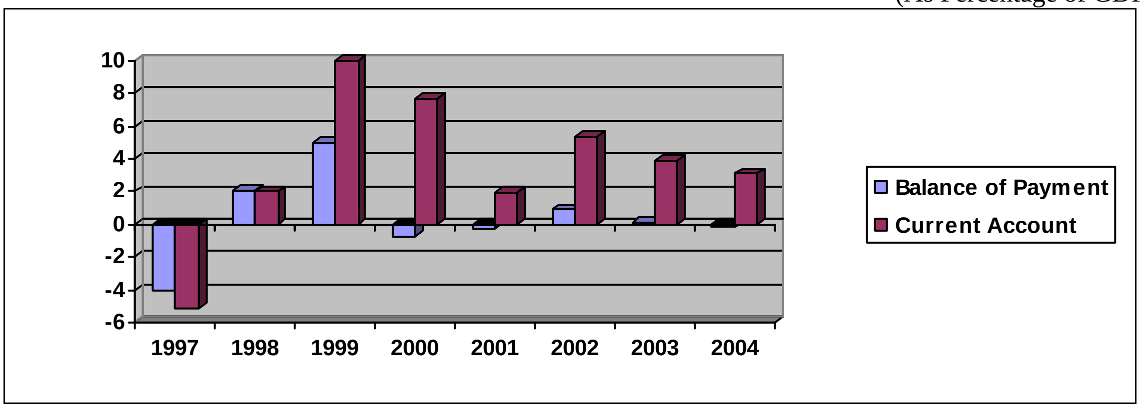
Table 1 Balance of Payment and Current Account Positions

(As Percentage of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004
Balance of Payment	-4.1	2.1	5.0	-0.7	-0.3	0.9	0.1	-0.2
Current Account	-5.2	2.0	10.0	7.7	1.9	5.4	3.9	3.1

Figure 1 Balance of Payment and Current Account Positions

(As Percentage of GDP)



The trade-in-goods balance posted a lower deficit of US$23 million in 2004 as exports growth of 11.5 percent slightly outpaced import growth of 10.9 percent. This reflected a reversal from the contraction of 3.1 percent and 4.2 percent, respectively, registered last 2003 for exports and imports of goods. Exports reached US$9,980 million propelled by electronics and machinery and transport equipment, which rose by 14.6 percent and 15.4 percent, respectively. Mineral products, specifically copper metal; coconut oil and chemicals also contributed to the strong export performance. Garments exports, while on the downtrend, remained to be the third largest export earner with a 6.4 percent share to total exports. These developments led to the 10.5 percent expansion in exports for the year.

Accordingly, imports of goods grew by 10.9 percent to reach US$10,003 million, with almost commodity groups displaying hefty rebounds. Raw materials and intermediate goods grew for 2004 by 9.7 percent, a reversal from the 15.0 percent decline in 2003. Similarly, consumer goods rose by 13.1 percent while mineral fuels accelerated by 30.1 percent. These developments brought 2004 total imports to US$29,419 million or an increase of 9.1 percent.

The NSO reported that total merchandise exports in 2004 amounted to US$39,599 million growing by a remarkable 15.4 percent year-on-year, following a 9.3 percent full year growth in 2004, while imports of goods rose to US$37,255 million or an expansion of 8.2 percent. Top destination for our export products continues to be Japan and the US but the biggest increase has been to China, expanding by 75.2 percent in January 2005.

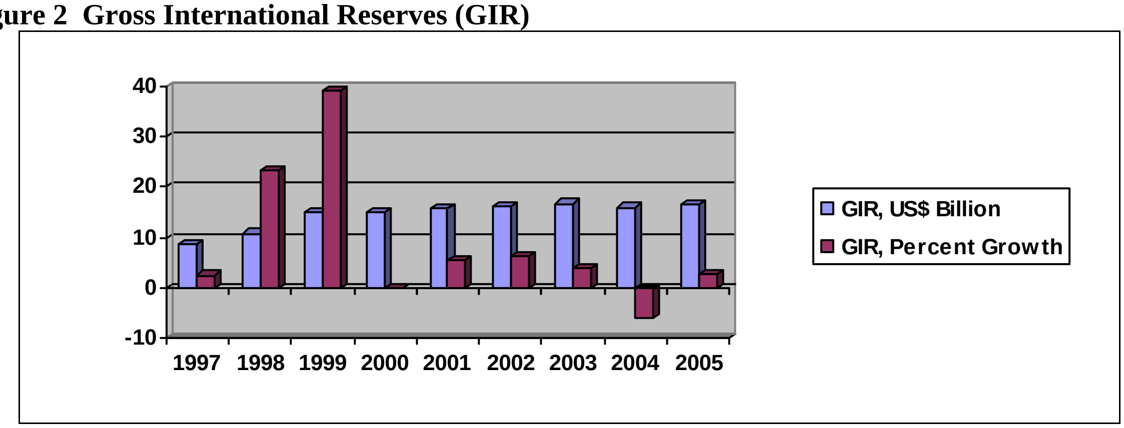
Remittances by overseas Filipino workers (OFWs) in December 2004 rose by 19.6 percent to US$867 million from the 2003 level. This brought the cumulative remittances for the full-year 2004 to US$8.5 million, or 11.8 percent higher than the US$7.6 billion posted a year ago. This level already exceeds expectation of a 6 percent growth for whole of 2004. The continued rise in OFW remittances from the comparable period last year may be attributed to: a) the growing demand for Filipino workers abroad; b) sustained marketing campaign abroad pursued by commercial banks; and c) seasonal transfers for the holiday season.

The country's end-February *gross international reserves* (GIR) of the BSP stood at US$ 16.477 billion, up 4.6 percent from US$15.746 billion in January. This reserve level now just covers 4.2 months of imports of goods and payments of services and income (or just 3.8 months, gold reserves excluded) and merely 1.5 times the size of the country's short-term debt based on residual maturity.

Table 2 Gross International Reserves (GIR)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
GIR, US$ Billion	8.8	10.8	15.0	15.0	15.9	16.2	16.8	16.0	16.5
GIR, Percent Growth	2.6%	23.2%	39.0%	0.0%	5.6%	6.4%	3.9%	-5.9%	2.9%

Figure 2 Gross International Reserves (GIR)



The higher GIR level as of end-February 2005 was attributed mainly to the deposit by the *National Government* (NG) with the BSP of the proceeds from the Global Bond issue due 2030. These inflows were, however, offset by the debt service requirements of the NG and the BSP.

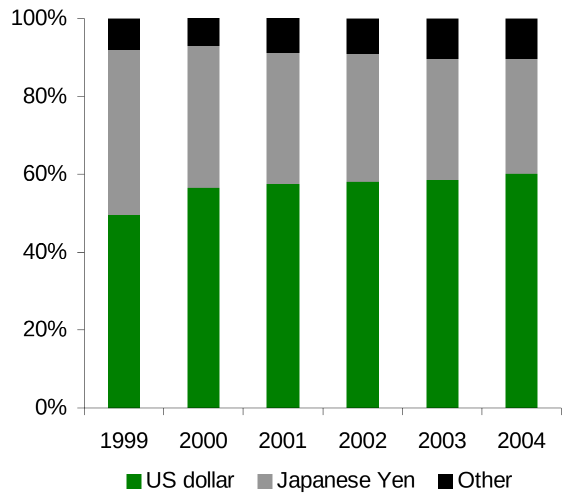
There continues to be concern over the Philippines' inability to build up adequate foreign currency reserves despite its strong current account performance since the 1997 Asian Crisis erupted[1]. Amidst healthy external balances in the last 7 years, slow growth in money supply relative to the rest of the region seems to suggest that disinflation objectives under the inflation-targeting policy framework have prevented the BSP from building up a more comfortable supply of foreign currency reserves and has been a key factor for the wide interest spreads on sovereign bond issuances as well as the volatility of the nominal exchange rate. This has also led the National Government to have a borrowing mix heavily in favor of foreign debt.

The country's outstanding external debt stood at US$58.3 billion in 2004, reflecting a 2 percent increase from the US$55.6 billion figure recorded in 2003. Behind this surge is the appreciation of most third currencies, net repayments of foreign borrowings, decreased resident investments in

[1] Take a look, for example, at the July 2004 issue of the ADB's regional economic monitor and the Sept 2004 issue of the IMF's Global Financial Stability Report.

the Philippine debt instruments issued offshore, and upward adjustments to account for late reports/audit findings on prior period's transactions.

Figure 3 External Debt of NG (currency)



Source: Institute of International Finance

The Department of Finance (DOF) continued to pursue a prudent debt management strategy to raise the required funding to support the government's economic growth objectives while pursuing its fiscal consolidation objective. For 2004, the National Government relied less on foreign borrowing to reduce exposure to foreign exchange risk. The financing mix on a gross basis during the year was 72 percent domestic and 28 percent foreign.

Gross domestic borrowings amounted to ₽383.8 billion. This is 32.2 percent or ₽93.5 billion higher than the gross domestic borrowings of P290.3 billion in 2003 reflecting the shift to domestic financing.

The DOF continued to tap Official Development Assistance (ODA) for program and project loans because they carry a grant element. ODA loan agreements signed in 2004 covered loans amounting to ₽39.5 billion. The DOF likewise took advantage of more favorable market conditions in the international capital market by issuing Global and Euro Bonds. In 2004, the DOF went to the global bond market nine (9) times and obtained commercial borrowings amounting to a total of US$2.9 billion.

Table 3 2004 Official Development Assistance

Particulars	Amount (In Million Pesos)
Project Loan	**34,472**
Asian Development Bank	1,512
IBRD (World Bank)	4,369
IFAD	140
JEXIM	799
OECF/JBIC	2,644
OFEC	21
Constructive Cash Receipts	24,987
Program Loan	**4,998**
Second Non bank Financial Governance	4,202
US PL 480	796
TOTAL	**39,470**

The debt portfolio remains characterized by longer maturity structure to ensure that there would be no bunching of maturities. The government continued to rely more on medium and long-term foreign borrowings. Medium and long-term debt of the National Government accounted for 85 percent while short-term debt accounted for 15 percent. Public sector external debt has an average maturity of 19.5 years.

Under the Bond Exchange executed in February 2004, the Republic retired approximately US$1.2 billion original principal amounts of old bonds, including Brady Bonds in exchange for bonds with a 2011 maturity. The successful exchange resulted in (a) smoother near term maturity profile through the elimination of debt maturity spikes in 2006 by US$323 million, 2008 by US$252 million and 2009 by US$356 million; (b) a longer average debt maturity; (c) the release of collaterals attached to some Brady Bonds; and (d) the introduction of a new benchmark (ROP 2011) with collective action clauses (CACs). CACs are means by which government can renegotiate or reschedule its debts in case of default.

Table 4 2003 - 2004 Commercial Borrowings

	Particulars	Amount (In Million US $)
1.	ROP Global Bond dues 2015 (with CSFB, HSBC and UBS) March 17, 2004	**500**
2.	ROP Zero Treasury Coupon Bonds due 2005 (with HSBC) April 1, 2004	**200**
3.	ROP Global Bonds due 2011 (with Morgan Stanley and Deutsche) May 4, 2004	**200**
4.	ROP Global Bonds due 2014 (with Morgan Stanley and Deutsche) May 14, 2004	**200**
5.	ROP Global Bonds due 2017 put 2012 (with JP Morgan) July 7, 2004	**250**
6.	ROP Euro 350 Million Euro Bonds due 2010 (with Deutsche) August 3, 2004	**422.14**
7.	ROP Global Bonds due 2015 (with CSFB, JP Morgan and Deutsche) September 17, 2004	**300**
8.	ROP Global Bonds due 2025 (with CSFB, JP Morgan and Deutsche) September 17, 2004	**700**
9.	Bonds Exchange (with JP Morgan, Citigroup and Deutsche) February 26, 2004	**120**
10.	US SEC Registered Global Bonds (with CSFB, JP Morgan and Morgan Stanley)	**500**
11.	Zero Coupon Treasury (with HSBC)	**200**
12.	Euro Denominated Bonds (with Deutsche, JP Morgan, CSFB)	**Euro 300**
13.	US SEC Registered Global Bonds (with Citigroup, Deutsche Bank and JP Morgan)	**175**
14.	US $175 Million (with Citigroup, Deutsche Bank and JP Morgan)	**175**
15.	ROP Global Bonds due 2014 (with HSBC, Morgan Stanley and UBS Warburg)	**750**
16.	ROP Global Bonds due 2025	**300**

2) Domestic Environment

We are now at that sensitive time in our history where we cannot sit back and “see how it goes”; this is the time, more than any other, when we need to do more.

a) Real Economy

The Philippines’ economic growth accelerated in 2004 as it resiliently withstood the threats posed by the continued hike in oil and consumer prices, the concerns over the country’s fiscal deficit and the typhoons that hit the country during the fourth quarter. In 2004, gross domestic product (GDP) rose by 6.1 percent, from 4.7 percent in 2003. With the moderate growth of 4.9 percent in net factor income from abroad (NFIA), coming mostly from an increase in compensation income of overseas Filipino workers (OFWs), the gross national product (GNP) grew by a similar 6.1 percent, from 5.6 percent in the previous year.

Table 5 Key Growth and Price Indication of the Philippines

(annual averages, percent growth except for inflation, T-bill and the peso-dollar rates)

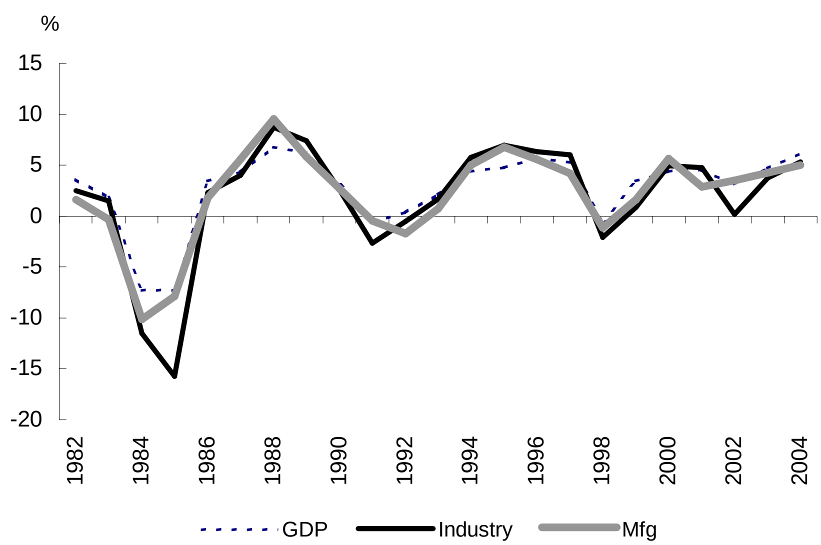
	2000	2001	2002	2003	2004
GDP	4.4	4.5	3.1	4.7	6.1
GNP	4.8	5.9	2.9	5.6	6.1
NFIA	12.8	26.0	2.4	19.3	4.9
Agriculture	3.4	4.7	3.8	3.8	4.9
Industry	4.9	4.8	0.1	3.8	5.3
Services	4.4	4.3	5.1	5.8	7.3
PCE	3.5	3.6	4.1	5.3	5.8
GCE	6.1	-5.3	-3.7	0.5	-0.8
Investments	5.5	19.9	-13.7	0.1	12.7
Inflation	4.4	6.1	3.1	2.5	5.0
I91-day T-bill Rate	9.9	9.7	5.5	5.9	7.3
Peso-Dollar	44.8	51.1	51.6	54.4	55.9

Sources: National Statistical Coordination Board, National Statistics Office, Bangko Sentral ng Pilipinas, Bureau of Treasury

All three major sectors fuelled growth last year: *agriculture, fishery and forestry* (AFF) accelerated by 4.9 percent from 3.8 percent; *industry* picked up its pace by 5.3 percent from 3.8 percent; and *services* grew faster by 7.3 percent from 5.8 percent in the previous year (see table 1). The AFF sector, which accounted for about 20 percent of total GDP, contributed 0.96-percentage point to total GDP growth. All sub-sectors posted positive growths in 2004 except Other Crops and Livestock. Fishery topped the sector's growth followed by palay, corn, poultry and sugarcane. These five top contributors jointly accounted for about 94 percent of the overall AFF growth.

Services, which accounted for about 47 percent of total GDP, contributed the most to GDP growth with 0.37 percentage points. All of its sub-sectors posted accelerated growths in 2004. Top contributors to growth were *trade, transportation, communication and storage* (TCS), and *private services*. Industry accounted for about 33 percent of GDP and contributed 1.77 percentage points to total GDP growth. All sub-sectors posted higher growths except mining and quarrying, which slowed down during the year. Manufacturing and construction led the invigorated performance of Industry.

Figure 4 GDP growth in 2004 was higher than expected



Source: National Statistical Coordination Board (NSCB)

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Despite the strong overall growth of the economy, the country's unemployment rate rose to 11.8 percent in 2004 from 11.4 percent in 2003. This developed as the 3.2 percent gain in the number of employed workers did not match the 3.7 percent growth in the number of new entrants in the labor force. Employment growth in the three major sectors —agriculture, industry and services- generated 976,000 jobs. The services sector continued to be the country's main source of employment during the year.

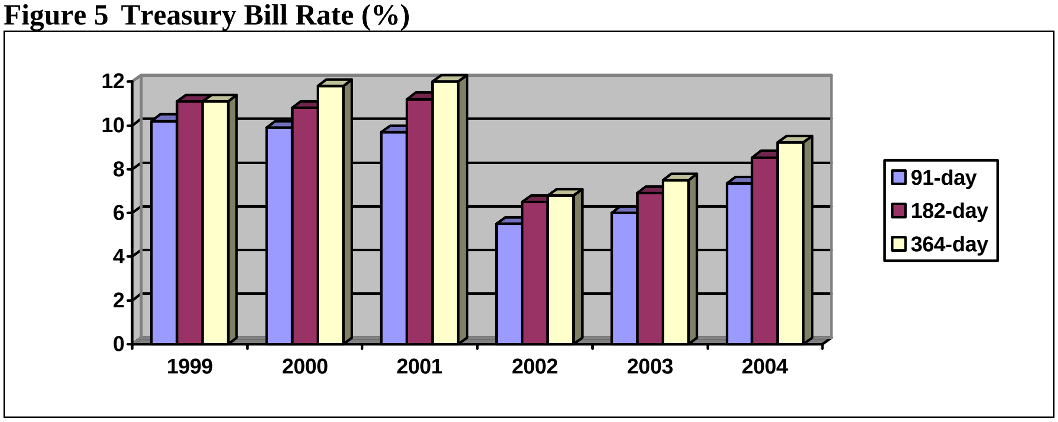
b) Monetary Policy

The meager expansion of monetary aggregates can be seen by its comparably slower growth compared to nominal GDP (see figure 2). Average growth of money supply (as defined by M2) between the years 2000 and 2004 was merely 6.7 percent whereas nominal GDP growth averaged more than 10.0 percent over the same period. The economy's 6.1 percent real GDP growth outpaced the bank credit growth was worst, implying that credit has become less responsive to increases in overall income and output.

Inflation for 2004, which averaged at 5.5%, was much higher than the 3.0 percent registered in 2003. The Bangko Sentral ng Pilipinas (BSP) attributes this inflation acceleration in 2004 largely to supply-side pressure, resulting mainly from a series of supply side shocks to the economy. The rise of local farm products due to typhoons and the sharp rise of global oil prices have both resulted in cost-push inflation. Thus, the BSP has maintained its key policy interest rates at their levels since July 2003.

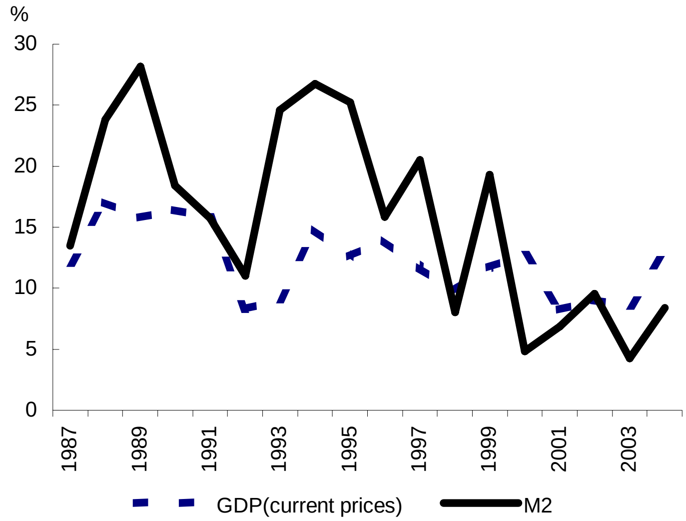
Higher inflation and a weakening currency pushed the benchmark 91-day T-bill rate. The 91-day T-bill rate rose to 7.34 percent in 2004 from 6.03 percent in 2003. Mirroring the rise in the bellweather 91-day issue, the range of bank lending rates in 2004 went up to average 10.07 to 12.08 percent, higher than the 8.92 to 10.75 percent range in 2003.

Figure 5 Treasury Bill Rate (%)



During the early months of 2005, however, both benchmark interest rates have been seeing a strong recovery despite headline inflation for January (8.4%) and February (8.5 percent) still relatively high. Easing pressures against the Philippine peso has allowed interest rates to decline. Unlike last year, therefore, the BSP is not expected to raise reserve requirements as long as foreign borrowings of the NG and portfolio capital inflows continue to keep the peso strong.

Figure 6 Money Supply Growth Has Lagged GDP Expansion



Source: Bangko Sentral ng Pilipinas, NSCB

c) Financial Sector

Loans granted by commercial banks grew by merely 3.6% as of end-November 2004. The biggest share of loans still went to the manufacturing sector growing by 15.0 percent as of end-November 2004. Most other sectors such as real estate and business services, construction, transportation, storage and communication, mining and quarrying saw declines, offsetting the gains in loans to manufacturers.

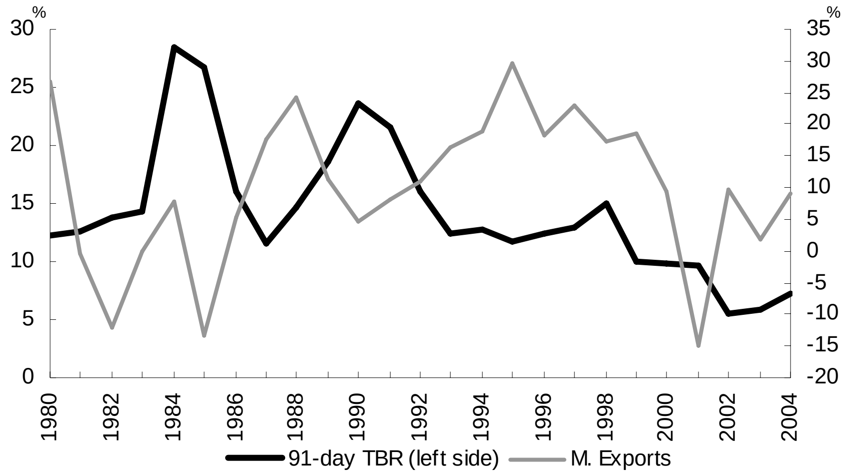
The remarkably slow growth in bank loans (2.5 percentage points lower than GDP growth) is still being attributed to the sizeable share of bad assets in the loan and asset portfolio of the banking system. The BSP reported an official figure of 13.0 percent NPL ratio as of end-December 2004.

The BSP reported that there has been progress in the disposal of bad bank assets as *non-performing assets* (NPAs) eligible for sale to SPVs has grown to ₱26.2 billion as of end-2004. More than P50 billion worth of assets are currently filed for eligibility under the SPV law putting the total transfer to almost ₱80.0 billion. While these signal the intention of banks to finally dispose of their NPAs, thus far, a major sale of the banking sectors' assets to SPVs required to significantly lower the NPL and NPA ratio of the country's ailing banks has yet to be seen.

The commercial banking system's *capital adequacy ratio* (CAR) increased to 18.3 percent as of March 2004 from 17.35 percent in December 2003, exceeding the statutory level set by the BSP at 10.0 percent and the Bank for International Settlements (BIS) standard of 8.0 percent. The high CAR reflects the banking system's improved ability to cover risky assets. So far, the Philippines' CAR was relatively high compared to that of its neighboring countries.

Amidst the fall of commercial bank NPL's, the bank's bad loan exposure remained adequately covered as the banking system's NPL coverage ratio, which remained steady at 53.3 percent as of November 2004, reflecting banks' diligent compliance with the loan-loss provisioning requirements of the BSP as a cushion against possible losses.

Figure 7 Policy Rates maybe Key to Sustained Exports Growth



Source: National Statistics Office

B. Fiscal Position

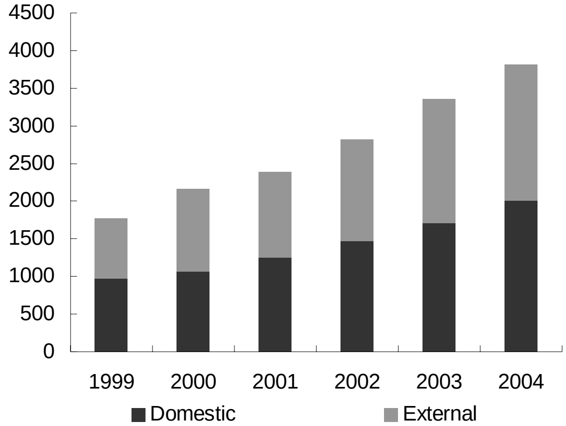
The National Government (NG) accelerated its deficit reduction program by containing the year-end deficit at 3.9 percent of GDP or ₱187.1 billion compared with the program of 4.2 percent and the 2003 level of 4.8 or ₱199.9 billion. This made the National Government at least a year forward in its balanced budget target by 2010.

After raising US$1 billion from a foreign bond issuance last September 2004 to help the National Power Corporation (NAPOCOR) meet its 2004 foreign currency financing requirements, the NG is again busy raising funds from abroad. The prominent share of foreign borrowings in the public sector's debt portfolio will likely persist in 2005 as the NG issued another $1.5 billion 25-year bond in Europe early this year to again borrow in behalf of the NAPOCOR. The spreads on this recent sovereign issue once again hovered at more than 500 basis points above equivalent United States (US) issues amidst the tightening of spreads of other Asian issuers.

1) Debt Picture

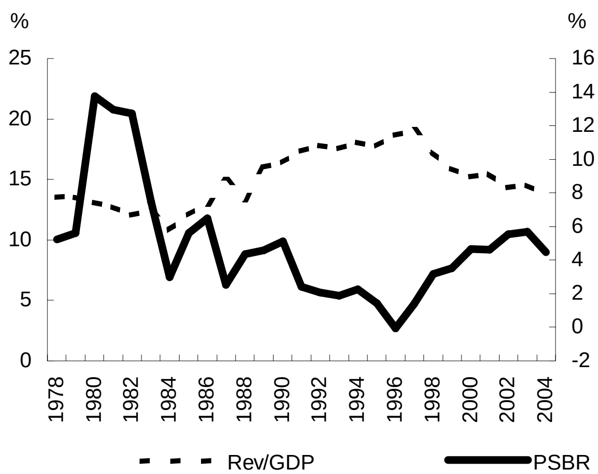
This active foreign borrowing strategy in the recent past has led to the sharp rise of fiscal debt measured from either the national government (NG) or the total public sector (*non-financial public sector* or NFPS) level. As of end-2004, NG debt has reached ₱3.8 trillion or almost 79 percent of GDP. Meanwhile the latest data on the NFPS deficit in end-2003 shows that the public sector debt has already reached PhP4.35 trillion or 101 percent of GDP. Guarantees granted by the NG to both private and public corporations explain a large part of the difference between the NFPS and the NG debt, the largest portion being guarantees to the National Power Corporation.

Figure 8 NG Outstanding Debt (in billion PhP)



Source: IIF, IFPO Estimates

Figure 9 Borrowing Requirement Follows Revenue Performance (percent of GDP)



Source: Institute of International Finance (IIF), *Public Sector Borrowing Requirement

2) Deficit Picture

The NG's budget deficit in 2004 stood at ₱186.1 billion, 5.9 percent below the program of ₱197.8 billion and 6.9 percent lower than the ₱199.9 billion-deficit level during the previous year. Fiscal managers are also ahead of their target as the deficit has shrunk to just 3.9 percent of GDP vs. its target of 4.2 percent of GDP. This is the second consecutive year that the NG outperformed its fiscal deficit goal, affirming the fiscal authorities' commitment to achieve fiscal consolidation.

Table 6 National Government Fiscal Performance

(In Billion Pesos)

Particulars	2002	2003	2004
REVENUES	**567.1**	**626.6**	**699.80**
Tax Revenues	*496.4*	*537.4*	*598.0*
Bureau of Internal Revenue	394.5	425.4	468.2
Bureau of Customs	96.2	106.1	122.5
Other Offices	5.6	5.9	7.3
Non-Tax Revenues	*70.8*	*89.3*	*101.7*
Bureau of the Treasury	47.2	56.7	
Fees & Charges	21.9	30.8	
Privatization	0.6	0.6	
Grants	1.1	1.2	
EXPENDITURES	**777.9**	**826.6**	**886.8**
SURPLUS/(DEFICIT)	**(210.7)**	**(199.9)**	**(187.1)**

The consolidated public sector deficit (CPSD) to GDP ratio reached 5.0 percent in 2004, well below the program of 6.7 percent. This is largely due to the following: (1) lower NG deficit; (2) lower losses posted by NAPOCOR due to privatization of its generating plants; (3) rationalization and prioritization in capital outlays of GOCCs; (4) surpluses posted by social security institutions (SSIs) and government financial institutions (GFIs); and (5) higher surplus accounts of LGUs.

The NG's better than expected performance was made possible by improvements in the revenue growth with Bureau of Internal Revenue (BIR) collections rising by 10 percent while Bureau of Customs (BOC) collections expanding by 15.3 percent y-o-y. Revenue and tax efforts have remained flat but are expected to improve in 2005.

Table 7 Consolidated Public Sector Financial Position

(In Billion Pesos)

Particulars	2002	2003	2004
Total Surplus/(Deficit)	(218.7)	(244.6)	(239.5)
Percent of GDP	-5.4%	-5.6%	-5.0%
National Government	(210.7)	(199.9)	(187.1)
CB Restructuring	(15.1)	(15.7)	(17.5)
14 MNFGCS			(90.7)
Monitoring GOCCs	(46.4)	(65.3)	
Adjustment of net lending & equity to GOCCs	3.9	5.8	(9.2)
SSIs (SSS, GSIS, PHIC)	25.6	7.8	25.1
BSP	1.2	6.9	3.3
GFIs (DBP, LBP, Philexim)	5.4	4.9	5.2
LGUs	18.9	7.9	15.4
Timing adjustment of interest payments to BSP	(1.6)	0.6	3.9
Other adjustments	0.0	2.2	(2.8)

III. Tax Structure: Institutions and Reality

A. Introduction to the Tax System

Governments can never create wealth. They must, therefore, support themselves by taking a portion of the wealth of their citizens. The chief means by which governments do this is taxation. Taxes are required payments of money that must be made regularly. Most of the money goes into a general pool of revenues from which all government expenses are paid.

In mammoth organizations - corporations, conglomerates, multi-nationals, and governments - the indispensability of a central finance office to manage and mobilize resources is a truism.

Without logistics and financial support "when needed, where needed", operations would be paralyzed in no time. That the birth of a revenue administration has undergone various structural and functional overhauls, but has nonetheless remained a key organization. Today, the critical tasks of revenue generation, resource mobilization and fiscal management rest on the shoulder of the revenue administration that ensures:

1) Taxpayers satisfaction with the services
2) An agency that is taxpayer-focused, efficient and transparent
3) An organization that is streamlined, productive and has fiscal and administrative flexibility
4) A workforce that is professional, competent, morally upright and motivated
5) A model of good governance in the public sector

The government must provide the citizenry with infrastructure, education, health and other basic services; and the revenue administration must be ready with the funds for them. Likewise, the revenue administration must steer fiscal programs toward an investment-friendly environment, which is the catalyst for growth.

Improving tax collection and administration, based in part on a modernized tax system, is critical for sustainable economic growth and the provision of key government services through establishing sound fiscal practices. For many developing countries, a stable and transparent tax revenue system for public expenditures has become more important to underpin growth and stability. Under decentralization, the capacity of local governments to raise revenue and administer national taxation policies has also become important. Tax policy makers and administrators face emerging challenges from the accelerated pace of globalization. These challenges are reflected not only in the need for increased public expenditures in social infrastructure, but also in tax policy harmonization on a global basis and improvement in tax administration, which will in turn contribute to good governance.

B. Overview of Philippine Tax Administration

The laws governing the taxation in the Philippines are contained within the National Internal Revenue Code (NIRC). This code underwent substantial revision with passage of the Tax Reform Act of 1997. This law took effect on January 1, 1998.

Taxation is administered through the Bureau of Internal Revenue (BIR) which comes under the Department of Finance. The chief executive of the BIR is the Commissioner who has exclusive and original jurisdiction to interpret the provisions of the code and other tax laws. The Commissioner has the powers to decide disputed assessments, grant refunds of taxes, fees and other charges and penalties, modify payment of any internal revenue tax and abate or cancel a tax liability. Taxpayers can appeal decisions by the Commissioner directly to the Court of Tax Appeals.

National Internal Revenue Code (NIRC) of 1997

The NIRC of 1997 provides the legal basis for the imposition and collection of all national internal revenues in the Philippines. It requires taxpayers to maintain a set of books to record all business transactions and to enable them to reflect their correct income, which shall be the basis for their filing of taxes. The law mandates that taxpayers shall voluntarily comply with tax laws, rules and regulations. It also provides for the necessity of audit or examination to verify whether or not taxpayers are dutifully complying with their obligations.

Bureau of Internal Revenue

The Bureau of Internal Revenue (BIR) is the agency responsible to administer and enforce national tax laws. It is under the Department of Finance (DOF) which sets the revenue collection targets. The BIR is mandated by law to assess and collect all national internal revenue taxes, fees and charges, and to enforce all forfeitures, penalties and fines connected therewith, including the execution of judgments in all cases decided in its favor by the Court of Tax Appeals and the ordinary courts.

The BIR is headed by a Commissioner who is assisted by four (4) Deputy Commissioners for Revenue Operations Group, Legal Affairs and Inspection Group, Information System Group and Resource Management Group. The agency operates under a decentralized system through its Regional Offices and Revenue District Offices which are charged with the operational activities of the bureau. There are nineteen (19) Regional Offices and one hundred twenty three (123) Revenue District Offices strategically located all over the country.

Table 8 Personnel Complement

	Functions	National Office		Regional Office		Total	
		2003	2004	2003	2004	2003	2004
1	Management	201	193	415	419	616	612
2	Assessment	326	279	2,232	2,267	2,558	2,546
3	Collection	157	170	2,354	2,341	2,511	2,511
4	Excise	285	145	18	140	303	285
5	Document Processing	151	152	972	955	1,123	1,107
6	Information Technology	681	703	1,625	1,666	2,306	2,369
7	Legal and Inspection	74	78	188	181	262	259
8	Taxpayer Assistance	15	18	160	158	175	176
9	Administrative	584	675	1,105	1,062	1,689	1,737
	Total	**2,474**	**2,413**	**9,069**	**9,189**	**11,543**	**11,602**

C. Primary Tax Incentives

Tax holiday

The Omnibus Investments Code grants to enterprises that have registered with the Board of Investments and that qualify under the annual Investments Priority Plan entitlements to tax holidays of either four or six years. In addition, they are granted tax credits for purchase of Philippine-made capital equipment and raw materials.

Special Economic Zones

There are over thirty special economic zones throughout the Philippines where export manufacturing firms are encouraged to start operations. Under the Philippine Export Zone Authority Law, a special economic zone is registered enterprise can; in lieu of all other national and local taxes pay a tax of 5% of its gross income.

A firm that has registered under the Omnibus Investment Code that is located and registered to do business within a special economic zone can have a tax holiday for the first four or six years of its operations, followed by a 5% tax thereafter. The exemption from national taxes covers all internal revenue taxes, including the Value Added Tax.

D. Tax Treaties

A tax treaty is designed primarily by their purpose. The Philippines has entered into several tax treaties with other governments in order to spur national stability and development mainly by encouraging investors to invest in the Philippines and for the purpose of increasing flow of trade and investment between the Philippines and other countries.

In this regard, among the objectives of tax treaties are the following:

1. to eliminate double taxation caused by multiple jurisdiction asserting tax authority over the same income;
2. to assist tax administrators in the fight against tax evasion and avoidance through Exchange of Information and Mutual Agreement Procedure; and

3. the reciprocal reduction of tax impediments to cross-border investment and trade to promote international trade and investment.

For the prevention of fiscal evasion with respect to income taxes, among others, in recent years, the Philippines has been actively negotiating tax treaties basically on the following:

1. The business profits of a resident of another country with whom the Philippines has a tax treaty are taxable in the Philippines only if the resident has a permanent establishment in the Philippines to which the profits are attributable.
2. The Philippine source compensation income of alien individuals who are residents of the countries enumerated below is exempt from Philippine income tax provided all the following conditions are met:
   -- The alien individual is present in the Philippines for a period (or periods) not exceeding in the aggregate 183 days (180 days for residents of Bahrain, etc.) in any 12-month period (any taxable calendar/fiscal year for other residents like Bangladesh, Vietnam residents…), commencing or ending in the fiscal year concerned;
   -- The remuneration is paid by, or on behalf of, an employer who is not a resident of the Philippines; and
   -- The remuneration is not borne as such by a permanent establishment or a fixed based which the employer has in the Philippines.

At present, there are 33 Philippine Tax Treaties in force from 1977 to 2003, with Australia, Austria, Bahrain, Bangladesh, Belgium, Brazil, Canada, Czech Republic, Denmark, Finland, France, Germany, Hungary, India, Indonesia, Israel, Italy, Japan, Korea, Malaysia, the Netherlands, New Zealand, Norway, Pakistan, Romania, the Russian Federation, Singapore, Spain, Sweden, Thailand, the United Kingdom, the United States and Vietnam. Pending exchange of instruments of ratification/notification is a treaty with Poland. Pending ratification by the Philippine Senate are treaties with Chile (limited to shipping), China, Finland (protocol amending the agreement), Nigeria, Switzerland and Yugoslavia and the renegotiated treaties with Indonesia and Sweden.

Taxes covered by the Philippine tax treaties are income taxes imposed by the domestic laws of the Contracting States, including substantially similar taxes that may be imposed later, in addition to, or in its place, are covered by the tax treaties. In the Philippines, this is limited to Title II (Tax on Income) and the stock transaction tax of the Tax code of 1997.

The business income is treated under the tax treaties as a resident of a contracting State shall not be taxable in the Philippines unless that enterprise of a resident of a Contracting State carries on business in the Philippines through a permanent establishment.

Permanent establishment is defined as a fixed place of business through which the business of the enterprise is wholly or partly carried on. The concept of permanent establishment is used to determine the rights of a Contracting State to tax the business profits of enterprises of the other Contracting State. Under this concept, profits of an enterprise of a Contracting State are not taxable by the other Contracting State, unless the enterprise carries on business through a permanent establishment situated in the other Contracting State.

A list of places, circumstances, and activities which constitute a permanent establishment is provided under the different tax treaties which the Philippines has with other countries.

E. Primary Types of Taxation

1) Income Tax is a tax on a person's income, emoluments, profits arising from property, practice of profession, conduct of trade or business or on the permanent items of gross income specified in the Tax code of 1997 less the deductions and/or personal and additional exemptions, if any, authorized for such types of income, by the Tax Code or other special laws.

Who Are Required To File Income Tax Returns

a) Individuals

Individuals who earn an income pay an income tax to government. This is the price he pays for the public goods and services that he consumes. This is also his share in the collective tasks of financing the country's requirements for development.

i. **Resident citizens receiving income from sources within or outside the Philippines**
   - -- individuals deriving compensation income from 2 or more employers, concurrently or successively at anytime during the taxable year
   - -- employees deriving compensation income regardless of the amount, whether from a single or several employers during the calendar year, the income tax of which has not been withheld correctly (i.e. tax due is not equal to the tax withheld) resulting to collectible or refundable return
   - -- employees whose monthly gross compensation income does not exceed P5,000 or the statutory minimum wage, whichever is higher, and opted for non-withholding of tax on said income
   - -- individuals deriving other non-business, non-professional related income in addition to compensation income not otherwise subject to a final tax
   - -- individuals receiving purely compensation income from a single employer, although the income of which has been correctly withheld, but whose spouse is not entitled to substituted filing

ii. **Non-resident citizens receiving income from sources within the Philippines**

iii. **Citizens working abroad receiving income from sources within the Philippines**

iv. **Aliens, whether resident or not, receiving income from sources within the Philippines**

Salaries and business income of individuals are subject to income tax but a part of his income is not subject to income tax. The exempt portion refers to his personal and additional exemptions from income tax. They are roughly equivalent to expenditures on his basic needs and those of his dependents.

The exemption levels are as follows:

i. For single or legally separated individuals, ₱20,000

ii. For the head of a family, ₱25,000

A head of a family is somebody who is single, or is legally separated, and is:

- -- supporting his parents;
- -- supporting his child, a brother or a sister who is 21 years old or younger;
- -- supporting a physically and mentally handicapped child, brother or sister, regardless of age.

iii. For each married individual, ₱32,000

iv. Additional exemption for individuals with dependents, ₱8,000

A dependent is a child who is 21 years old or younger, or a physically and mentally handicapped child, regardless of age, who is dependent on the taxpayer for support.

The additional exemption can only be claimed by one of the spouses. In case of legally separated couples, the additional exemption can be claimed by the spouse who has custody of the children.

The number of dependents entitled to an additional exemption is limited to four (4). The total exemption for a family with four children and where both father and mother work, is ₱96,000.

Some other forms of income are not subject to tax. These are the following:

i. Proceeds of life insurance policies which are paid to beneficiaries

ii. Return of premium from an insurance policy

iii. Gifts, bequests and devises (income or property granted to another through somebody's will

iv. Compensation for injuries or sickness from health insurance or from the Workmen's Compensation Act

v. Income which is exempt from any treaty obligation of the Philippine government
vi. Retirement benefits, pension gratuities
vii. Separation pay
viii. Benefits paid to veterans
ix. Benefits received under the Social Security System under RA 8282
x. Benefits received under the Government Service Insurance System under RA 8291
xi. Prizes and awards in recognition of achievement in religious, charitable, scientific, educational, artistic, literary and civic areas, and local and international sports competition
xii. 13th month pay, bonuses and other productivity incentive pay, up to a maximum of ₱30,000
xiii. Contributions to GSIS, SSS, Medicare and union dues
xiv. Gains from sale, exchange, or retirement of bonds, debentures or other certificate of indebtedness with a maturity of more than 5 years
xv. Gains from the redemption of shares from mutual funds.

Individuals with income from business of the exercise of their trade or profession can deduct ordinary and necessary expenses to compute their net income. They can also choose to deduct a standard deduction equal to ten percent (10%) of gross income. The income tax rates are thereafter applied to net income.

Aside from insurance for health care, there are no deductions which can be claimed by individuals receiving salary or any other forms of compensation from an employer-employee relationship. A family with a gross income of ₱250,000 or less can deduct premiums paid for health and insurance up to a maximum of ₱24,000 per family. Thereafter, taxable income (i.e. gross income less exclusions and personal and additional exemptions) is multiplied by the income tax rates as follows:

Table 9 For Individuals Earning Purely Compensation Income and Individuals Engaged in Business and Practice of Profession

Over	But Not Over	Rate
	₱10,000	5%
₱10,000	₱30,000	₱500 + 10% of the Excess over ₱10,000
₱30,000	₱70,000	₱2,500 + 15% of the Excess over ₱30,000
₱70,000	₱140,000	₱8,500 + 20% of the Excess over ₱70,000
₱140,000	₱250,000	₱22,500 + 25% of the Excess over ₱140,000
₱250,000	₱500,000	₱50,000 + 30% of the Excess over ₱250,000
₱500,000		₱125,000 + 34% of the Excess over ₱500,000 in 1998

Note:
1. Effective January 1, 1999, the maximum rate shall be thirty-three percent (33%) and thirty-two percent (32%) on January 1, 2000.
2. When the tax due exceeds P2,000.00, the taxpayer may elect to pay in two equal installments, the first installment to be paid at the time the return is filed and the second installment on or before July 15 of the same year at the Authorized Agent Bank (AAB) within the jurisdiction of the Revenue District Office (RDO) where the taxpayer is registered.

b) Corporations no matter how created or organized including general professional partnerships

The corporate income tax complements the individual income tax. It ensures that all incomes of the corporation are taxed including those that are not distributed to shareholders and are kept as retained earnings of a corporation. It is also a contribution from corporations for the benefits that they receive from government such as protection through the legal system.

Corporations are taxed on their net income and using the residence principle:
- domestic corporations receiving income from sources within and outside the Philippines
- foreign corporations receiving income from sources within the Philippines

Corporations are allowed to deduct all ordinary and necessary expenses which, have been paid or incurred during the taxable year in carrying on their trade or business. These include salaries, wages and other forms of compensation for personal services; interest expense; taxes, losses; bad debts; depreciation; charitable contributions and other donations; research and development expenditures; and pension trusts.

There are limitations on the amount of expenses that corporations can claim. General and specific limitations on deductible expenses are prescribed under Chapter 7 of the NIRC.

The general limitations include the non-deductibility of the following:

i. Personal, living and family expenses
ii. Any amount paid for new buildings, permanent improvements which increase the value of any property or estate
iii. Any amount spent in restoring corporate property
iv. Premiums paid for any life insurance policy of any officer or employee when the taxpayer is the beneficiary of such policy
v. Bribes, kickbacks, and similar payments
vi. Entertainment expenses that are contrary to law, moral, public policy or public order

Specific limitations are prescribed on the following:

i. Entertainment, amusement and recreation are subject to ceilings prescribed by the Secretary of Finance
ii. Interest expense shall be reduced by 38% of the interest income that is subject to a final tax of 20 percent. (The limitations were 41% for 1998 and 39% for 1999)
iii. Tax credit on taxes paid to foreign government is generally limited to the Philippine income tax payable on the said income.
iv. Charitable contributions are subject to a ceiling of ten percent (10%) of taxable income of an individual and five percent (5%) of the taxable income of a corporation. The ceiling does not apply on donations made to: certain programs of government; certain foreign institutions in accordance with international agreements; and, accredited non-government organizations.

The taxpayer must also substantiate the deductions through official receipts and prove that the expenses are necessary to the conduct of trade or business.

The other guidelines on deductions are as follows:

i. Taxes are paid in connection with the taxpayer's profession, trade or business are deductible except the income tax, estate and donor's tax; and special assessments levy.
ii. Losses during the taxable year that are not compensated for by insurance or other forms of indemnity that have been incurred in business are deductible. The net operating loss of a business can be carried forward for three years.
iii. Debts that have been determined as worthless and have been charged-off during the taxable year; and are connected with trade or business are deductible. Bad debts from transactions between related parties are not deductible.
iv. Research and development expenditures are deductible except those undertaken to improve properties that are subject to depreciation and depletions, as well as those incurred to find deposits of ore, mineral, oil and gas.

Table 10 Corporate Income Tax Table

	Tax Rate	Taxable Base
1. Domestic Corporations:		
a. In General	32%	Taxable income from all sources
b. Minimum Corporate Income Tax*	2%	Gross Income
c. Improperly Accumulated Earnings	10%	Improperly Accumulated Taxable Income
2. Proprietary Educational Institution	10%	Taxable income from all sources
3. Non-stock, Non-profit Hospitals	10%	Taxable income from all sources
4. GOCC, Agencies & Instrumentalities		
a. In General	32%	Taxable income from all sources
b. Minimum Corporate Income Tax*	2%	Gross Income
c. Improperly Accumulated Earnings	10%	Improperly Accumulated Taxable Income
5. National Gov't. & LGUs		
a. In General	32%	Taxable income from all sources
b. Minimum Corporate Income Tax*	2%	Gross Income
c. Improperly Accumulated Earnings	10%	Improperly Accumulated Taxable Income
6. Taxable Partnerships		
a. In General	32%	Taxable income from all sources
b. Minimum Corporate Income Tax*	2%	Gross Income
c. Improperly Accumulated Earnings	10%	Improperly Accumulated Taxable Income
7. Exempt Corporation		
a. On Exempt Activities	0%	
b. On Taxable Activities	32%	Taxable income from all sources
8. General Professional Partnerships	0%	
9. Corporation covered by Special Laws	Rate specified under the respective special laws	
a. In General	32%	Taxable income from all sources
b. Minimum Corporate Income Tax*	2%	Gross Income
c. Improperly Accumulated Earnings	10%	Improperly Accumulated Taxable Income
10. International Carriers	2.5%	Gross Philippine Billings
11. Regional Operating Head	10%	Taxable Income
12. Offshore Banking Units (OBUs)	10%	Gross Taxable Income On Foreign Currency Transaction
	32%	On Taxable Income other than Foreign Currency Transaction
13. Foreign Currency Deposit Units (FCDU)	10%	Gross Taxable Income On Foreign Currency Transaction
	32%	On Taxable Income other than Foreign Currency Transaction

Note: Effective January 1, 1999, the maximum rate shall be thirty-three percent (33%) and thirty-two percent (32%) on January 1, 2000.

* Beginning on the 4th year immediately following the year in which such corporation commenced its business operations, when the minimum corporate income tax is greater than the tax computed using the normal income tax.

Table 11 Resident Foreign Corporations

	Tax Rates
1) a. In General	32%
b. Minimum Corporate Income Tax	2%
c. Improperly Accumulated Earnings	10%
2) International Carriers	25%
3) Regional Operating Headquarters	10%
4) Corporation Covered by Special Laws	Rate specified under the respective special laws
5) Offshore Banking Units (OBUs)	10%
6) Foreign Currency Deposit Units (FCDU)	10%

Effective January 1, 2000, the tax code includes an option for corporations to be taxed at a rate of 15% of gross income if the President of the Philippines chooses to enact this option. If the option is granted by the President, only firms whose proportion of the cost of sales or receipts from all sources does not exceed 55% may exercise the option. This method of taxation, once elected, shall be irrevocable for three consecutive years.

Under the Tax Reform Act, the Philippines has also established a Minimum Corporate Income Tax (MCIT). The MCIT approximates the payment of true and correct income taxes by domestic corporations. Subsequent to the fourth taxable year after a corporation has started its business, a minimum corporate income tax of 2% of the gross income is imposed if this amount is greater than the regularly computed tax. This amount can be carried forward and credited against the normal income tax for the three immediately succeeding taxable years.

The MCIT is imposed only on domestic corporations that are subject to the regular corporate income tax of 32%. The MCIT serves as a floor tax and is paid when the regular income tax is lower. Any excess of the MCIT over the regular income tax can be carried forward and can be credited against the regular income tax for three succeeding years.

The base of the MCIT is gross income:

i. Gross sales less sales returns, discounts, allowances, and cost of goods sold; or
ii. Gross receipts less sales returns, allowances, discounts, and cost of services.

c) Estates and trusts engaged in trade or business

An income tax is imposed on the income of estates or of any property held in trust, including:

i. Income accumulated in trust for the benefit of unborn or unascertained person or persons with contingent interests;
ii. Income accumulated or held for future distribution under the terms of the will or trust;
iii. Income which is to be distributed currently by the fiduciary – person designated as a trustee – to the beneficiaries;
iv. Income collected by a guardian of an infant which is to be held or distributed as the court may direct;
v. Income received by estates of deceased persons during the period of administration or settlement of the estate; and
vi. Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

The tax rates on estates and trusts are identical to those imposed on the income of citizens and resident aliens.

2) Passive Incomes are subject to a final withholding tax.

Table 12 Passive Income Tax Table

	Tax Rates
1. Interest on any peso bank deposit	20%
2. Royalties (except on books as well as literary & musical composition - 10%)	20%
3. Prizes (except prizes amounting to P10,000 or less -5%)	20%
4. Winnings (except from PCSO and lotto)	20%
5. Interest Income of Foreign Currency Deposit	7.5%
6. Interest from long-term deposit	
Holding Period	
- Four (4) years to less than five (5) years	5%
- Three (3) years to less than four (4) years	12%
- Less than three (3) years	20%
7. Cash and/or Property Dividends	
Beginning January 1, 1998	6%
Beginning January 1, 1999	8%
Beginning January 1, 2000 & thereafter	10%
8. On capital gains presumed to have been realized from sale, exchange or other disposition of real property (capital asset)	6%
9. On capital gains for shares of stock not traded in the stock exchange	
- Not over P100,000	5%
- Any amount in excess of P100,000	10%

Table 13 For Non-Resident Aliens Engaged in Trade or Business

	Tax Rates
1. On Certain Passive Income*	20%
2. Interest Income from long time deposits	
Holding Period	
-Four (4) years to less than five (5) years	5%
-Three (3) years to less than four (4) years	12%
-Less than three (3) years	20%
3. On capital gains presumed to have been realized from the sale, exchange or other disposition of real property	6%
4. On capital gains for shares of stock not traded in the Stock Exchange	
- Not over P100,000	5%
- Any amount in excess of P100,000	10%

*Cash and/or Property Dividends, Share in the distributable net income of the partnership, Interest on any bank deposits, Royalties (except on books as well as literary works and musical composition), Prizes (except prizes amounting to P10,000 or less), Winnings

a) Interest

A 'final' tax of 20% is imposed on interest income. This tax is withheld at the source. Exceptions to this are:

i. Interest income from a depositary bank with a Foreign Currency Deposit Unit is subject to a final tax rate of 7.5%.

ii. Philippine long term investments of over five years are exempt from tax.

b) Dividends

A final tax of 8% (which goes up to 10% on January 1, 2000) is imposed on cash or property dividends from domestic corporations, joint stock companies, insurance or mutual funds, or regional operating headquarters of multinational corporations.

The distributable net income, after tax, of a partnership is subject to the same final tax as dividends.

c) Capital Gains Tax

A tax imposed on the gains presumed to have been realized by the seller from the sale, exchange, or other disposition of capital assets located in the Philippines, including pacto de retro sales and other forms of conditional sale.

The tax code imposes a final tax of 5% on net capital gains from the sale of stock in a domestic corporation up to 100,000 pesos. The tax is 10% for any income over 100,000 pesos. If the stock is stock exchange listed, a transfer tax of 0.5% is also imposed.

What are the applicable tax rates of Capital Gains?

i. Real Properties – 6%
ii. For Share of Stocks not Traded in the Stock Exchange, on the Net Capital Gains
    - Not over ₱100,000 - 5%
    - Any amount in excess of ₱100,000 - 10%

Who are required to file the Final Capital Gains Tax return?

Every person, whether natural or juridical, resident or non-resident, including estates and trusts, who sells, transfers, exchanges or disposes real properties located in the Philippines classified as capital assets, including pacto de retro sales and other forms of conditional sales or shares of stocks in domestic corporations not traded through the local stock exchange classified as capital assets.

d) Fringe benefits

Fringe benefit tax (FBT), is an equity measure. It ensures that an income tax is paid on all forms of compensation, including those which are given in perks or in non-cash forms. The FBT is collected at the firm's level for effective compliance and tax administration.

The FBT is a final tax at 32% on the grossed-up monetary value of fringe benefits granted to managerial and supervisory employees. Rank and file employees are not subject to the FBT.

Since the FBT rate is aligned with the highest marginal income tax rate on individuals, the FBT on non-resident foreigner who is not engaged in trade or business in the Philippines is 25%, and a 15% rate applies on a foreigner employed by regional or area headquarters of multinational company (including OBUs). Filipinos who are employed and occupying the same positions are also subject to a 15% FBT.

The grossed-up monetary value of the fringe benefit is determined by dividing the monetary value of the fringe benefit by 68%.

Fringe benefits means any goods, services, and other benefits granted in cash or in kind by an employer to an individual employee such as:

i. housing
ii. expense accounts
iii. vehicles of any kind
iv. household personnel
v. interest rate in loan at less than market rate
vi. membership fees, dues and other expenses borne by the employee in social and athletic clubs or other similar organizations
vii. expenses for foreign travel
viii. holiday and vacation expenses
ix. educational assistance to the employee or his dependents
x. life or health insurance and other non-life insurance premiums

The following are the benefits not subject to the FBT:

i. fringe benefits which are exempt from income tax;
ii. contributions of the employer for the benefit of the employee to retirement, insurance and hospitalization benefit plans;
iii. benefits given to the rank and file employees, whether granted under a collective bargaining agreement or not;

iv. de minimis benefits or facilities or privileges that are of relatively small value and are offered as a means of promoting the health, goodwill, contentment or efficiency of the employees;
v. fringe benefits that are required by the nature of the trade, business or profession of the employer; and
vi. fringe benefits that are granted for the convenience of the employer.

3) Value Added Tax is a business tax imposed and collected from the seller in the course of trade or business on every sale of properties (real or personal) lease of goods or properties (real or personal) or vendors of services. It is an indirect tax, thus, it can be passed on to the buyer.

Who Are Required To File VAT Returns

- -- Every person or entity who in the course of his trade or business, sells or leases goods, properties and services subject to VAT, if the aggregate amount of actual gross sales or receipts exceed Seven Hundred Fifty Thousand Pesos (P 750,000.00) for any twelve month period.
- -- A person required to register as VAT taxpayer but failed to register
- -- A person who imports goods
- -- Professional practitioners
- -- Professional Practitioners (PPs) are formerly classified as non-VAT taxpayers and were exempt from the Value-Added Tax and Percentage taxes under Section 109 of the National Internal Revenue Code (hereinafter referred to as the Code), until December 31, 2002. Prior to this date, they were subject only to Income Tax under Section 24 of the Code. Effective January 1, 2003, however, by virtue of Republic Act Nos. 7716 and 9010, which were implemented by Revenue Regulation Nos. 1-2003 and 3-2003, services of PPs are also subject to either VAT (if gross professional fees exceed P 750,000.00 for a 12-month period) or 3% Percentage Tax (if gross professional fees totals P 750,000 and below for a 12-month period), depending on their gross professional fee for a twelve (12) - month period.

Professional Practitioners" include the following:

i. Certified Public Accountants
ii. Insurance Agents (Life & Non-life)
iii. Other Professional Practitioners required to pass the government examination
iv. Others

VAT Tax Rates

-- For output tax – 0% or 10%
-- For input tax

i. 0% or 10%
ii. Transitional input tax rates - 8% or 10%
iii. Presumptive input tax rate - 1 ½ %
iv. Creditable VAT withheld by the Government and the licensee or lessee - 3%, 6%, 8.5% and 10%

4) Other Taxes

Documentary Stamp Tax is a tax on documents, instruments, loan agreements and papers evidencing the acceptance, assignment, sale or transfer of an obligation, rights, or property incident thereto.

Donor's Tax is a tax on a donation or gift, and is imposed on the gratuitous transfer of property between two or more persons who are living at the time of the transfer.

Table 14 Tax Rate Effective January 1, 1998 to present

Net Gift Over	But not Over	The Tax Shall Be	Plus	Of the Excess Over
	₱ 100,000	exempt		
₱ 100,000	200,000	0	2%	₱ 100,000
200,000	500,000	₱ 2,000	4%	200,000
500,000	1,000,000	14,000	6%	500,000
1,000,000	3,000,000	44,000	8%	1,000,000
3,000,000	5,000,000	204,000	10%	3,000,000
5,000,000	10,000,000	404,000	12%	5,000,000
10,000,000	and over	1,004,000	15%	10,000,000

Notes:

1. Rate applicable shall be based on the law prevailing at the time of donation.
2. When the gifts are made during the same calendar year but on different dates, the donor's tax is computed on the total net gifts during the year.

Donation made to a stranger is subject to 30% of the net gift. A stranger is a person who is not a:

- brother, sister (whether by whole or half blood), spouse, ancestor and lineal descendants; or
- relative by consanguinity in the collateral line within the fourth degree of relationship (up to first cousin)

Estate Tax is a tax on the right of the deceased person to transmit his/her estate to his/her lawful heirs and beneficiaries at the time of death and on certain transfers which are made by law as equivalent to testamentary disposition.

Table 15 Tax Rate Effective January 1, 1998 to present

Net Estate is Over	But not Over	The Tax Shall Be	Plus	Of the Excess Over
		Exempt		
₱ 200,000	500,000	0	5%	₱ 200,000
500,000	2,000,000	₱ 15,000	8%	500,000
2,000,000	5,000,000	135,000	11%	2,000,000
5,000,000	10,000,000	465,000	15%	5,000,000
10,000,000		1,215,000	20%	10,000,000

Table 16 Other Tax Rates

Particulars	Rates
For Non-Resident Aliens Not Engaged in Trade or Business	
1. On the gross amount of income derived from all sources within the Philippines	25%
2. On capital gains presumed to have been realized from the exchange or other disposition of real property located in the Phils.	6%
Aliens Employed by Regional Headquarters (RHQ), Regional Operating (ROH), Offshore Banking Units (OBU), Petroleum Service Contractors and Subcontractors	15%
General Professional Partnerships	0%

Percentage Tax is a business tax imposed on persons or entities who sell or lease goods, properties or services in the course of trade or business whose gross annual sales or receipts do not exceed ₱550,000 and are not VAT-registered.

Who Are Required To File Percentage Tax Returns

i. Any person who is not a VAT-registered person (persons exempt from VAT under Sec. 109z of the Tax Code)
ii. Domestic carriers and keepers of garages, except owners of bancas and owners of animal drawn two- wheeled vehicle
iii. Operators of international air and shipping carriers doing business in the Philippines
iv. Franchise grantees of electric, gas or water utilities

v. Franchise grantees of radio and/or television broadcasting companies whose gross annual receipts for the preceding year do not exceed Ten Million Pesos (P 10,000,000.00) and did not opt to register as VAT taxpayers
vi. Operators of communication equipment sending overseas dispatch, messages, or conversations from the Philippines, except on services involving the following:
    1) Government of the Philippines - for messages transmitted by the Government of the Republic of the Philippines or any of its political subdivisions and instrumentalities
    2) Diplomatic services - for messages transmitted by any embassy and consular offices of a foreign government
    3) International organizations - for messages transmitted by a public international organization or any of its agencies based in the Philippines enjoying privileges, exemptions and immunities which the government of the Philippine is committed to recognize pursuant to an international agreement
    4) News Services - for messages from any newspaper, press association, radio or television newspaper broadcasting agency, or newsticker services to any other newspaper, press association, radio or television, newspaper, broadcasting agency or newsticker services, or to bonafide correspondents, which messages deal exclusively with the collection of news items for, or the dissemination of news items through public press, radio or television broadcasting or a newsticker service furnishing a general news service similar to that of the public press
vii. Banks and non-bank financial intermediaries and finance companies
viii. Life insurance premiums
ix. Agents of foreign insurance companies
x. Proprietor, lessee, or operator of cockpits, cabarets, night or day clubs, boxing exhibitions, professional basketball games, jai-alai and race tracks
xi. Every stock broker who effected a sale, barter, exchange or other disposition of shares of stock listed and traded through the Local Stock Exchange (LSE) other than the sale by a dealer in securities
xii. Corporate issuer / stock broker, whether domestic of foreign, engaged in the sale, barter, exchange or other disposition through Initial Public Offering (IPO) seller in secondary public offering of shares of stock in closely held corporations

Table 17 Percentage Tax Table

Coverage	Basis	Tax Rate
Persons exempt from VAT under Sec. 116	Gross Sales or Receipts	3%
Domestic carriers and keepers of garages	Gross Receipts	3%
International Carriers:		
International air/shipping carriers doing business in the Philippines	Gross Receipts	3%
Franchise Grantees:		
Electric , gas and water utilities	Gross Receipts	2%
Radio and television broadcasting companies whose annual gross receipts of the preceding year do not exceed P 10,000,000 and did not opt to register asVAT taxpayer	Gross Receipts	3 %
Banks and non-bank financing intermediaries	Interest, commissions and discounts from lending activities as well as income from leasing on the basis of remaining maturities of instruments:	
	• Short term maturity (not over 2 years)	5 %
	• Medium term (over 2 years but not over 4 years)	3 %
	• Long Term Maturity	
	-Over 4 years but not over 7 years	1 %
	-Over 7 years	0 %
On Dividends		0 %
On royalties, rentals of properties, real or personal, profits from exchange and all other items treated as gross income under Sec. 32 of the Code		5 %
Finance Companies	On interest, discounts and other items of gross income paid to finance companies and other financial intermediaries not performing quasi banking functions	5 %
	Interest, commissions and discounts paid from their loan transactions from finance companies as well as income from financial leasing shall be taxed based on the remaining maturities of instruments:	
	• Short term maturity (not over 2 years)	5 %
	• Medium term (over 2 years but not over 4 years)	3 %
	• Long Term Maturity	
	-Over 4 years but not over 7 years	1 %
	-Over 7 years	0 %
Life Insurance Companies (except purely cooperative companies or associations)	Total premiums collected	5 %
Agents of foreign insurance companies: (except reinsurance premium)		
Insurance agents authorized under the Insurance Code to procure policies of insurance for companies not authorized to transact business in the Phils.	Total premium collected	10 %
Owners of property obtaining insurance directly with foreign insurance companies	Total premium collected	5 %
Proprietors, lessee or operator of the following:		
Cockpits	Gross receipts	18%
Cabarets, Night or Day Clubs	Gross receipts	18%
Boxing exhibitions	Gross receipts	10%
Professional basketball games	Gross receipts	15%
Jai-alai and race track (operators shall withheld tax on winnings)	Gross receipts	30%
Every stock broker who effected a sale, barter, exchange or other disposition of shares of stock listed and traded through the Local Stock Exchange (LSE) other than the sale by a dealer in securities	Gross selling price or gross value in money of shares of stocks sold, bartered, exchanged or otherwise disposed	½ of 1 %
A corporate issuer/stock broker, whether domestic of foreign, engaged in the sale, barter, exchange or other disposition through Initial Public Offering (IPO)/secondary public offering of shares of stock in closely held corporations	Gross selling price or gross value of in money of shares of stocks sold, bartered, exchanged or otherwise disposed in accordance with the proportion of stocks sold, bartered or exchanged or after listing in the stock exchange	
	Up to 25 %	4%
	Over 25% but not over 33 1/3%	2%
	Over 33 1/3 %	1%

e) Withholding Tax on Compensation is the tax withheld from income payments to individuals receiving purely compensation income arising from employer-employee relationship.

i. ***Expanded Withholding Tax*** is a kind of withholding tax which is prescribed only for certain payors and is creditable against the income tax due of the payee for the taxable quarter/year.
ii. ***Final Withholding Tax*** is a kind of withholding tax which is prescribed only for certain payors and is not creditable against the income tax due of the payee for the taxable year. Income Tax withheld constitutes the full and final payment of the Income Tax due from the payee on the said income.
iii. ***Withholding Tax on Government Money Payments (GMP)*** is a tax withheld by government bureaus, offices and instrumentalities, including government-owned or-controlled corporations and local government units, before making any payments to private individuals, corporations, partnerships and/or associations.
iv. ***Withholding Tax on GMP Percentage Taxes*** is the tax withheld by government bureaus, offices and instrumentalities, including government-owned or -controlled corporations and local government units, before making any payments to private individuals, corporations, partnerships and/or associations from non-VAT taxpayers.
v. ***Withholding Tax on GMP VAT Taxes*** is the tax withheld by government bureaus, offices and instrumentalities, including government-owned or -controlled corporations and local government units, before making any payments to private individuals, corporations, partnerships and/or associations who are VAT registered.

f) Excise Tax is a tax on the manufacture or sale of certain products. Generally, these products are those which exhibit negative externalities, such as tobacco and alcohol. Their consumption increases the likelihood of illness. The costs of medical care are borne by all taxpayers. Excise taxes are thus collected from consumers of “socially bad products” to correct their negative externalities.

Excise tax can also be “user charges” for government services. Excise taxes on petroleum products are collected from users of roads and other public infrastructures.

Excise taxes are also imposed on less essential foods to complement a uniform or a single-rate VAT.

Excise taxes are also imposed to regulate the use of non-renewable resources. An example is the excise tax on mineral products.

An excise tax can either be specific or ad valorem. Ad valorem rates are based on value, i.e. price, of the good, while specific rates are based on unit or volume, i.e. liter of gasoline. Specific taxes are easier to administer. Further, if the tax should correct negative externalities, the tax should be heavier on those who are consuming more of the “socially bad” commodity.

F. The Self-Assessment System

The self-assessment system is widely adopted in many countries for its cost effectiveness in limiting audit to special cases and eliminating the burden of administrative assessment work and serves as a deterrent to possible collusion between taxpayers and examiners. Except for Vietnam which has a separate tax assessment system for wage earners and businesses, a survey of the collection methods used by fifteen (15) tax authorities disclosed that all countries have adopted the self-assessment system of taxation.

The self-assessment system which is based on the principle that internal revenue taxes are fundamentally self-assessing was first introduced in the Philippines in 1959. Under the system, the need for a letter of demand or assessment notice is no longer necessary because the taxpayer is held responsible for the assessment of his tax liability. The self-assessment concept encourages professionals in the private and government sectors to report their true income and pay the correct amount of taxes. In the Philippines, more than 95% of tax collection comes from voluntary assessments which leave very little room for the agency in-charge to engage in enforcement actions.

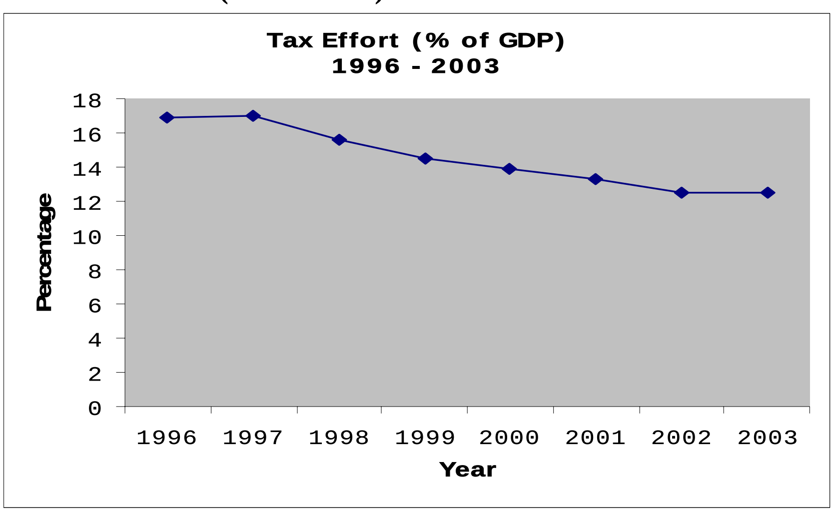
G. Performance of Tax Administration

In years following the Asian currency crisis and the implementation of the CTRP, the tax collection shortfall resulted to the degeneration of the overall tax effort. As shown in figure 10, the ratio of total tax collected to GDP declined to 12.5% in 2003 from a high of 17% in 1997. Though this contraction is a collective result of the weakening collection performance of all revenue generating agencies of the government, the BIR has emerged as the principal source of the flagging tax effort (see figure 11). The deficit is primarily attributed to leakages from income tax and VAT collections. Moreover, even if other major tax sources like excise tax and percentage tax exceeded the collection level of previous years, it nonetheless fell short relative to collection goals.

Over the last six years, public revenue in the Philippines fell from its peak of 18.7 percent of GNP in 1997 to 13.4 percent in 2003. The decline stems largely from lower tax collection, which fell from 16.3 percent of GNP in 1993 to 11.5 percent in 2003. In turn the erosion in tax revenue resulted primarily from lower collection of taxes on income and profit, as well as weaker excise tax collection – both fell by 1.3 percentage points during this period.

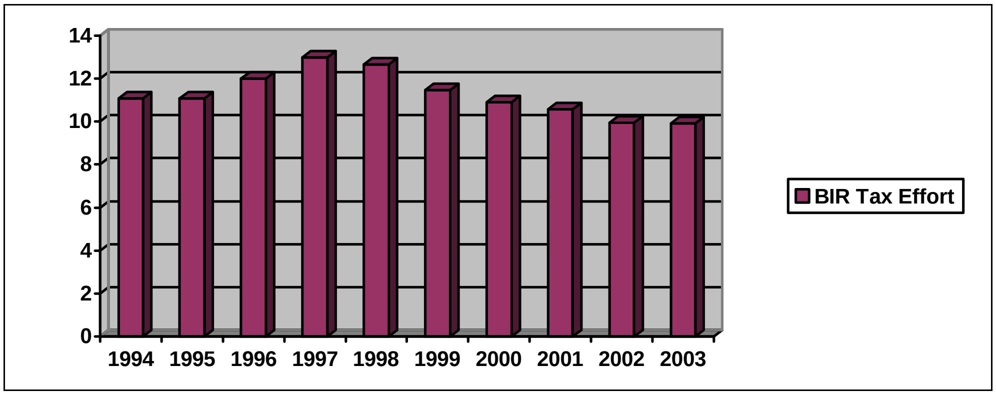
The decline in public revenue for the Philippines has been unprecedented. In 1997, the revenue effort of the Philippines was better than China, Indonesia, or Thailand. Six years later, it ranked poorly relative to these countries as the ratio of total revenue to GDP fell by 5 percentage points. The decline in tax revenue is attributable to three factors: (i) shift in tax policy, (ii) change in economic structure, and (iii) increase in tax evas

Figure 10 Overall Tax Effort (1996 – 2003)



Source: DOF Philippines Fiscal Update (July 2004)

Figure 11 BIR Tax Effort (1994 – 2003)



Source: BIR Annual Report 2003 (www.bir.gov.ph)

The fall in tax effort was primarily due to changes in tax policy and tax administration, and to a lesser extent to changes in economic structure. Further decomposition by tax type show that main reasons for the decline in revenues was policy for excise taxes; administration and evasion for VAT; and a mix of changes in economic structure and increase evasion for profit and income taxes.

Table 18 BIR Collections, GDP and Tax Effort, CY 1995 - 2004

(in Million of Pesos)

Year	BIR COLLECTIONS		GDP in Current Prices		Tax Effort
	Amount	Growth Rates %	Amount	Growth Rates %	
2004	₱ 468,177	9.90	₱ 4,739,140	12.56	9.88
2003	426,010	7.97	4,210,505	8.43	10.12
2002	394,549	1.51	3,883,230	6.93	10.16
2001	388,679	7.73	3,631,474	8.25	10.70
2000	360,802	5.71	3,354,727	12.69	10.76
1999	341,320	1.23	2,976,904	11.70	11.47
1998	337,177	7.14	2,665,060	10.07	12.65
1997	314,697	20.68	2,421,306	11.48	13.00
1996	260,774	23.32	2,171,922	13.93	12.01
1995	211,462	12.81	1,906,328	12.61	11.09
Average		**9.80**		**10.87**	**11.18**

Notes:
1. Tax Effort is the ratio of collections to Gross Domestic Product at Current Prices.
2. Source of GDP data (2000-2004), Revised National Accounts of the Philippines as of May 2005.

Another reason for the fall in tax effort is the proliferation of tax incentives to various industries and business activities. Many of these incentives significantly distort economic activity by discriminating between different types of businesses. In addition, by making the corporate tax system more complicated and nontransparent, they also increase opportunities for tax avoidance and corruption. However, total revenue performance exceeded its target by ₱1.3 billion in 2003 despite the fall in tax effort. The BIR reached ₱425.4 billion, an increase of 7.8% from the previous year's level.

Table 19 BIR Share in National Government Tax Revenues, CY 1995-2004

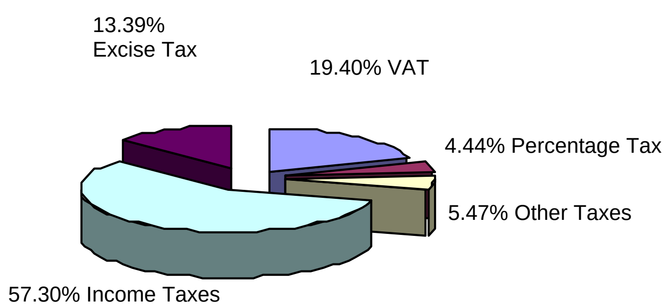
(In Million Pesos)

Year	National Government Tax Revenues	BIR Collections	Other Agencies Share in Government Tax Revenues (%)	BIR Share in Government Tax Revenues (%)
2004	₱ 597,911	₱ 468,177	21.70	78.30
2003	538,019	426,010	20.82	79.18
2002	496,372	394,549	20.51	79.49
2001	489,859	388,679	20.65	79.35
2000	460,034	360,802	21.57	78.43
1999	478,502	341,320	28.67	71.33
1998	416,585	337,177	19.06	80.94
1997	412,165	314,698	23.65	76.35
1996	367,894	260,774	29.12	70.88
1995	310,517	211,462	31.90	68.10

Source: Cash Operations Report, Bureau of Treasury

The percentage distribution of BIR collected taxes in the 2003 is shown in figure 12. The improvement in collection is largely credited to the computerization and systems improvements which were launched by the BIR throughout its regional offices nationwide.

Figure 12 Percent Distribution of BIR Collection by Type of Tax (2003)



In addition, measures were implemented to detect and eliminate leakages through timely issuance of revenue regulations, intensified audit and assessment findings and launching of technology based projects to upgrade taxpayer services were launched.

H. Sources of Leakages

The BIR through its Tax Compliance Verification Drive conducts inspection of business establishments in major cities and municipalities. A survey of 4,202 business establishments conducted in 2004 showed that nearly 95% have been violating their tax reporting requirements and were not complying with standard business practices such as issuing purchase receipts or maintaining proper accounting records. The BIR also reported that 49% of the businesses surveyed were not issuing official receipts for purchases, 37% were not registered with the BIR and 54 percent had no books of accounts at all.

Violations were uncovered for various tax types. For income taxes, the following are the primary sources of leakages: (i) non-reporting of second/third employment income, (ii) under-declaration of business and professional income and/or overstatement of expenses, (iii) non-filing of tax returns among self-employed individual. For VAT, the following are the key sources: (i) exorbitant claims and/or fraudulent applications of input tax credits, (ii) under-declaration of sales, and (iii) non-issuance of official receipts and/or issuance of unofficial or fraudulent receipts.

The use of unregistered receipts, use of multiple sets of receipts, use of unregistered books of accounts, non-registration of professionals, failure to properly post the certificate of registration, and use of unregistered cash register machines. There are suspicions that the problem is even worse in the remote areas. Outside of the metropolitan area, few stores, restaurants, markets and other business outlets issue official receipts. Most self-employed individuals including traders, doctors, dentists, store and shop owners, farmers, and fishermen do not pay income taxes at all.

I. Areas of Concern

The poor revenue effort appears to have been taken for granted in government planning and projections. The Government must confront the following three major issues to reverse the decline in revenue collection performance and bring it back to a more sustainable path.

1) The proliferation of exemptions has further narrowed the tax base.
2) Tax buoyancy has fallen due to the absence of revaluation and non-indexation of excise tax rates.
3) Tax administration capacity has not kept pace with changes in tax policies.

III. Country-Specific Fiscal Issues

In the face of continuing political uncertainties, critical factors are so necessary for economic growth. The new fiscal managers have recognized the importance of reducing the rapid rise of the country's debt/GDP ratio and are determined to address the issue of rising debt/GDP ratio with the final resolve of reducing it. Improvements in revenue collections are expected to come from reforming the tax structure e.g. sin taxes, VAT, etc., improvement in collection efficiency as well as through optimization of administrative measures.

Going forward, sustaining the growth in 2005 entails raising business confidence, improving productivity and enhancing the country's competitiveness. To meet these requirements, implementation of structural reforms should be pursued with greater vigor.

A. Restructuring and Reforming the Financial System

The banking policy must focus on three main objectives:

First, promoting a stronger and more stable financial system that requires raising the standards based on international best practices; facilitating the recovery of financially-distressed enterprises and the resolution of their indebtedness through rationalized rules; and ensuring the passage of important legislative measures to effectively support the existing legal and regulatory framework that governs the banking system. There is also a need to strengthen further the enforcement powers of supervisory authorities by providing them with legal protection and to build up their capability through intensified training and improved system.

Second, developing the country's capital market that require the creation of an enabling environment to allow for orderly and efficient securities transactions through the establishment of basic financial structures; establishing an environment of transparency and accountability in accordance with international standards; reducing the cost of borrowing for investors and consumers through greater sharing of information; and pushing for the passage of legislative reform measures.

Third and finally, ensuring the accessibility and availability of funds for small and medium-sized enterprises entails the creation of a regulatory and supervisory environment that is conducive to the establishment of microfinance-oriented banks in the country. To this end, the Bangko Sentral ng Pilipinas (BSP) endeavors to promote its microfinancing program by strengthening existing regulations that govern microfinance activities, instituting a comprehensive and reliable credit information system that will allow a more accurate assessment of borrower's creditworthiness and establishing guidelines, standards and procedures that conform to international forms.

B. Fiscal Sustainability

Fiscal sustainability is a key component of the macroeconomic agenda for the medium term. The main policy of the National Government's (NG) fiscal program is to achieve fiscal consolidation by 2010. Achieving a balanced budget requires a package of measures, strategies and activities geared towards increasing revenues, managing government expenditures and debts, reducing the deficit of government-owned and controlled corporations (GOCCs) and most important, growing the Philippine economy.

On the revenue side, the government must implement administrative reforms and push for the passage of legislative tax measures. Part of the revenue administrative reforms is the implementation of administrative measures by the Bureau of Internal Revenue, Bureau of Customs and the Bureau of the Treasury. This is expected to generate a 14-percent increase in revenues by 2010, particularly if accompanied by new tax measures.

On the expenditure side, the government must conduct an efficient expenditure management program and will ensure the full implementation of devolved functions following the Local Government Code and related laws. Moreover, the government must pursue measures that will improve the performance of the country's official development assistance (ODA) and expand public capital formation.

In line with managing public debt, the government should intensify its efforts to promote the domestic capital market as well as manage contingent liabilities by developing a risk management system to identify, quantify and monitor the NG's level of exposure to contingent liabilities, among others. This shall also be consistent with the strategy to diversify sources of financing. Reducing reliance on foreign borrowings overtime will help limit the foreign exchange rate risk which could raise the cost of foreign debt servicing.

The Philippines Government should not rely on the remittances of more than eight million overseas Filipino workers to keep its economy afloat. The Philippines recorded 11.6 billion dollars in remittances in 2004, making it the fifth largest recipient behind India, China, Mexico and France. The amount represented 13.5 percent of the country's gross domestic product, the largest in proportion to the domestic economy among the five countries. Remittances worldwide have amounted to 232 billion dollars so far this year, of which developing countries like the Philippines accounted for 167 billion dollars -- more than twice the foreign aid received. Over the years, excellent performance of remittances may have contributed to complacency in addressing fiscal deficits and low productivity growth. Remittances should not distract the country from its huge potential for domestic investment and growth. The Government should not view overseas employment as a substitute for economic development in the origin country as ultimately, development depends on sound domestic economic policies. In such case, 1,000 private hospitals have been forced to close for lack of manpower over the past five years, and 6,000 doctors have shifted to nursing, which is in demand overseas. 10,000 teachers have left for jobs abroad since 1988, and 32,000 teachers now work as maids in neighboring countries in Asia. This is an area of concern that over the increasing number of skilled workers taking on unskilled work overseas, resulting in a serious brain drain, particularly in the health and education sectors.

Meanwhile, reducing the deficit of GOCCs necessitates the privatization of generation assets, the restoration of the financial health of the National Power Corporation (NPC), and the rationalization of automatic guarantee provisions to reduce GOCC's reliance on government support. Restructuring the NPC tariff is one important strategy that can help in the NPC's financial recovery.

C. Power Sector Reform

The government needs to press ahead with the power sector reform program to ensure the viability of the NPC, thereby enabling it to deliver adequate power supply to meet the requirements of the growing economy in the medium term. The comprehensive agenda is aimed at enhancing the viability of the power sector by addressing issues of ownership, industry structure, competition, pricing, and regulation. An important policy move towards a sustainable power supply is the full implementation of the Electric Power Industry Reform Act of 2001 (EPIRA).

The privatization of the NPC through the sale of its generation assets and the Transco concession is among the most urgent non-tax revenue-generating measures. Cleaning government's books entails putting an end to the fiscal drain caused by inefficient corporations. NPC's privatization is expected to bring in $4.0 to $5.0 billion.

The proceeds from NPC's sales will free government resources from subsidizing NPC towards public services and social reforms. NPC's privatization will also save government P20.0 to P30.0 billion in interest payments alone and free that amount for public services and social reforms.

D. Export Competitiveness

Export must continue to be an important driver of economic growth in the future. Ensuring strong export growth will require a comprehensive and sustained policy on export development and promotion. The government's endeavors to rally the nation to find its bearing in the export market expand the country's share in the market and increase its global competitiveness. Among the government important infrastructure projects to support export growth include the expansion of highway system to link the entire country, improve transport within Metro Manila and address critical infrastructure bottlenecks along national roads and bridges to speed traffic our of Metro Manila.

E. Comprehensive Infrastructure Support

An efficient infrastructure network which includes power, water, transportation and communication facilities is one of the key elements of an economic environment that encourages investments. Authorities thus face the challenge of ensuring that adequate public resources are devoted to infrastructure projects and that these projects are implemented efficiently. Moreover, given the limits of government resources, a framework for encouraging greater private sector participation in the provision and improvement of infrastructure facilities should also be formulated.

F. Credible Population Management Program

The rapid increase in population, which already exceeded the 80million mark, necessitates that the economy should expand at an even faster rate to employ a growing labor force and to increase per capita incomes. In addition, the high population growth rate also exerts pressure on the supply of natural resources and on the state of the environment. Hence, the Government needs to draw up a comprehensive and consistent population management program which ensures that population growth does not impinge on family welfare and natural resources.

IV. Conclusions: Where We Stand and Where We Go?

ONCE again we find ourselves at a crossroad. We don't know where to turn, but we have a strong sense that we must alter course if we are to survive and grow as a nation. We are convinced that if we allow our current crop of politicians to continue governing the country, we are doomed to go around in circles. We have a vague idea of the kind of leaders we need: they must be firm, inspiring and trustworthy. But we are not sure who among our remaining leaders we can still trust.

The degrading poverty of the majority of our people remains our most daunting problem. Our historic failure to solve it has meant the waste of so much human capital. It has broken the spirit of our young people, who, increasingly, are unable to look at their nation's heritage with pride, or to imagine investing their lives in its future. We search our minds and hearts for any explanation for this failure. And always we arrive at one conclusion-the lack of a visionary and selfless leadership.

This insight is basically correct, but it does not give a complete picture. It overlooks the fact that there have been leaders of great integrity and capability in every generation. It glosses over the system that actively co-opts or excludes the visionary rebels among them, usually portraying them as enemies or fools, and installing them as heroes when they are safely dead.

Even now, it is not difficult to find many good leaders at every level of our society. But in their youth, they are typically broken until they learn to bow to the imperatives of the system. Subdued, they often become its cynical apologists. So it is important, when we ask for new leaders, to remember to also ask for new structures, new values and new practices.

The routines and forms of government are probably the easiest to change. The change may be done by executive order, by legislation, or by constitutional revision. Far more resistant to change, however, are the basic structures that determine the distribution of wealth and power across society's classes and groups. The operation of these structures is carefully masked in everyday life, or explained away as an aspect of the natural order of things. Access to wealth is the most contested part of social life, the final object of all politics.

Shifting from presidential to a parliamentary system, or from a unitary to a federal government, is nothing more than cosmetic change unless there is also substantive alteration in the distribution of economic resources, and in the nature and basis of state power. The present system, to state the obvious, remains in the hands of a small oligarchy, whose chronic inability to develop a robust economy and alleviate mass poverty is at the root of its recurrent crisis.

The economy's weakness is visible in its almost total dependence on the remittances of overseas workers. The country's agricultural base, where the majority of our people still work and live, is a picture of stagnation and neglect. Manufacturing has progressively contracted over the years. The remaining vibrant sector, services, thrives mainly on the resources made available by our overseas workers.

But the most significant index of the present system's bankruptcy is the gigantic debt burden that successive administrations have passed on to the Filipino people. The debt service constitutes the single largest component of the national budget. The senselessness of this burden is best exemplified by the Bataan Nuclear Power Plant, a facility that Filipinos have been paying for since 1986 even if it has not produced a single kilowatt of electricity.

Our problem clearly is not just Gloria Macapagal-Arroyo. It is the whole country's political leadership. It is not just corruption, patronage politics, or electoral fraud; or smuggling, jueteng and illegal logging. It is the entire system. It is not just the high population growth. It is the whole way of life that the poor have been forced to invent in order to deal with the pressures of unmitigated want.

We have not been lacking in people who tell us that the system itself must change as a precondition for solving our most pressing problems. However, it is doubtful if such people will ever be elected into office under the existing rules of the game. Yet ironically, the three extra-constitutional episodes in the nation's recent past-martial law in 1972, Edsa I in 1986, and Edsa II in 2001-have only nurtured in our people, distrust for political upheavals. This defensive conservatism is what is propping up the dysfunctional government of Ms Arroyo.

In the presidential elections of 2004, the upper and middle classes turned a blind eye to the massive cheating and gross misuse of public funds that attended the election of Ms Arroyo. They suspended their values and lowered their ideals in the belief that the alternative to her presidency could be worse. Their fear of chaos has made them politically quiescent.

I personally do not think that anyone needs to worry about a catastrophic breakdown of public order. What I find disturbing is the corrosive mood of surrender that is spreading among our people. Many are simply giving up and moving out. How to reverse this tide of demoralization is the challenge of leadership in our time. The country awaits leaders who can still mobilize trust, and instill hope in our people by offering them a roadmap to viable social reform and a vision of a future that is worth fighting for.

To the people's rejection of politics, which rationalizes their cynicism, there is a need to contra pose a redefinition of politics in a democracy. Our hopes for a stable, orderly and peaceful society must not breed intolerance for debate and dissent. If we are to avoid the seduction of dictatorship, or the antagonistic politics of communal identities based on ethnicity and religion, we have no choice but to patiently find our way through the paradoxes of democracy.

There’s still hope for an excellent outcome in steering the country’s ship to a better place where we are now. We are at the threshold of a new beginning, where we forge ahead as a working team to sustain the early gains that our economy is affirming. With the new state, we are starting together on a refined roadmap for the Philippines, focused on the beneficial changes being wrought by the recent beginnings of a turnaround in our economy.

Finally, we need to **own our work**; for in so doing, we would always strive for seamless delivery of our talents, efforts and time as a member of a family within the Republic of the Philippines.

Resources:

Asian Development Bank (www.adb.org)
Bangko Sentral ng Pilipinas (www.bsp.gov.ph)
Bureau of Internal Revenue (www.bir.gov.ph)
Department of Finance (www.dof.gov.ph)
National Economic Development Authority (www.neda.gov.ph)
Randy David, Philippine Daily Inquirer.
Philippine Institute of Development Studies (www.pids.gov.ph)
World Bank (www.worldbank.org)