

Philippines update

Taxes are the issue, not politics

- The political sideshow in the Philippines continues, but the President is unlikely to leave office before next year.
- The real issue in the short term is the Supreme Court's decision on the EVAT after arguments were heard yesterday.
- A Supreme Court decision could take at least a month and there is no deadline. The government's contingency plans thus far do not compensate for the lost revenue under the EVAT regime.
- A big day to watch is 25 July when Congress reconvenes and the President gives her State of the Nation address.

The opposition in the Philippines staged a demonstration this week, predicting a turnout of 100,000 and raising the spectre that "People Power" would rise again to oust President Gloria Macapagal Arroyo. The fact that the turnout was again lower than expected raises the probability that Arroyo will remain in office for now.

Behind the scenes, however, the stage may have already been set for a more organised change of government to occur next year.

Arroyo's graceful exit

The local press has reported that Arroyo has agreed to consider the recommendations of "leading political parties" to shift from a presidential to a parliamentary system of government. The party in question is actually one: Lakas, the party that was led for years by former President Fidel Ramos; that is the dominant party in Congress; and that remains the main support behind Arroyo. The man who convened the meeting to put forward the parliamentary system proposal was the current speaker and leader of Lakas, Jose de Venecia.

Reading the tea leaves, the most likely outcome of the political shenanigans is this:

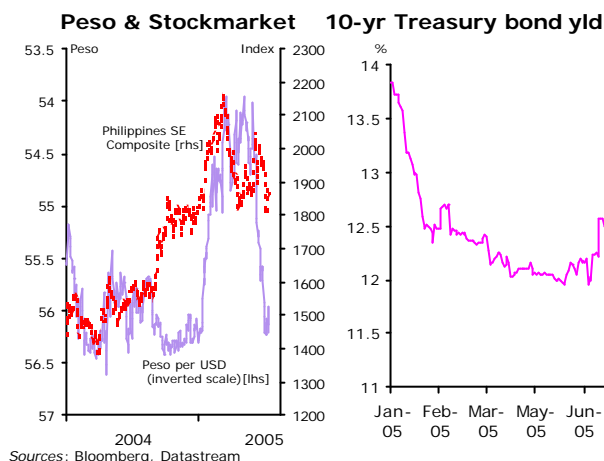
- At the upcoming State of the Nation address on 25 July, Arroyo will announce a proposal for the Congress to become a Constitutional Assembly to amend the constitution or Charter and for a commission of seven leading citizens to be convened to consider policy changes;
- The new Charter would shift the Philippines to a parliamentary form of government, to be completed by next year;
- Elections under the new system will be held in 2006; and

- Arroyo herself will not seek a seat in the new Parliament and will leave office by January 2007.

Little economic impact, except that deficit....

The peso, stock market and bond markets have barely yawned while watching this bit of theatre. This is unsurprising as the local markets are used to dealing with political uncertainty, and the economy has continued to function as though insulated from the political fires.

Chart 1: Muted response from financial markets



In fact there would be relatively little to be concerned about in the short or medium term from this period of political upheaval, were it not for the rapidly deteriorating state of public finances. That is why the truly critical event in the Philippines this month is the pending Supreme Court decision on the Extended Value Added Tax (EVAT).

The EVAT expands the tax base by eliminating existing exemptions as well as raising energy taxes and the corporate tax rate. These measures alone in 2005 are expected to raise 0.7% of GDP in revenue. A two percentage point increase in the VAT to 12% next year would raise a further 1.5% of GDP in tax revenue. The increase would help stem the slide in tax revenue, which fell to 14% of GDP in 2004 from 16% in 2000.

Table 1: Overview of public finances

	2002	2003	2004
Fiscal balance (% GDP)	-5.3	-4.6	-3.9
Gov't interest pmnts / GDP	4.7	5.3	5.4
Gov't debt / GDP	71.1	78.0	78.7
Public sector debt / GDP	123.0	130.3	137.5

Source: Bangko Sentral ng Pilipinas

Table 1 provides an overview of the deterioration in the public finances over the past few years. Although the fiscal deficit has seen a marginal improvement, interest payments are continuing to grow and are vulnerable to both ongoing rate increases by the central bank (about 40% of the debt stock is issued in pesos) and a weakening peso. The debt stock has continued to rise, albeit at a slower pace through 2004.

A Court decision to allow the EVAT to remain in place would provide some comfort that the fiscal situation will remain intact even if Congress sits on its hands during the next 12-18 months of political uncertainty. The rejection of the EVAT by the Court, on the other hand, would introduce significant uncertainty as to the amount of damage that will be done to public finances during this period and what it would take to fix it when a new government is ushered into office.

Outlook for the Court decision

Arguments heard yesterday focused on the constitutionality of presidential discretion to raise the VAT rate from 10% to 12% next year, as taxes are under the purview of Congress. Another argument focused on the power of the bicameral congressional conference committee to insert and/or delete clauses in the bill that were not part of the original House or Senate version of the bill.

As such, there may some possibility that if the Court agrees that such provisions are unconstitutional, it could strike out those particular articles and let the rest of the EVAT stand. This would be slightly positive, but would still leave the government short of the 1.5% of GDP increase in revenue that would come from the 12% VAT rate.

Technically there is no deadline for the Court to issue a decision on this matter. However, a Court spokesman said yesterday that given the importance of the decision to the economy, a decision could be issued within a month.

Will the political play reach its staged conclusion?

The fact that this week's demonstrations were largely a tempest in a teapot would seem to indicate that Ramos and his allies in Lakas have the situation firmly under control, for now. While the opposition has said it will not go along with the plan and will impeach Arroyo in Congress, the fact is that the opposition does not have sufficient support to get 1/3 (79 members) of the House to endorse impeachment articles for a vote in the Senate.

It would appear that the intention of the Lakas plan is to get Arroyo out of office while avoiding handing over the executive to Vice President Noli de Castro or former President Joseph Estrada. In that sense, from the Lakas point of view, Ramos' plan may be the best short-term solution for this rather intractable situation.

The long term implications are less certain. First, it seems rather doubtful that a parliamentary system would raise political stability in the Philippines. Parliamentary systems are defined by the fact that the executive is dependent upon the support of the legislative branch, which in the Philippines is a volatile place. Parliamentary systems are notoriously unstable in the more ethnically, religiously or geographically diverse countries where they are found – examples include India, Turkey and even Israel and Italy. The availability of a vote of no confidence is simply too great a temptation in countries where civil society does not censure its abuse by opportunistic politicians.

Second, it is worth remembering that Arroyo won the 2004 election by just over 1 million votes. It cannot be assumed that the next election will be dominated by Lakas, even without Arroyo or Estrada in the picture.

Third, the Lakos plan has already run into opposition in the Senate, which would be folded into a unicameral legislature under the parliamentary plan. Several Senators and other politicians have also expressed opposition to the seven-member policy commission as they view it as a ploy to return Ramos to the position of running the country.

Finally, this latest episode appears likely to set yet another unfortunate precedent in the Philippines for a President to be kicked out of office before the end of the term – not by popular or congressional vote, but by noise. The opportunity for the Philippines to establish itself as a stable and functioning democracy diminishes with each such episode.

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