# Chapter 6

# Assessment on the Impact of Stimulus, and Fiscal Transparency : The Philippines

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# CHAPTER 6

# Assessment of the Impact of the Fiscal Stimulus, Fiscal Risk and Fiscal Transparency: The Philippines

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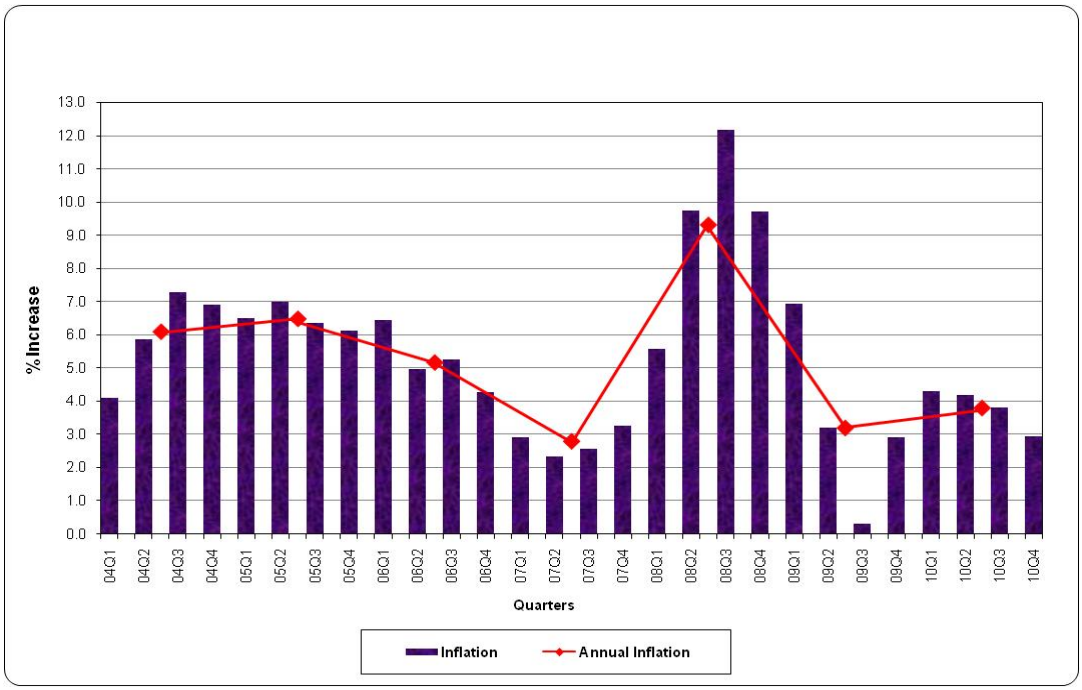
*Like many countries around the world, the Philippine government put together a fiscal stimulus package in response to the economic slowdown in its major trading partners in 2009. Prior to this, the government expanded the rice price subsidy program and launched a number of programs meant to provide temporary relief to vulnerable sectors in response to the surge in the price of food and petroleum products in 2008. This study aims (i) to assess the size and composition of the fiscal stimulus applied in 2008-2009 and its effectiveness in increasing aggregate demand, (ii) to evaluate the country's exit strategy and (iii) to identify risks to fiscal sustainability.*

*While the evidence on the relative effectiveness of expenditure expansion versus tax cuts is mixed, the overall effectiveness of the fiscal stimulus appears to be well supported by evidence. A number of fiscal risks associated with the fiscal stimulus package was noted by the paper. First, the Philippine experience validate concerns raised in the literature that tax cuts made in response to an economic slowdown tends to be permanent or are difficult to reverse. Second, while most of the spending programs included in the fiscal stimulus package are temporary in nature, the expansion of the conditional cash transfer program is not. Third, Third, even when the a country's fiscal position appears to be benign at the start of the crisis, countries with high debt-to-GDP ratio like the Philippines have very little elbow room to do countercyclical policy without running into fiscal sustainability concerns. Fourth, while the government's fiscal stance in 1998/ 1999 and 2009 is appropriately countercyclical, its fiscal stance was procyclical in about half the time in the period between 1991 and 2010. Given this perspective, there is a need to guard against procyclical policy as it tends to foster smaller than warranted fiscal balances and, consequently, higher levels of government debt over time. The lesson here is simple: fiscal prudence even during good times helps enhance the government's ability to do countercyclical fiscal policy when times are bad.*

## 1. Introduction

The Philippines was buffeted by external shocks in 2008 and 2009. Inflation surged to 9.3% in 2008 from 2.9% in 2007 largely due to the rapid rise in the price of food and petroleum products (Figure 1). Food prices dipped towards the end of the third quarter of 2008 (as indicated by the decline in the Consumer Price Index for food) but surged once again in January 2009. Thus, the increase in the price of food in the first quarter of 2009 is even higher than that in the first quarter of 2009 is even higher than that in the first quarter of 2008 and continues to be high for most of the second quarter of 2009.

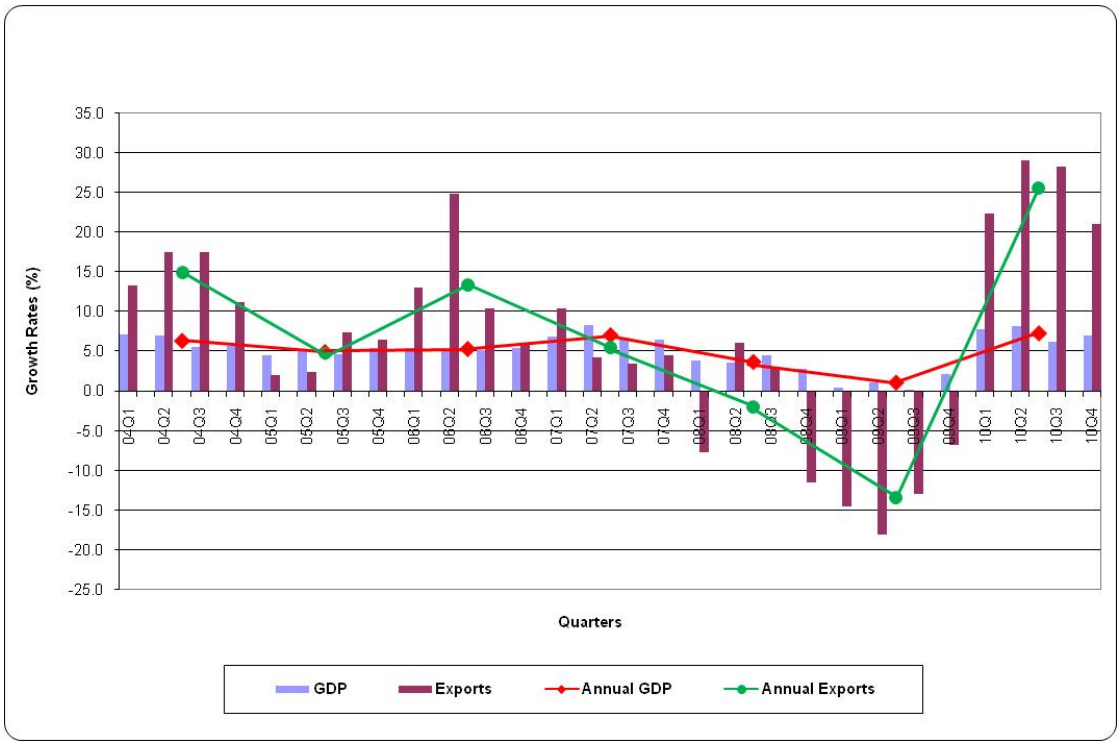
**Figure 1. Quarterly (Q-o-Q) and Annual inflation, 2004-2010**




On the other hand, the global financial and economic crisis that started with the implosion of the US housing market and the ensuing recession in key developed economies in the latter half of 2008 has had an adverse impact on the country's exports and remittances of overseas workers. In particular, Philippine exports (in constant prices) registered negative growth in the fourth quarter of 2008 and through all four quarters of 2009 (Figure 2). On the other hand, while the remittances of overseas workers continued to post positive growth in 2008 and 2009, its growth waned from 13.2% and 13.7%, respectively, in 2007 and 2008 to 5.6% in 2009. In line with these

developments, the growth of GDP in constant prices decelerated from a high of 7.1% in 2007 to 3.7% in 2008 and 1.1% in 2009 while the growth of GNP slowed down from 7.5% in 2007 to 6.4% in 2008 and 4.0% in 2009 (Table 1).

**Figure 2. Quarterly (Q-o-Q) Annual Growth Rates of GDP and Exports, 2004-2010**




On the other hand, unemployment rose from a low of 7.3% on the average in 2007 to 7.4% in 2008 and 7.5% in 2009 (Table 2). Also, while the underemployment rate dipped from 20.1% in 2007 to 19.3% in 2008 and 19.1% in 2009, the share of the visibly underemployed (i.e., those who worked less 40 hours a week) to the total number employed is higher in all rounds of the Labor Force Survey (LFS) conducted in 2008 and 2009 relative to those conducted in 2007.

**Table 1. Overseas Filipinos' Remittances (in million US dollar)**

| | Remittances | Growth rate (%) |
|---|---|---|
| **2003** | **7,578** | |
| **2004** | **8,550** | **12.8** |
| **2005** | **10,689** | **25.0** |
| **2006** | **12,761** | **19.4** |
| **2007** | **14,450** | **13.2** |
| Q1 | 3,490 | 24.0 |
| Q2 | 3,544 | 12.7 |
| Q3 | 3,443 | 9.2 |
| Q4 | 3,972 | 8.9 |
| **2008** | **16,427** | **13.7** |
| Q1 | 3,950 | 13.2 |
| Q2 | 4,291 | 21.1 |
| Q3 | 4,032 | 17.1 |
| Q4 | 4,154 | 4.6 |
| **2009** | **17,348** | **5.6** |
| Q1 | 4,057 | 2.7 |
| Q2 | 4,423 | 3.1 |
| Q3 | 4,310 | 6.9 |
| Q4 | 4,558 | 9.7 |
| **2010** | | |
| Q1 | 4,339 | 7.0 |
| Q2 | 4,723 | 6.8 |
| Q3 | 4,720 | 9.5 |

**Table 2. Unemployment and Underemployment Rate, 2005-2010**

| | Jan | April | July | Oct | Average |
|---|---|---|---|---|---|
| **Unemployment** | | | | | |
| 2005 | 7.3 | 8.3 | 7.7 | 7.4 | 7.7 |
| 2006 | 8.1 | 8.2 | 8.0 | 7.3 | 7.9 |
| 2007 | 7.8 | 7.4 | 7.8 | 6.3 | 7.3 |
| 2008 | 7.4 | 8.0 | 7.4 | 6.8 | 7.4 |
| 2009 | 7.7 | 7.5 | 7.6 | 7.1 | 7.5 |
| 2010 | 7.3 | 8.0 | 6.9 | 7.1 | 7.3 |
| **Underemployment** | | | | | |
| 2005 | 16.1 | 26.1 | 20.5 | 21.2 | 21.0 |
| 2006 | 21.3 | 25.4 | 23.5 | 20.4 | 22.7 |
| 2007 | 21.5 | 18.9 | 22.0 | 18.1 | 20.1 |
| 2008 | 18.9 | 19.8 | 21.0 | 17.5 | 19.3 |
| 2009 | 18.2 | 18.9 | 19.8 | 19.4 | 19.1 |
| 2010 | 19.7 | 17.8 | 17.9 | 19.6 | 18.8 |
| **Underemployment** | | | | | |
| 2005 | 64.5 | 54.3 | 61.4 | 58.9 | 59.7 |
| 2006 | 60.7 | 58.3 | 56.6 | 61.6 | 59.3 |
| 2007 | 57.7 | 58.26687 | 50.9 | 58.5 | 56.3 |
| 2008 | 61.2 | 57.5 | 55.8 | 61.8 | 59.1 |
| 2009 | 60.8 | 62.6 | 54.5 | 59.4 | 59.3 |
| 2010 | 57 | 58.7 | 58.1 | 55.5 | 57.3 |

*Source:* Labor Force Survey, National Statistics Office

In 2009, like many countries around the world, the Philippine government put together a fiscal stimulus package in response to the economic slowdown in its major trading partners. This study aims (i) to assess the size and composition of the fiscal stimulus applied in 2008-2009 and its effectiveness in increasing aggregate demand, (ii) to evaluate the country's exit strategy, (iii) to identify risks to fiscal sustainability, and (iv) to review fiscal transparency issues that may affect the overall assessment of the country's fiscal health.

## 2. Fiscal Performance before the Crisis

The country's overall fiscal performance registered significant gains in 2003-2007. Thus, the Philippine state of public finance at the onset of the global financial crisis was fairly good, thereby giving it some elbow room to conduct countercyclical fiscal policy.

The consolidated public sector position improved from 5.7% of GDP in 2002 to small surpluses in 2006-2007 (Figure 3). This turnaround was largely driven by the concominant improvement in national government fiscal position in 2002-2007. It was furthered reinforced by the favorable movement in the fiscal position of government-owned and controlled corporations in 2004-2007. In line with this, the outstanding debt of the consolidated public sector contracted from 117.6% of GDP in 2003 to 71.1% of GDP in 2008 (Figure 4). Thus, the state of public sector finances was fairly good at the onset of the global financial crisis, giving the government some elbow room to conduct countercyclical fiscal policy.

**Figure 3. Consolidated Public Sector Surplus/ (Deficit), 2000-2009**

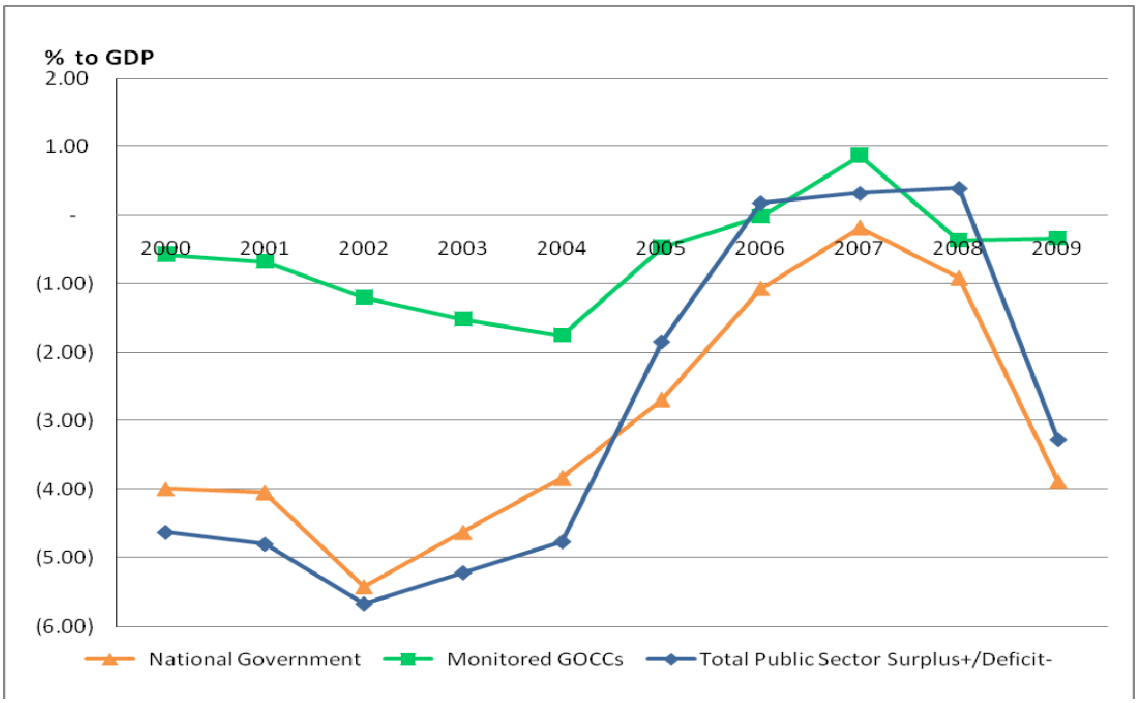
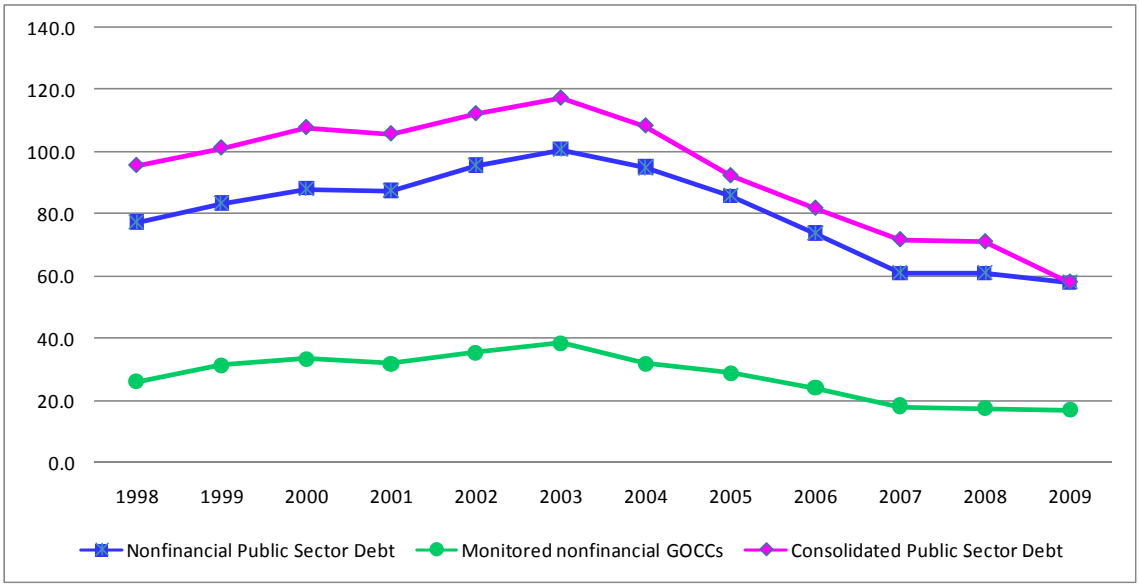



**Figure 4. Consolidated Public Sector Debt, 1998-2009**




## 2.1. Monitored Government-owned and Controlled Corporations (GOCCs)

Following the government corporate sector reform that was started in the mid-1980s, the fiscal deficit of the 14 GOCCs was less 1% of GDP for most of the 1990s. However, serious problems have re-emerged starting in the late 1990s. Thus, the

combined fiscal deficit of the monitored GOCCs surged to 1.2% of GDP in 2002 from its level (0.7% of GDP) in the previous year. Subsequently, the combined fiscal deficit of these corporations increased some more to 1.5% of GDP in 2003 and 2.1% of GDP in 2004 (Table 3).

Of the monitored GOCCs, the most notable in terms of their contribution to the deficit in 2000-2005 are: the National Power Corporation (NPC), the National Food Authority (NFA), the Light Rail Transit Authority (LRTA), the Metropolitan Waterworks and Sewerage System (MWSS), the National Irrigation Administration (NIA) and the Home Guaranty Corporation (HGC). The NPC accounted for some 52% of the total GOCC deficit in 2000-2005 while the NFA and the LRTA accounted for 15% and 10%, respectively. On the other hand, the MWSS accounted for 6% of the combined GOCC deficit in 2001-2004 while the NIA accounted for 9% in 2002-2005 (Table 3).

## Table 3. Financial Position of Monitored Government-owned and Controlled Corporations, 2000-2010 (in million pesos)

| | NPC, TRANSCO & PSALM | PNOC | MWSS | NIA | NDC | LRTA | LWUA | NEA | NHA | PNR | PPA | NFA | PEZA | HGC | TOTAL | % of GDP |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2000 | (3,421) | (7,822) | (72) | (122) | (1,708) | (2,342) | (60) | (575) | (1,054) | (304) | 926 | (1,898) | 566 | (1,274) | (19,161) | (0.6) |
| 2001 | (8,294) | (7,275) | (3,047) | 82 | (1,207) | (2,977) | (335) | (968) | (379) | (209) | 2,196 | (2,274) | (361) | (213) | (25,259) | (0.7) |
| 2002 | (21,656) | 633 | (2,630) | (2,059) | (1,078) | (5,770) | (1,006) | 163 | 234 | (176) | 1,285 | (8,086) | 220 | (6,161) | (46,085) | (1.2) |
| 2003 | (47,622) | 584 | (2,087) | (9,738) | 290 | (625) | (1,260) | (314) | (320) | (315) | 383 | (3,689) | 357 | (958) | (65,313) | (1.5) |
| 2004 | (86,556) | 1,245 | (2,544) | (3,294) | 213 | (1,730) | (1,736) | 726 | (211) | (480) | (93) | (8,112) | 153 | (1,495) | (103,914) | (2.1) |
| 2005 | (14,618) | 3,822 | 4,463 | (3,321) | (534) | (5,020) | (1,176) | 1,199 | 14 | (192) | 147 | (9,978) | (88) | (92) | (25,374) | (0.5) |
| 2006 | 6,871 | 14,416 | (1,447) | (4,247) | (219) | (1,915) | 363 | 1,592 | (902) | (185) | (331) | (16,430) | 498 | (21) | (1,955) | (0.0) |
| 2007 | 55,973 | 15,365 | 1,635 | (3,757) | 877 | (4,430) | 475 | 1,320 | 1,442 | (1,263) | (3,852) | (2,652) | 75 | (346) | 60,860 | 0.9 |
| 2008 | 28,180 | 7,001 | 786 | (3,263) | 914 | (1,748) | 1,624 | 879 | 1,061 | (122) | (1,153) | (61,277) | (17) | (24) | (27,159) | (0.4) |
| 2009 | 60,266 | 4,755 | (699) | (2) | 70 | (1,588) | (722) | (448) | (213) | (471) | 1,954 | (88,612) | 477 | (653) | (25,885) | (0.3) |
| 2010 | (10,331) | 2,508 | 384 | (5,353) | (165) | (1,429) | (570) | 566 | (1,417) | (820) | 1,439 | (43,541) | 128 | 395 | (58,206) | (0.7) |

*Note*: NPC- National Power Corporation, Transco - National Grid Corporation, PSALM - Pxx, PNOC - Philippine National Oil Corporation, NIA - National Irrigation Administration, NDC - National Development Corporation, LRTA - Light Rail Transport Authority, LWUA - Local Water Utilities Administration, NEA - National Electrification Administration, NHA - National Housing Authority, PNR - Philippine National Railroads, PPA - Philippine Ports Authority, NFA - National Food Authority, PEZA - Philippine Export Processing Zone Authority, HGC - Housing Guaranty Corporation

*Source*: Department of Finance

The problems ailing these GOCCs are common to many of them. Although generally viewed as entities that are akin to private enterprises in the sense that they produce private goods (as opposed to pure public goods), government ownership has been justified on the basis of some market failure like the presence of natural monopolies (e.g., power generation and transmission). Also, many of the GOCCs are assigned special developmental roles like the provision of public infrastructure services that the private sector may be reluctant to supply given their large investment costs and the associated uncertain and long gestation periods.

At the same time, many of these GOCCs suffer from poor cost recovery due to inadequate tariff adjustments. Political interference in tariff setting, often in response to populist clamor, prevents them from increasing their prices in response to rising costs (e.g., NPC and LRTA). In the case of other GOCCs, government's subvention policy itself dictates that the prices they charge would be lower than what the cost recovery principle calls for (e.g., the NFA, NIA since the time of the Estrada administration; MWSS does not charge for raw water but finances development of water source). Meanwhile, the large fiscal deficits of still other GOCCs are linked with the contingent liabilities they have earlier contracted (e.g., NPC, LRTA, HGC). In addition, because of the poor incentive structure in the public sector, some of these GOCCs are afflicted with a poor record in collecting fees while others are overstaffed. By and large, many of them are saddled with a large debt stock which further aggravates their already weak fiscal positions.

However, the privatization of the NPC and the MWSS in 2005/2006 greatly improved the combined fiscal position of monitored GOCCs. Thus, monitored GOCCs as a group posted a surplus in 2007.

### 2.2. National Government Fiscal Position

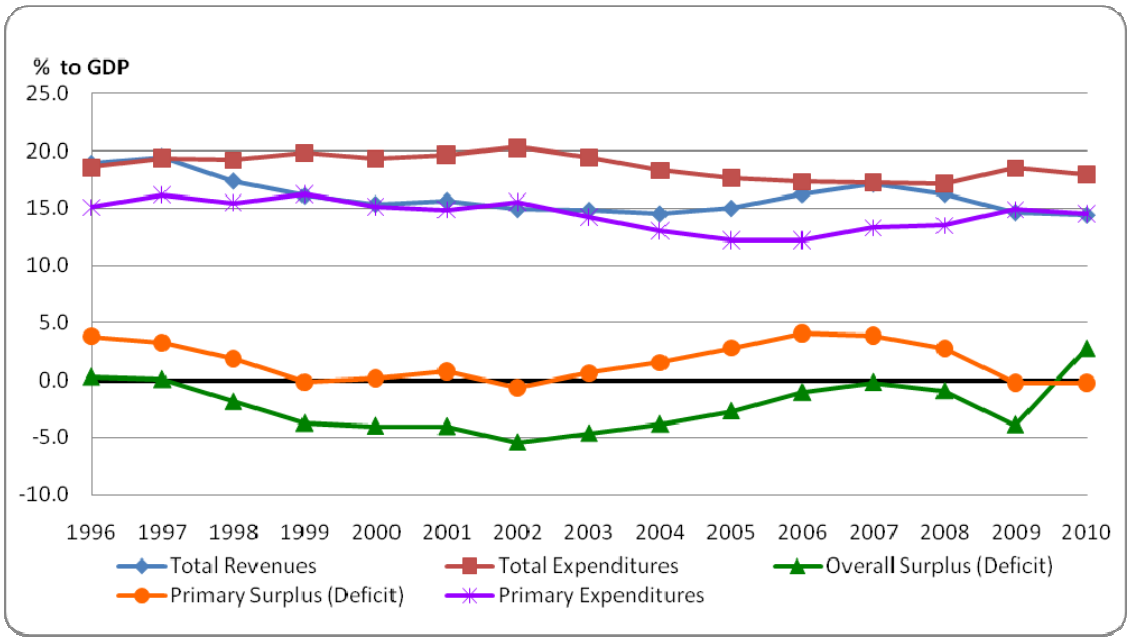
Following the Asian financial crisis of 1997/1998, the national government fiscal position deteriorated quite rapidly and continuously from a small surplus in 1997 to deficits of 1.9% of GDP in 1998, 4.0% in 2000 and 2001 and 5.4% in 2002 essentially because of a concomitant decline in the overall revenue effort of the national government (Figure 5). However, the national government successfully managed to

turn around its fiscal position from 4.6% of GDP in 2003 to 1.1% in 2006 and 0.2% in 2007. As a result of the fiscal consolidation achieved in 2002-2007, national government outstanding debt contracted from 78.2% of GDP in 2004 to 55.8% in 2007 (Figure 6). If contingent liabilities are included, national government debt went down from 95.4% of GDP in 2004 to 63.1% in 2007.

About two-thirds of the reduction in the national government fiscal deficit in 2003-2007 was due to expenditure compression as national government expenditures went down from 20.2% of GDP in 2002 to 17.3% in 2006 and 2007 (Figure 5) and national government expenditures net of interest payments contracted from 15.5% of GDP in 2002 to 12.2% in 2006. On the other hand, the other third of the reduction in the fiscal deficit in 2002-2006 was attributable to the rise in tax effort from 13.1% of GDP in 2002 to 14.3% in 2006. The increase in tax effort was due to the enactment of new tax measures in late 2004 and in the first half of 2005. Republic Act (RA) No. 9334, which amended excise tax rates on sin products was legislated in late 2004 and took effect in January 2005. Meanwhile, Republic Act No. 9337, otherwise known as the Reformed VAT Law was legislated in the first half of 2005 and took effect in the last quarter of that year. It (i) expanded the coverage of the VAT to include power and electric cooperatives, petroleum products, medical and legal services, agricultural non-food products, and works of art, (ii) converted the Philippine VAT system from a "consumption-type" VAT[1] to an "income-type" VAT[2], and (iii) provided for a temporary increase in the corporate tax rate from 32% to 35%[3] and increases in the gross receipts tax (on royalties, rentals of property, real or personal, profits from exchange and all other items treated as gross income) of banks and non-bank financial intermediaries from 5% to 7%. In addition, as provided under RA 9337, the President authorized the increase in the VAT rate from 10% to 12% in January 2006.

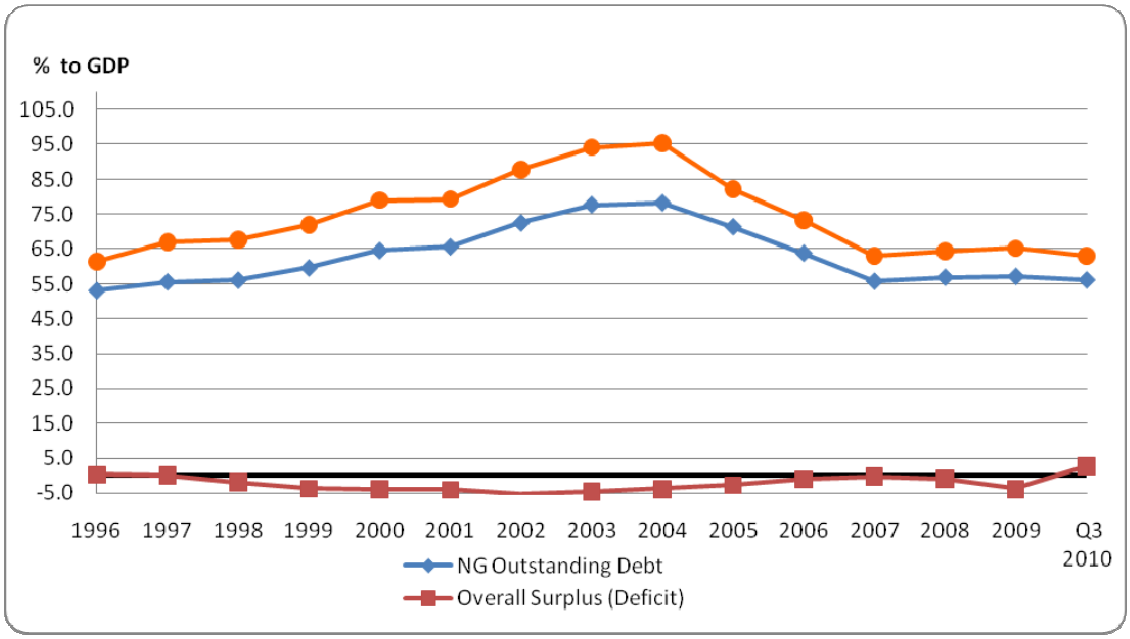
[1] A consumption-type VAT allows producers to get credit for taxes paid on their inputs including their capital goods purchases.
[2] An income-type VAT allows producers to get credit for taxes paid on all their inputs but the tax credit on capital goods purchases is limited to the depreciated part of capital only.
[3] The reformed VAT law provides that the corporate income tax rate will subsequently be reduced to 30% starting in 2009.

**Figure 5. National Government Fiscal Performance, 1996-2010**




*Source: Bureau of Treasury*

**Figure 6. NG Outstanding Debt (% to GDP), 1996-2010**




*Source: Bureau of Treasury*

However, the improvement in tax effort was very short-lived, lasting between 2004 and 2006 only. Thus, the tax-to-GDP ratio slipped from 14.3% of GDP in 2006 to 14.1% in 2008. Likewise, the total revenue effort of the national government decreased

from 16.0% in 2006 to 15.7% in 2007 and 15.8% in 2008 when privatization proceeds are netted out. Despite this, the overall fiscal balance continued to be under control in 2007-2008 largely because of the substantial reduction in interest payments in those years following the decline in national government debt in earlier years. Also, it is noteworthy that the gains made in improving the national government fiscal position has freed enough fiscal space in 2007 to allow national government primary expenditures to rise somewhat in that year (in an attempt to unwind the tight grip on expenditures in earlier years) while maintaining the overall fiscal deficit at a creditable 0.2% of GDP.

## 3. The Fiscal Stimulus Package

In response to the surge in the price of food and petroleum products in 2008, the government expanded the rice price subsidy program and launched a number of programs meant to provide temporary relief to vulnerable sectors, including the Pantawid Kuryente and the Tulong Para Kay Lolo at Lola. The Pantawid Kuryente was meant to soften the impact of the rising cost of electricity on poor households. It consists of a one-time cash grant equal to PhP 500 to lifeline electricity consumers. The Tulong Para Kay Lolo at Lola provides a one-time cash subsidy of PhP 500 to qualified senior citizens, i.e., those (i) who are at least 70 years old, (ii) who are not be covered by the SSS, GSIS or any other government retirement benefit scheme (e.g., that for the military or police) and (iii) who do not have any regular income.

In response to projected economic downturn following the contraction of exports and remittances of overseas Filipino workers, the government formulated the Economic Resiliency Plan (ERP) and announced the same in early 2009. The Plan aims (i) to ensure sustained growth and attain the higher end of the government's economic growth targets (i.e., to pursue a countercyclical policy), (ii) to save and create as many jobs as possible, (iii) to protect the most vulnerable sectors – poorest of the poor, returning overseas Filipino workers, and workers in export industries, (iv) to ensure low and stable prices, and (v) to improve competitiveness in preparation for the global rebound.

The ERP is worth PhP 330 billion, divided into PhP 160 billion of government budget interventions, PhP 40 billion of tax cuts, and PhP 130 billion of off-budget interventions (Table 4). The programs that form part of the 2009 budget interventions include labor - intensive community level infrastructure, the expansion of some social protection programs and the comprehensive livelihood and emergency employment program. The budgeted interventions stress the implementation of small quick disbursing projects that generate jobs. As such, it involved the realignment of the budget from projects that may be difficult to implement (e.g., because of right-of-way issues) to those that are fast-moving projects. As a target, the government aimed to spend at least 60% of the productive portion of the implementing agencies' budgets in the first semester of 2009. The government has had limited success in fast tracking the implementation of government infrastructure projects and, therefore, government spending. The disbursement rate for the non-mandatory portion of the budget is higher in the first half/ first three quarters of 2009 relative to that of earlier years but not as high as programmed. To wit, it is estimated that the national government disbursed 46% of the non-mandatory portion of its budget in the first half of 2009 compared to 45%, 44% and 37% in 2006, 2007 and 2008, respectively. In like manner, the national government disbursed 71% of the non-mandatory portion of its budget the first three quarters of 2009 compared to 65% in 2006 and 2007 and 63% in 2008.

**Table 4. Economic Resiliency Plan (Fiscal Stimulus Package), 2009**

| Stimulus Measures | Amount (in billion pesos) |
|---|---|
| * **2009 Budget interventions** | PhP 160 billion |
| - quick disbursing, high impact, labor intensive community level infrastructure projects like repair of roads (e.g., asphalt overlay), farm-to-market roads, communal irrigation systems, etc. | |
| - additional social protection programs<br>(i) increased allocation for conditional cash transfer program (PhP 5 B)<br>(ii) Additional national government contribution to PhilHeatlh Indigent Program (PhP 1 B)<br>(iii) Additional allocation for Scholarship Program for TechVoc training (PhP 5.7 B)<br>(iv) Additional allocation for primary and secondary hospitals (PhP 2.0 B)<br>(v) Accelerated Hunger Mitigation Program, incl. rice price subsidy program | |
| - Comprehensive Livelihood and Emergency Employment Program (CLEEP) | |
| * **Tax cuts** | |
| - Individual income tax & corporate income tax cut | PhP 40 billion |
| * **Off-budget Interventions** | |
| - additional benefits to members of PhilHealth, GSIS and SSS to be funded by these entities | PhP 30 billion |
| - Large infrastructure projects to be funded by GOCCs, GFIs and private sector | PhP 100 billion |
| **TOTAL** | PHP 330 billion |

*Source:* National Economic and Development Authority

The individual income tax was effectively reduced starting in July 2008 while the corporate income tax was cut starting in 2009. Both tax cuts are permanent in nature.

Republic Act 9504 was enacted in early 2008 in order to give some (tax) relief to minimum wage earners in response to the rapid increase in the price of food and fuel. However, it did so by increasing the amount of so-called personal exemptions for all income tax payers. The revenue loss arising from this provision is estimated to be about 0.3 percentage points of GDP per year in the initial years of implementation.

The corporate income tax rate was also reduced from 35% to 30% 2009. Unlike the reduction of the effective personal income tax rate which was made in response to the

food/ fuel price surge, the diminution in the corporate income tax rate was planned well before the onset of the global crisis as this was a provision of the reformed VAT law that was legislated in the first half of 2005. It was aimed at aligning the Philippine rate with those of its neighbors with the end in view of improving the country's global competitiveness.

The off-budget interventions under the ERP are of two kinds: (i) additional temporary benefits to members of PhilHealth, GSIS and SSS, and (ii) large infrastructure projects to be funded by the private sector under public-private-partnership-type arrangements and by government-owned and controlled corporations and government financial institutions. The additional benefits to members of social security institutions are generally in the form of calamity/ emergency loans and a moratorium on loan repayments to allow qualified borrowers to address more pressing financial concerns during or after a calamity. For instance, the GSIS implemented a one year moratorium on consolidated and housing loans starting from October 2009 and September 2010 in view of the serious damage caused by Typhoons Ondoy and Pepeng.

On the other hand, the PhP 100 billion worth of large infrastructure projects that are envisioned under the ERP are expected to arise in 2010 yet as this type of projects entail complex engineering plans and approval processes and, as such, need more time to get off the ground. To date, no major PPP projects under the ERP have been started, highlighting perhaps the inappropriateness of including such a scheme as part of a fiscal stimulus package.

The size of the fiscal stimulus as announced may not necessarily reflect the actual size of discretionary fiscal policy for a number of reasons. First, there is a tendency to include in the package items that are realigned from other expenditure items that are already budgeted prior to the announcement of the fiscal stimulus, i.e., some spending included in the stimulus package may not represent "new" spending in the real sense. Second, even if all the programs included in the fiscal stimulus package represent incremental spending, the actual additional spending from the package may be less than planned because of implementation lags.

On the other hand, the actual change in fiscal aggregates (say, national government revenues, primary expenditures or primary balance) is not a good measure of discretionary fiscal policy because the actual change in fiscal aggregates is the sum of

discretionary fiscal policy and their "automatic" response to other factors including cyclical changes in output. For instance, revenues from income taxes tend to weaken "automatically" when the economy slows down as profits of the business sector and income of households the of firms and revenues decline. On the expenditure side, unemployment benefits, when they are available, tend to rise when there is an economic downturn.

Following Fedelino *et al*. (2009), the actual primary balance may be decomposed into the cyclically adjusted primary balance (CAPB) and the cyclical primary balance (CPB).[4] That is, the CAPB is that part of the primary balance that is affected by cyclical fluctuations while the CPB is that part of the primary balance that automatically reacts to the cycle. In turn, the change in the CAPB may be used as a measure of discretionary fiscal policy.

Table 5 presents estimates of the CAPB and changes in CAPB, broken down into their revenue and expenditure component for the period 1991-2010. It indicates that discretionary fiscal policy is expansionary in 2008 (1.1% of potential GDP), 2009 (2.2% of potential GDP) and 2010 (0.4% of GDP). The size of the discretionary fiscal expansion is about 50% larger than that indicated by the actual change in the primary balance in 2008. On the other hand, it is 24% smaller than that indicated by the actual change in the primary balance in 2009. In contrast, while the change in the actual primary balance indicates a small contraction, the change in the CAPB indicates some expansion.

Table 5 also shows that the bulk of the discretionary fiscal stimulus in 2008-2010 is accounted for by incremental spending. This is very similar to the situation in 1998 and 1999. This finding may have some bearing on the effectiveness of the fiscal stimulus in

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[4] The primary balance, PB, is:

$PB = CAPB + CPB$

On the other hand, CAPB, expressed as a proportion of potential output, *capb*, is:

$capb = r\,(1+gap)^{-(\varepsilon_R - 1)} - g\,(1+gap)^{-(\varepsilon_G - 1)} \approx r\,(1-(\varepsilon_R - 1)\,gap) - g\,(1-(\varepsilon_G - 1)\,gap)$

where r and g denote ratio of revenue and expenditure to GDP,

$\varepsilon_R$ is the elasticity of revenue with respect to the output gap,

$\varepsilon_G$ is the elasticity of expenditure with respect to the output gap

$gap = (Y - Y^P) / Y^P$ ,

$Y$ is actual GDP, and

$Y^P$ is potential GDP.

influencing aggregate demand given the differences in the estimates of the tax multiplier and the spending multiplier.

## 4. Impact of the Fiscal Stimulus

In principle, the impact on aggregate demand of the fiscal stimulus measures that were put in place in response to the global financial crisis may be expressed as the weighted sum of the revenue cut and incremental government spending where the weights are the tax multiplier and the expenditure multiplier, respectively. To wit:

$$dY = M_T\, dT - M_E\, dG,$$

where $M_T$ is the tax multiplier, and

$M_E$ is the expenditure multiplier.

Estimates of the fiscal multiplier may be calculated from macroeconometric model simulations. Alternatively, fiscal multipliers may be derived from structural vector autoregression models (SVAR). The estimates of fiscal multipliers for the Philippines arising from model based simulations and SVARs are all positive in sign but they differ in size.

## Table 5. Cyclically Adjusted Primary Balance and Discretionary Fiscal Policy, 1995-2010

| 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 a/ | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1.02 | -0.29 | 0.44 | 2.37 | 0.42 | -2.75 | -2.34 | -0.68 | 0.05 | 0.24 | 0.51 | 2.58 | -1.98 | 0.72 | **output gap = $(Y - Y^P) / Y^P$ (in %)** b/ |
| 3.31 | 1.86 | -0.18 | 0.20 | 0.77 | -0.62 | 0.60 | 1.51 | 2.81 | 4.08 | 3.86 | 2.83 | -0.25 | -0.22 | **PB as % of $Y^P$** |
| 3.11 | 1.91 | -0.25 | -0.16 | 0.70 | -0.21 | 0.95 | 1.60 | 2.81 | 4.04 | 3.77 | 2.41 | 0.04 | -0.33 | **CAPB** |
| -0.16 | -0.88 | -1.98 | 0.07 | 0.85 | -0.85 | 1.14 | 0.75 | 1.36 | 1.50 | 0.10 | -1.05 | -2.18 | -0.36 | **change in CAPB; discretionary fiscal policy** |
| 2.53 | -0.12 | 0.42 | 0.81 | 1.72 | 0.74 | 1.37 | 1.15 | 1.92 | 2.68 | 2.32 | 0.58 | -0.34 | 0.76 | **Change in rev component of CAPB** c/ |
| -2.69 | -0.76 | -2.40 | -0.74 | -0.87 | -1.59 | -0.22 | -0.40 | -0.56 | -1.18 | -2.22 | -1.63 | -1.84 | -1.12 | **Change in expd component of CAPB** d/ |
| -0.14 | -1.11 | -1.86 | 0.37 | 0.58 | -1.32 | 1.16 | 0.96 | 1.46 | 1.53 | 0.15 | -0.71 | -2.86 | 0.01 | **change in primary balance as % of $Y^P$** |
| 2.56 | -0.35 | 0.54 | 1.11 | 1.46 | 0.27 | 1.39 | 1.37 | 2.01 | 2.72 | 2.37 | 0.92 | -1.02 | 1.13 | **change in actual revenue as % of $Y^P$** |
| -2.69 | -0.76 | -2.40 | -0.74 | -0.87 | -1.59 | -0.22 | -0.40 | -0.56 | -1.18 | -2.22 | -1.63 | -1.84 | -1.12 | **change in actual expd as % of $Y^P$** |
| 94.0 | 102.7 | 138.7 | -78.1 | 91.6 | 34.3 | 157.9 | 106.5 | 99.8 | 99.0 | 97.8 | 85.2 | -15.6 | 146.5 | **CAPB as % of PB** |

*Note:* a/ Author's estimate based on January-November 2010 data
b/ potential output is derived by de-trending GDP data by the Hodrick Prescott filter.
c/ negative sign indicates revenue reduction
d/ negative sign indicates increased spending

Ducanes *et al.* (2006) estimated fiscal multipliers for the Philippines based on a small macroeconometric model developed by Cagas *et al.* (2006) by simulating three types of fiscal shocks.[5] Scenario 1a (referred to as *Expenditure 1*) involved a fiscal expansion through an increase in government spending equivalent to 1% of GDP in year 1 of the simulation period, such that the allocation of spending between current and capital spending is assumed to follow that of the most recently observed period. Scenario 2a (called *Expenditure 2*) is exactly the same as *Expenditure 1* with one exception – all of the incremental spending is assumed to go to capital expenditures. Meanwhile, under Scenario 3a (referred to as *Tax*), the fiscal expansion is made through a reduction in the tax rate equivalent to 1% of GDP in year 1 of the simulation period while keeping spending fixed at the baseline level for the shock period. Ducanes *et al.* (2006) also looked at Scenario 1b, Scenario 2b and Scenario 3b which are exactly the same at that of Scenario 1a, Scenario 2a and Scenario 3a, respectively, except that the fiscal shocks equivalent to 1% of GDP are applied all throughout the simulation period of 5 years.

Their estimates of the fiscal multipliers based on these simulations are presented in Table 6. It shows that the tax multiplier is generally larger than the expenditure multiplier. Also, the expenditure multiplier is larger when the incremental spending is allocated to capital outlays only than when the incremental spending of the same size consists of a mix of current consumption and capital outlays. Even when the fiscal shock are not permanent (i.e., they occur in year 1 of the simulation period alone), the medium term multipliers are larger than the short term multipliers under the *Expenditure 2* and *Tax* scenarios. That is, their positive impact on output persists into the medium term. In contrast, the simulations also show that the multiplier under the *Expenditure 1* scenario is zero in the medium term. This means that when the incremental spending is a mix of current and capital spending the impact on output is limited in the short term only.

[5] This model is estimated using quarterly data from 1990-2004. It has 48 behavioral and technical equations, 17 identities and 81 variables. The model is divided into 8 blocks: private consumption, investment, government, trade, production, prices, monetary and labor sectors.

On the other hand, Jha *et al.* (2010) analyzed the dynamic effects of unexpected shocks in government spending and revenues on economic activity by applying a structural vector autoregression (SVAR) framework on Philippine quarterly data from 1985-2009. Their model includes 8 variables: real GDP, real government expenditure, real government revenue, interest rate (benchmark policy rate), real broad money, GDP deflator, real consumption, and real investment. While they do not provide estimates of the fiscal multiplier per se, their estimates of the impulse responses to fiscal shocks (either a positive spending shock or a tax increase) for the Philippines (Table 7) do provide some measure of the effectiveness of discretionary fiscal policy. They found that tax cuts have a significant positive impact on output in the Philippines in both the short run and long run with the long run impact being larger than the short run impact by a factor of three.[6] This result is consistent with that of Ducanes et al. (2006). On the other hand, increased government spending is shown to have a significant positive impact on output in the short term but not in the long term. Again, this result validates the finding of Ducanes *et al.* (2006) under the *Expenditure 1* scenario.

[6] Short run is defined as four quarters while the long run response is calculated as the sum of the coefficients of the lagged variables in the VAR.

**Table 6. Fiscal Multipliers from Ducanes *et al*. (2006) Macroeconometric Model Simulations**

| **Fiscal shock equivalent to 1% of GDP in year of simulation period** | |
|---|---|
| Short term multiplier a/ | 0.27 |
| Expenditure 1 | 0.74 |
| Expenditure 2 | 0.03 |
| Tax | |
| *Medium term multiplier b/* | |
| Expenditure 1 | 0.00 |
| Expenditure 2 | 1.36 |
| Tax | 0.09 |
| **Fiscal shock equivalent to 1% of GDP all throughout the 4-year simulation period** | |
| Short term multiplier a/ | |
| Expenditure 1 | 0.27 |
| Expenditure 2 | 0.74 |
| Tax | 0.03 |
| Medium term multiplier b/ | |
| Expenditure 1 | 0.55 |
| Expenditure 2 | 4.47 |
| Tax | 0.27 |

*Note*: a/ multiplier applicable to first 2 years of simulation period
b/ multiplier applicable to last 3 years of simulation period
*Source*: Ducanes *et al*. 2006

**Table 7. Impulse Responses to Fiscal Shocks**

| **Positive tax revenue shock** | **Short run** | **Long run** |
|---|---|---|
| real GDP | -0.0119 * | -0.0309 * |
| Govt expenditure | -0.0119 | -0.0243 |
| Govt revenue | 0.0345 * | 0.1081 * |
| Interest rate | 0.0008 | 0.0258 * |
| GDP deflator | -0.0025 | -0.0859 * |
| Real money | -0.0010 | 0.1164 * |
| Private consumption | -0.0021 | -0.0088 |
| Fixed investment | -0.0453 * | 0.0682 * |
| **Positive expenditure shock** | | |
| real GDP | 0.0053 * | -0.0113 |
| Govt expenditure | 0.0709 * | 0.1104* |
| Govt revenue | -0.0110 | -0.0600 |
| Interest rate | -0.0003 | -0.0095 |
| GDP deflator | -0.0046 | -0.0727 |
| Real money | 0.0072 | -0.0019 |
| Private consumption | -0.0002 | -0.0140 * |
| Fixed investment | 0.0274 * | 0.0743 * |

Note: * indicates the impact being significantly different from zero (both upper 84th percentile and lower 16th percentile bands are significantly different from zero line)

The indicators of the effectiveness of discretionary fiscal policy derived from the macroeconometric model simulations and those from the SVAR analysis are different on one major point, however. The fiscal multiplier for spending calculated from the macro model is larger than that for the tax cut by a factor of 9 in line with a priori expectation based on the textbook Keynesian model. In contrast, the impulse response of output to a tax cut is larger than the impulse response to a spending increase by a factor of 2.

Recall that close to 60% of the fiscal policy response to the global financial crisis came from incremental spending. While such an allocation appears to be appropriate based on the macro model simulations, it does not appear to be so based on the SVAR results.

Setting aside for the moment, the caveats about the indicators of the effectiveness of fiscal shocks in affecting aggregate demand that are discussed above , we decomposed the growth in GDP in 2007-2010 (Table 8). Table 8 indicates that indeed the fiscal stimulus package was effective in counteracting the decline in net exports and private sector investments during the economic downturn. It also shows the major drivers of

the growth in GDP in 2009 are personal consumption expenditures, government consumption and government construction. In contrast, the major contributors to the record growth in GDP in 2010 are personal consumption, capital formation (largely attributable to private sector investment) and net exports. It, thus, appears that the tax cuts might have worked its way largely through increased household consumption in 2009 rather than through the private sector investment channel while the opposite is true in 2010.

**Table 8. Contribution to GDP growth, (% share), 2007-2010**

| | PCE | GC | CF | o/w: GCons | PrCons | X | M |
|---|---|---|---|---|---|---|---|
| **2007** | 64.6 | 6.2 | 30.6 | 11.3 | 8.4 | 38.9 | -29.9 |
| **2008** | 97.9 | 0.8 | 11.4 | -1.2 | 10.6 | -26.4 | 10.1 |
| **2009** | 300.0 | 66.2 | -97.9 | 71.0 | -12.9 | -592.5 | -81.4 |
| **2010** | 58.4 | 2.6 | 39.3 | 2.1 | 12.3 | 140.2 | 122.5 |

PCE - personal consumption expenditures; GC- government consumption, CF - capital formation
GCons - government construction, PrCons, X- exports, M- imports
*Source of basic data:* National Statisical Coordination Board

## 5. The Exit Strategy, Fiscal Risks and Fiscal Sustainability

The government's exit strategy is clearly laid out in the Economic Resiliency Plan. The ERP specifically states that the budgeted interventions are included in the 2009 budget only. Table 5, however, indicates that discretionary fiscal policy continued to be expansionary in 2010 even if potential output is well above actual output, thereby indicating the appropriateness of a more restrained fiscal stance instead.

It appears that the government started to withdraw the fiscal stimulus in the third quarter of 2010. In particular, non-interest expenditures of the national government started to decline and its primary fiscal balance started to improve in the third quarter of 2010 (Table 9). On the other hand, the decline in real government consumption and real government construction is evident in the third and fourth quarter of 2010 (Figure 7). It is not clear whether the higher than programmed spending in the first two quarters of 2010 is election driven or stimulus driven. The frontloading of government spending is even more evident in 2010 than in 2009. Since the overall fiscal deficit target is even

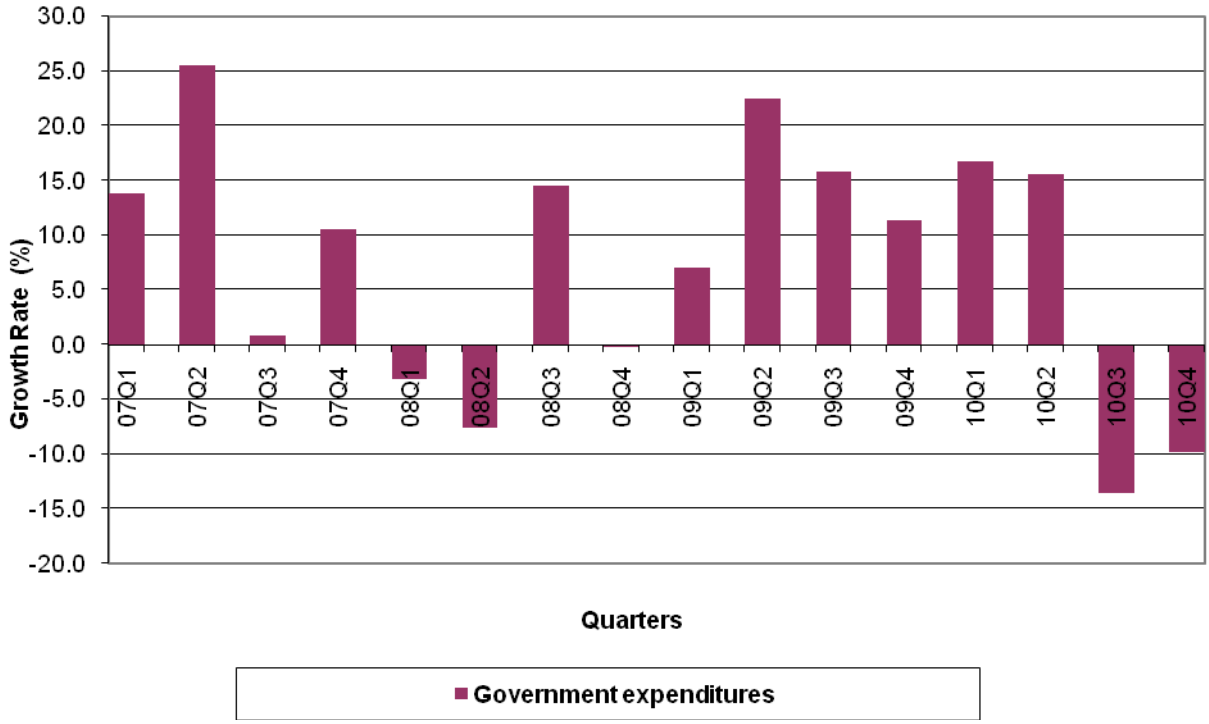
lower than programmed in 2010, it appears that the new administration applied the brakes on government spending in the last half of 2010 to compensate for the fast tracking of government spending in the first half of the year.

**Table 9. National government fiscal aggregates (% of GDP), Q1 2004 - Q4 2010**

| | Total revenues | Tax revenues | Non-tax revenues | Primary expd | Interest payments | Primary deficit | Overall deficit |
|---|---|---|---|---|---|---|---|
| **2004** | **14.4** | **12.3** | **2.1** | **12.8** | **5.4** | **1.5** | **-3.8** |
| Q1 | 13.8 | 11.7 | 2.0 | 14.4 | 6.0 | -0.6 | -6.7 |
| Q2 | 16.3 | 14.0 | 2.3 | 13.6 | 4.6 | 2.6 | -2.0 |
| Q3 | 14.4 | 12.3 | 2.1 | 13.1 | 6.5 | 1.4 | -5.2 |
| Q4 | 13.2 | 11.2 | 2.0 | 12.0 | 4.4 | 1.2 | -3.2 |
| **2005** | **15.0** | **13.0** | **2.0** | **11.8** | **5.5** | **3.2** | **-2.3** |
| Q1 | 13.9 | 11.6 | 2.3 | 12.1 | 6.9 | 1.8 | -5.1 |
| Q2 | 16.2 | 14.4 | 1.8 | 12.1 | 4.4 | 4.1 | -0.3 |
| Q3 | 15.4 | 12.7 | 2.6 | 11.5 | 6.9 | 3.8 | -3.1 |
| Q4 | 14.6 | 13.0 | 1.6 | 11.5 | 4.1 | 3.1 | -1.1 |
| **2006** | **16.2** | **14.3** | **2.0** | **12.2** | **5.1** | **4.1** | **-1.1** |
| Q1 | 14.8 | 12.9 | 1.8 | 12.2 | 7.5 | 2.6 | -4.9 |
| Q2 | 18.3 | 16.4 | 1.9 | 12.2 | 3.6 | 6.1 | 2.5 |
| Q3 | 16.6 | 14.6 | 1.9 | 11.2 | 6.6 | 5.3 | -1.3 |
| Q4 | 15.4 | 13.2 | 2.2 | 13.0 | 3.2 | 2.4 | -0.8 |
| **2007** | **17.1** | **14.0** | **3.1** | **13.3** | **4.0** | **3.8** | **-0.2** |
| Q1 | 15.6 | 12.2 | 3.4 | 13.1 | 5.9 | 2.4 | -3.4 |
| Q2 | 16.9 | 15.2 | 1.6 | 13.7 | 2.5 | 3.2 | 0.7 |
| Q3 | 18.8 | 15.6 | 3.2 | 12.9 | 5.8 | 5.8 | 0.1 |
| Q4 | 17.1 | 13.2 | 3.9 | 13.2 | 2.4 | 3.8 | 1.5 |
| **2008** | **16.2** | **14.2** | **2.1** | **13.5** | **3.7** | **2.8** | **-0.9** |
| Q1 | 15.3 | 13.1 | 2.1 | 12.4 | 6.0 | 2.9 | -3.1 |
| Q2 | 17.4 | 16.2 | 1.2 | 13.3 | 2.2 | 4.1 | 1.8 |
| Q3 | 16.7 | 15.0 | 1.8 | 13.6 | 5.1 | 3.2 | -1.9 |
| Q4 | 15.6 | 12.5 | 3.0 | 14.5 | 1.8 | 1.1 | -0.7 |
| **2009** | **14.6** | **12.8** | **1.8** | **14.9** | **3.6** | **-0.3** | **-3.9** |
| Q1 | 13.6 | 11.6 | 2.0 | 14.3 | 6.1 | -0.8 | -6.9 |
| Q2 | 16.7 | 15.4 | 1.3 | 16.4 | 2.1 | 0.2 | -1.8 |
| Q3 | 15.7 | 13.1 | 2.6 | 15.4 | 4.8 | 0.3 | -4.5 |
| Q4 | 12.8 | 11.3 | 1.5 | 13.6 | 2.0 | -0.8 | -2.8 |
| **2010** | **14.2** | **12.8** | **1.3** | **14.4** | **3.5** | **-0.2** | **-3.7** |
| Q1 | 13.7 | 12.2 | 1.5 | 15.0 | 5.6 | -1.3 | -6.9 |
| Q2 | 15.6 | 14.5 | 1.1 | 16.8 | 1.8 | -1.2 | -3.0 |
| Q3 | 14.8 | 13.1 | 1.7 | 13.1 | 4.8 | 1.7 | -3.1 |
| Q4 | 12.9 | 11.8 | 1.1 | 13.1 | 2.0 | -0.2 | -2.2 |

*Source of basic data*: Cash Operations Report, Bureau of Treasury

**Figure 7. Quarterly (q-o-q) and Annual Growth Rates of the Sum of Government Consumption and Government Capital Expenditures, 2004-2010**




## 5.1. The national government's fiscal position in 2009 and 2010

Primary expenditures of the national government expanded from 13.3% of GDP in 2007 to 13.5% in 2008 and 14.9% of GDP in 2009 on account of the expansionary fiscal stance that government took in response to the 2008 global financial and economic crisis (Table 9). On the other hand, total revenues of the national government contracted from 17.1% of GDP in 2007 to 16.2% in 2008 and 14.6% of GDP in 2009, largely due to the decline in the tax-to-GDP ratio. Consequently, the fiscal deficit surged from 0.2% of GDP in 2007 and 0.9% in 2008 to 3.9% in 2009.

Even more worrisome, the national government incurred a small primary deficit in 2009, for the first time since 1999. As a result, outstanding debt of the national government started to rise again from 55.8% of GDP in 2007 to 57.0% in 2009 and 57.2% of GDP in 2009 (Figure 6). If contingent liabilities were included, total

outstanding debt went up from 63.1% of GDP in 2007 to 65.2% in 2009. Both these developments raise serious fiscal sustainability concerns moving forward.

Moreover, the primary deficit of the national government remained in negative territory (Table 9) as the national government's fiscal stance continued to be expansionary in 2010 (Table 5). This means that the national government has to borrow just to pay for interest on existing loans in 2009 and 2010.

### 5.2. Fiscal risks

First, the Philippine experience validate concerns raised in the literature that tax cuts made in response to an economic slowdown tends to be permanent or are difficult to reverse. This is true of the reduction in the corporate income tax rate as well as the increase in personal exemptions under the individual income tax that were implemented as part of the Economic Resiliency Plan. These tax cuts are particularly problematic in the Philippine context where the tax-to-GDP ratio registered a well-defined downtrend for most of the period 1998-2010. Such lackluster tax performance has been attributed to poor tax administration and problems in the tax structure.

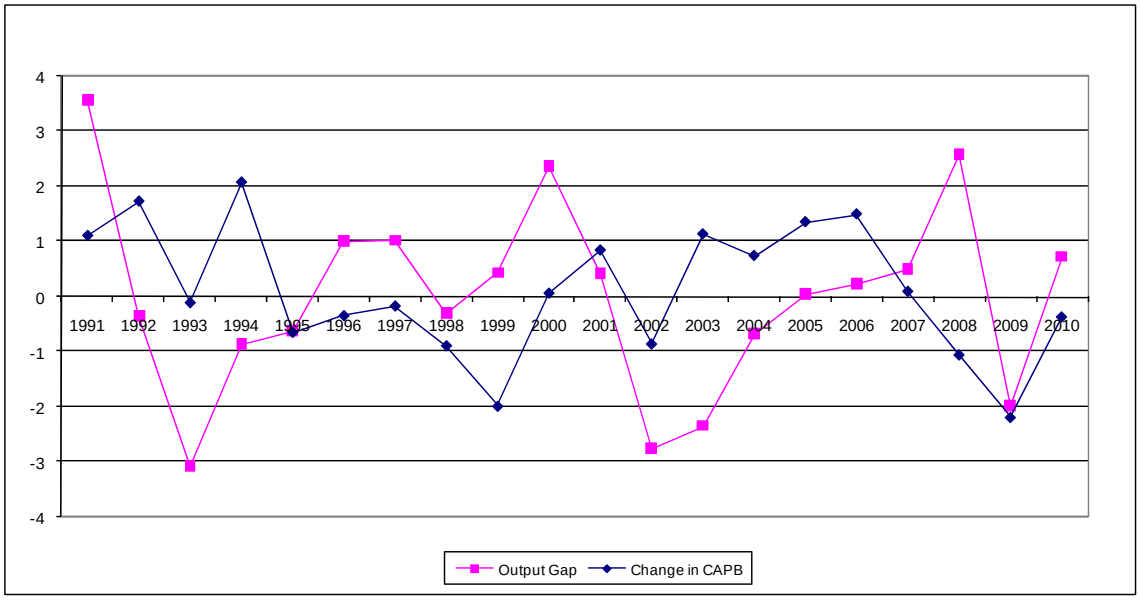
Second, while most of the spending programs included in the fiscal stimulus package are temporary in nature, the expansion of the conditional cash transfer program is not. The conditional cash transfer program has been proven to be an effective social protection program in many countries and is, thus, a desirable program from an equity perspective. However, to be effective, the implementation of the conditional cash transfer program has to be sustained on at least a medium term basis. Thus, its inclusion in the fiscal stimulus package and the timing of its expansion in 2009 appears to be out of sync with the many as yet unresolved financing issues then. More recently, however, this issue was addressed when the government decided to reduce the funding of other programs like the Food-for-School Program that overlap with the conditional cash transfer program in terms of objectives and target beneficiaries and which are apparently inferior to the latter (Manasan 2009).

Third, even when the a country's fiscal position appears to be benign at the start of the crisis, countries with high debt-to-GDP ratio like the Philippines have very little elbow room to do countercyclical policy without running into fiscal sustainability concerns. The Philippines fiscal stimulus package, modest as it is by international

standards, led to a primary deficit and an increase in the debt ratio in the first year of its implementation. Thus, there is a need for the Philippines to further reduce its debt ratio so as to improve its fiscal sustainability.

Fourth, while the government's fiscal stance in 1998/ 1999 and 2009 is appropriately countercyclical, its fiscal stance was procyclical in about half the time in the period between 1991 and 2010 (**Figure 8**). As noted earlier, its fiscal stance is expansionary in 2010 despite record high GDP growth in that year. Given this perspective, there is a need to guard against procyclical policy as it tends to foster smaller than warranted fiscal balances and, consequently, higher levels of government debt over time. The lesson here is simple: fiscal prudence even during good times helps enhance the government's ability to do countercyclical fiscal policy when times are bad.

**Figure 8. Change in CAPB and Output Gap (as % of GDP), 1991-2010**




## 5.3. Going back to basics

The last row of Table 5 indicates movements in the actual primary balance are largely driven by movements in the structural primary balance (or the cyclically adjusted primary balance). Given this perspective, it is imperative that the government sticks to unwinding the fiscal stimulus as it has started to do and to go back to the basics by addressing the structural problems in its fiscal position so that it is able to achieve fiscal consolidation on a more sustainable basis.

On the one hand, the Philippine revenue effort net of privatization proceeds exhibited a clear downward trend all throughout 1997-2010 with the exception of a brief period in 2005-2008. On the other hand, although there is some slight upward movement in primary national government spending in 2007-2010, the improvement is not enough to fully reverse the persistent and worsening compression of primary national government spending is evident in 1997-2006. The contraction is particularly marked for national government spending on education, health and infrastructure is marked in 1997-2007 (Table 10).

Prospectively, such a compression of national government spending to address the fiscal imbalance does not appear to be consistent with the government's avowed commitment to achieving the Millennium Development Goals (MDGs) and inclusive growth. Underspending on basic social services and infrastructure and the concomitant service deficit in these sectors in earlier years has put at risk the country's attainment of the MDGs (Manasan 2010). On the other hand, the lack and poor quality of infrastructure, particularly in the roads/ transport and power sectors, holds back economic growth which has been found to be an important determinant of poverty reduction. The infrastructure shortage also contributes to unequal access to basic social services which then diminish their ability to benefit more fully from economic growth.

The fiscal sustainability analysis[7] that was undertaken as part of this study suggests that national government revenues need to increase from 14.5% of GDP in 2009-2010 to 17.4% - 17.9% in 2012-2016 if fiscal consolidation[8] were to be achieved while providing adequate budgetary support for the much needed basic social services and infrastructure that are necessary for inclusive growth and the achievement of the MDGs[9]

[7] In the conduct of debt sustainability analysis, it is assumed that:

- GDP will grow by 5.5% in 2011, and 4.5% in 2012-2016
- Inflation will be 3.5% in 2011-2016
- Overall interest rate on national government debt is assumed to be 6.6% in 2012-2016, same as in 2010
- Peso-dollar exchange rate will rise from PhP 46.5 in 2010 to PhP 47.5 in 2016.

[8] It is assumed that the overall fiscal deficit will go down from 3.6% of GDP in 2010 to 3.1% in 2011, 2.5% in 2012, 2.0% in 2013, 1.5% in 2014, 1.0% in 2015 and 0.5% in 2016. These figures are extrapolated from the Aquino administration's stated goal of reducing the fiscal deficit to 2.0% by 2013.

[9] The estimates of the budgetary requirement of achieving the MDGs are from Manasan (2010). The same study also argues that even with greater private sector participation in the financing, construction and operation of various infrastructure projects through public-private partnership

– Scenario 1 (Table 11). Otherwise, if revenue effort remains lackluster and if interest rates are fixed at the low level prevailing in 2010, then the fiscal deficit will rise from 3.6% of GDP in 2010 and 3.5% in 2011 to 5.0% - 3.1% in 2012- 2016 – Scenario 2 (Table 12). As a result, outstanding debt stock of the national government will not post any reduction during the period under study but will hover around 56% of GDP.

(PPP) schemes as envisioned by the Aquino administration, the national government still needs to spend at least 2.5% of GDP on the infrastructure sectors yearly in 2012-2016. For instance, the investment requirement of the national roads sub-sector alone is estimated to be equal to 2.0% yearly (Encarnacion 2009). Moreover, the share of PPPs in the financing of investments in the national road sub-sector has been limited in the last decade.

## Table 10. National Government Expenditures (Obligation Basis) as a Percent of GDP, 1995-2011

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 prelim | 2011 proposed |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total NG expenditures | 19.5 | 19.2 | 20.3 | 20.2 | 19.5 | 20.3 | 19.5 | 19.1 | 19.1 | 17.8 | 17.4 | 17.3 | 17.4 | 17.7 | 18.7 | 18.1 | 17.8 |
| Total economic services | 4.4 | 3.9 | 4.5 | 3.8 | 3.6 | 3.8 | 3.2 | 2.6 | 2.7 | 2.5 | 2.2 | 2.7 | 3.4 | 3.8 | 4.0 | 3.0 | 2.4 |
| of w/c infrastructure | 2.7 | 2.2 | 2.5 | 2.4 | 2.3 | 2.4 | 2.0 | 1.5 | 1.6 | 1.6 | 1.2 | 1.7 | 2.1 | 2.2 | 2.6 | 1.9 | 1.6 |
| Social services | 4.4 | 4.9 | 5.4 | 5.5 | 5.2 | 5.0 | 4.5 | 4.4 | 3.9 | 3.5 | 3.2 | 3.2 | 3.4 | 3.4 | 3.6 | 3.9 | 4.2 |
| of which: | | | | | | | | | | | | | | | | | |
| Education | 3.2 | 3.4 | 3.9 | 4.0 | 3.7 | 3.5 | 3.4 | 3.3 | 3.1 | 2.7 | 2.5 | 2.5 | 2.6 | 2.5 | 2.8 | 3.0 | 3.1 |
| of w/c DepEd | 2.7 | 2.8 | 3.2 | 3.2 | 3.0 | 2.9 | 2.8 | 2.7 | 2.5 | 2.2 | 2.0 | 2.0 | 2.2 | 2.1 | 2.3 | 2.5 | 2.7 |
| Health | 0.4 | 0.5 | 0.6 | 0.5 | 0.5 | 0.4 | 0.4 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.5 | 0.4 |
| of w/c DOH | 0.4 | 0.4 | 0.5 | 0.4 | 0.4 | 0.3 | 0.3 | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 | 0.4 |
| National defense | 1.3 | 1.2 | 1.2 | 1.2 | 1.1 | 1.1 | 1.0 | 1.0 | 1.3 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 | 1.2 |
| Public administration | 1.5 | 1.6 | 1.6 | 1.6 | 1.2 | 1.3 | 1.3 | 1.2 | 1.1 | 1.0 | 1.3 | 1.1 | 1.2 | 1.4 | 1.4 | 1.2 | 0.9 |
| Peace & order | 1.2 | 1.3 | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 | 1.3 | 1.2 | 1.3 | 1.3 | 1.3 | 1.4 | 1.4 | 1.4 |
| Debt service | 3.8 | 3.5 | 3.2 | 3.7 | 3.6 | 4.2 | 4.8 | 4.8 | 5.2 | 5.4 | 5.5 | 5.1 | 4.0 | 3.7 | 3.6 | 3.2 | 3.9 |
| Others | 2.9 | 2.7 | 2.9 | 3.0 | 3.4 | 3.6 | 3.3 | 3.6 | 3.5 | 3.0 | 2.9 | 2.8 | 3.0 | 3.1 | 3.4 | 4.1 | 3.9 |
| Total NG expd net of debt service | 15.7 | 15.6 | 17.1 | 16.4 | 15.9 | 16.1 | 14.7 | 14.3 | 13.9 | 12.4 | 11.9 | 12.2 | 13.4 | 14.1 | 15.0 | 14.8 | 13.9 |

*Note*: Author's estimates based on data from the BESF (various years)

## Table 11. Debt Sustainability Simulation: Scenario 1

| | 2007 actual | 2008 actual | 2009 actual | 2010 prelim | 2011 projected | 2012 projected | 2013 projected | 2014 projected | 2015 projected | 2016 projected |
|---|---|---|---|---|---|---|---|---|---|---|
| **Assume:** | | | | | | | | | | |
| Non-interest expd (in million pesos)[a/] | 891,201 | 998,804 | 1,142,877 | 1,237,806 | 1,363,933 | 1,670,428 | 1,756,031 | 1,872,177 | 1,999,114 | 2,134,881 |
| % to GDP | 13.4 | 13.5 | 14.9 | 14.5 | 14.7 | 16.6 | 16.1 | 15.9 | 15.7 | 15.5 |
| Fiscal deficit (in million pesos) | 12,441 | 68,117 | 298,532 | 310,400 | 290,000 | 251,347 | 217,481 | 176,416 | 127,205 | 68,791 |
| % to GDP | 0.2 | 0.9 | 3.9 | 3.6 | 3.1 | 2.5 | 2.0 | 1.5 | 1.0 | 0.5 |
| **Implied NG total revenues:** | | | | | | | | | | |
| NG total revenues (in million pesos) | 1,136,560 | 1,202,905 | 1,123,211 | 1,219,000 | 1,410,000 | 1,756,698 | 1,893,957 | 2,066,742 | 2,255,773 | 2,459,596 |
| % to GDP | 17.1 | 16.2 | 14.6 | 14.3 | 15.2 | 17.5 | 17.4 | 17.6 | 17.7 | 17.9 |
| NG outstanding debt (in million pesos) | 3,712,487 | 4,220,903 | 4,396,640 | 4,784,327 | 5,090,585 | 5,358,792 | 5,593,649 | 5,787,885 | 5,933,266 | 6,020,489 |
| % to GDP | 55.8 | 57.0 | 57.3 | 56.2 | 54.8 | 53.3 | 51.4 | 49.2 | 46.6 | 43.8 |

*Note*: a/ assumes non-interest spending is enough to meet address the MDGs for education and health plus infrastructure outlays equal to 2% of GDP in 2012 and 2.5% in 2013-2016

## Table 12. Debt Sustainability Simulation: Scenario 2

| | 2007 actual | 2008 actual | 2009 actual | 2010 prelim | 2011 projected | 2012 projected | 2013 projected | 2014 projected | 2015 projected | 2016 projected |
|---|---|---|---|---|---|---|---|---|---|---|
| **Assume:** | | | | | | | | | | |
| NG total revenues (in million pesos) | 1,136,560 | 1,202,905 | 1,123,211 | 1,219,000 | 1,378,277 | 1,510,818 | 1,655,811 | 1,814,406 | 1,987,857 | 2,177,533 |
| % to GDP | 17.1 | 16.2 | 14.6 | 14.3 | 14.8 | 15.0 | 15.2 | 15.4 | 15.6 | 15.8 |
| Non-interest expd (in million pesos) [a/] | 891,201 | 998,804 | 1,142,877 | 1,237,806 | 1,363,933 | 1,670,428 | 1,756,031 | 1,872,177 | 1,999,114 | 2,134,881 |
| % to GDP | 13.4 | 13.5 | 14.9 | 14.5 | 14.7 | 16.6 | 16.1 | 15.9 | 15.7 | 15.5 |
| **Implied fiscal deficit & NG outstanding debt:** | | | | | | | | | | |
| Fiscal deficit (in million pesos) | 12,441 | 68,117 | 298,532 | 310,400 | 321,723 | 499,331 | 474,181 | 464,371 | 449,909 | 427,156 |
| % to GDP | 0.2 | 0.9 | 3.9 | 3.6 | 3.5 | 5.0 | 4.4 | 3.9 | 3.5 | 3.1 |
| NG outstanding debt (in million pesos) | 3,712,487 | 4,220,903 | 4,396,640 | 4,784,327 | 5,122,308 | 5,638,564 | 6,130,697 | 6,613,986 | 7,083,754 | 7,531,671 |
| % to GDP | 55.8 | 57.0 | 57.3 | 56.2 | 55.1 | 56.1 | 56.4 | 56.2 | 55.7 | 54.7 |
| Interest payments (in million pesos) | 257,800 | 272,218 | 278,866 | 291,594 | 336,067 | 339,722 | 373,961 | 406,600 | 438,653 | 469,809 |
| % to GDP | 3.9 | 3.7 | 3.6 | 3.4 | 3.6 | 3.4 | 3.4 | 3.5 | 3.4 | 3.4 |

*Note*: a/ assumes non-interest expd enough to meet address the MDGs for education and health plus infra outlays equal to 2% of GDP in 2012 and 2.5% in 2013-2016

However, if revenue effort shows only minimal improvements yearly and if the interest rate rises to the higher level prevailing in 2003, the fiscal deficit will rise from 3.6% of GDP in 2010 to 5.7% - 4.3% in 2012-2016 while debt-to-GDP ratio will 54% of GDP in 2011 to 58% in 2016 (see last two rows of Table 12). This last point underscores another important source of fiscal risk. It should be emphasized that at present the fiscal correction is made easier by the well defined downward movement in domestic interest rates since 2008 (Table 13). Likewise, the spreads on Philippine debt paper has fallen from the peak of over 500 basis points in December 2008 to 200 basis points in December 2009 and 159 basis points in December 2010 (Figure 8).

Thus, there is an urgent need to increase national government revenues so that the fiscal imbalance is corrected while providing the fiscal space for the much needed basic social services and infrastructure that are critical for economic growth and poverty reduction. The Aquino administration has repeatedly said that the much needed revenue increases will be derived solely from improvements in tax administration rather than from the imposition of new taxes or increases in the rate of imposition of existing taxes. This emphasis on plugging the leakages in tax collection is well placed. The tax gap (or the difference between potential revenue and actual collections) from the VAT and the individual income tax on non-wage income alone is estimated to exceed 4% of GDP in 2007-2009 (Table 14).[10]

On the average, only 36% and 86% of potential revenues from the VAT and the individual income tax on non-wage income earners, respectively, are actually collected in 2004-2009. Moreover, Table 14 also shows that tax evasion tends to make the tax system inequitable. To wit, the average effective individual income tax rate on wage earners (4.9%) is 7 times that on non-wage income earners (0.7%) in 2009.

[10] The tax gap is estimated as the difference between potential tax revenue and actual tax revenue. Potential tax VAT revenue is estimated using a VAT simulation model with 56 sectors that corresponds to the finer sectoral disaggregation found in the Philippine National Income Accounts. This model makes use of the most recent Input-Output Tables to derive parameters VAT-able input ratios in both VAT-able and VAT-exempt sectors. On the other hand, potential revenue from the individual income tax on non-wage income is estimated by applying the effective individual income tax rate on wage income to the net operating surplus of the household sector as measured in the National Income Accounts.

**Table 13. Key Interest Rates (%), 2004- 2010 a/**

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|
| Reverse repurchase rate (policy rate) | | | | | | | |
| Overnight term | 6.75 | 7.04 | 7.50 | 6.77 | 5.44 | 4.39 | 4.14 |
| | 6.84 | 7.07 | 7.59 | 7.19 | 5.70 | 4.45 | 4.34 |
| Treasury bill rates | | | | | | | |
| 91 - Day | 7.34 | 6.36 | 5.35 | 3.41 | 5.39 | 4.19 | 4.06 |
| 182 - Day | 8.32 | 7.67 | 6.15 | 4.18 | 6.19 | 4.40 | 4.26 |
| 364 - Day | 9.22 | 8.68 | 6.96 | 4.92 | 6.49 | 4.59 | 4.53 |
| All Maturities | 8.13 | 7.53 | 6.20 | 4.21 | 6.36 | 4.46 | 4.35 |

*Note:*a/ weighted averages in percent per annum

*Source:* Bangko Sentral ng Pilipinas

**Table 14. Tax Gap for Selected Taxes, 2004-2009**

| | **2004** | **2005** | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|---|---|
| VAT (in billion pesos) | 63.2 | 93.6 | 125.0 | 160.8 | 192.0 | 199.3 |
| % of potential revenue | 31.2 | 37.4 | 32.5 | 37.0 | 39.3 | 39.7 |
| % of GDP | 1.3 | 1.7 | 2.1 | 2.4 | 2.6 | 2.6 |
| Individual income tax from non-wage earners (in billion pesos) | 87.6 | 91.0 | 103.2 | 124.4 | 133.6 | 108.1 |
| % of potential revenue | 87.6 | 83.0 | 84.0 | 87.6 | 88.4 | 85.2 |
| % of GDP | 1.8 | 1.7 | 1.7 | 1.9 | 1.8 | 1.4 |
| Ave. effective tax rate (%) on wage income a/ | 6.0 | 6.0 | 6.1 | 6.3 | 6.0 | 4.9 |
| Ave. effective tax rate %) on non-wage income a/ | 0.7 | 1.0 | 1.0 | 0.8 | 0.7 | 0.7 |

*Note*: a/ Average effective tax rate is estimated as the ratio of actual tax collection to the tax base
*Source*: Author's estimate

The record of the BIR and BOC in increasing their revenue effort through improvements in tax administration does not inspire optimism, however. An analysis breaking down the sources of change in the tax-to-GDP ratio of the major types of taxes in 2005-2009 suggests that tax-to-GDP ratio for the VAT, the corporate income tax and the excise tax on tobacco and petroleum products would have been higher than they actually were during the period if collection efficiency had been maintained at the 2004 level (Manasan 2010).

Given this perspective, the present administration may have no recourse but to consider new tax measures in order to generate the much needed revenues to finance the MDGs and inclusive growth in the context of fiscal consolidation in the medium term

because tax administration improvements do not happen overnight primarily because the installation and operationalization of system-wide changes take time. The challenge then is to identify tax measures that will generate additional revenues in the least distortionary manner. The best options in this regard include:

(i) The restructuring of excise tax on sin products,

- as a first best option, levy a uniform rate on all brands and index the specific rate to inflation automatically subsequently; initially, uniform specific rate should be set so as to yield A uniform rate of PhP 13.90 per pack (in 2010 prices) is estimated to result in a tax effort ratio equal to the 1996 level; tax rate may be set at a higher rate than this if one wishes the tax to result in a stronger deterrent effect on smoking/ drinking bearing in mind that revenues from the excise tax may decline if the specific tax rate were set above a certain level, depending on the price elasticity of demand.
- at the minimum, allow for the automatic indexation of the specific tax rates with inflation;
- alternatively, price survey of tobacco and alcoholic products should be conducted immediately to permit the reclassification of said products for excise tax purposes in accordance with their current retail prices; in addition, the specific tax rates applicable for 2011 under RA 9334 should be adjusted so that they fully reflect the change in prices between 2005 and 2011

(ii) The rationalization of fiscal incentives,

- abolish the ITH and replace it by a 25% corporate income tax or a 5% tax on gross income; and
- unify the fiscal incentives provided by the various investment promotion agencies

(iii) Reforming the road user charge.

- increase motor vehicle registration fees especially on heavy trucks which are taxed at a rate that is disproportionately less than the cost of damage they cause on the roads introduce a variable road user charge in the form of an additional excise tax on petroleum products.

In addition, the government should also consider the simplification of tax structure by reducing the number of rates at which various taxes are levied or by reducing the number of taxpayers/ transactions/ or types of income which are exempt from any given tax. Tax simplification makes tax administration easier by minimizing the opportunities for evasion. It also improves equity.

At the same time, there is need for the institutionalization of systemic improvements in processes and procedures in the area of taxpayer registration, audit and enforcement including:

(i) Cleaning up the existing record and broadening the tax registry;

(ii) Greater use of third party information by establishing arrangements with the Social Security System, Bangko Sentral ng Pilipinas, Land Transportation Office, the Register of Deeds, the Land Registration Administration and LGUs, in addition to BOC and SEC; introduction of some flexibility in the Bank Secrecy Law;

(iii) Expansion of the coverage of *e*-filing and payment so as to improve taxpayer services and voluntary compliance as well as to facilitate the audit process;

(iv) Installation of a risk-based audit system; and

(v) Provision of adequate IT support to the BIR and BOC.

On the other hand, the government has initiated a number of budget reform measures that enhance the quality of spending as well as the manner by which spending is carried out. These measures should be further strengthened in order to complement the reforms on the revenue side. The more important budget reforms measures are:

(i) Application of zero-based budgeting; support initiative with the conduct of evidence-based research on the effectiveness and impact of various government programs and improvement in the availability of good quality data that will allow the evaluation of government programs;

(ii) Timely enactment of General Appropriations Act (GAA) yearly;

(iii) Strengthening of public expenditure management reforms; enhancement of the performance indicators that have been formulated for the major final outputs of each national government department/ agency; improvement of the processes and procedures for performance review and reporting of agencies; and most important, engaging Congress in the medium-term expenditure framework (MTEF) and performance based budgeting (OPIF) reform process soonest.

(iv) Enactment of a fiscal responsibility law anchored on the institutionalization of a rule that all new expenditure and tax measures should be deficit-neutral and a cap on the cyclically adjusted primary balance.

## 6. Fiscal Transparency

The coverage of the fiscal accounts is fairly comprehensive and information is accessible to the public. The government monitors the overall fiscal position and outstanding debt of the consolidated public sector. The consolidated public sector includes the national government, 14 monitored government-owned and controlled corporations (GOCCs), local government units, the social security institutions (Government Service Insurance System or GSIS, Social Security System or SSS, and Philippine Health Insurance Corporation or PhilHealth), the government financial institutions (GFIs), the Bangko Sentral ng Pilipinas (BSP). However, the reporting time lag for public dissemination is close to one year. For instance, the latest data that is available on the website of the Department of Finance (DOF) on the fiscal position and outstanding debt of the consolidated public sector pertains to December 2009 yet. Also, data on the fiscal position of monitored GOCCs are not widely disseminated and are less accessible than most fiscal data. In principle, the individual financial statements of the individual GOCCs are available on the Commission on Audit (COA) website but said postings are incomplete and, at best, have reporting time lags of nine months.

However, there are three items where fiscal transparency can be improved. First, tax expenditures as reported in the Cash Operations Report of the Bureau of Treasury include mostly tax and duty exemptions of government entities only. They do not include the cost of fiscal incentives granted to registered enterprises. The reporting of revenue foregone from fiscal incentives will greatly enhance their rationalization.

Second, while contingent liabilities the national government are reported by the Bureau of the Treasury, their coverage is not clear. Also, there appears to be some issue on the recognition as well as valuation of contingent liabilities.

Take the case of the National Food Authority (NFA), for instance. The provision of rice at subsidized prices by the National Food Authority form part of the fiscal stimulus package. Because the NFA is engaged in an activity that inherently entails some losses, the government supports the NFA by providing it with budgetary support in terms of both equity infusions and operational subsidies through the General Appropriations Act (GAA). For instance, the national government's direct subsidy to the NFA was PhP 4.8 billion in 2006, PhP 2.1 billion in 2007 and PhP 2.0 billion in 2008. In addition, the national government guarantees all NFA debt. Thus, the cost to the taxpayers of NFA operations does not only include budget support but also the increase in NFA debt since the latter represents an increase in future obligations of the national government. Table 15 shows that the total financial cost of NFA interventions was PhP 18.8 billion in 2007 (or 0.28% of GDP) down from PhP 21.2 billion in 2006 (or 0.35% of GDP). With the rapid rise in price of rice in 2008, the total financial cost of NFA interventions went up correspondingly to PhP 100.4 billion (or 1.36% of GDP). These figures include the tax expenditures (i.e., the implied subsidy provided by the national government to cover the tariff imposed on NFA imports of rice. The question remains: When is net loss of the NFA after subsidies from the national government recognized as a contingent liability? When it is incurred or when there is an urgent need to re-capitalize the said government corporation?

**Table 15. Fiscal cost of NFA Operations, 2007-2008 (in million pesos)**

| | 2006 | 2007 | 2008 | 2010 |
|---|---|---|---|---|
| **Net loss before gov't subsidy** | **(21,241)** | **(18,772)** | **(100,448)** | **(71,204)** |
| *of w/c: operating expense* | 37,625 | 46,698 | 65,659 | 46,566 |
| **Sources of finance** | | | | |
| Operational subsidies from NG | 4,811 | 16,120 | 39,172 | 27662.44 |
| Other sources a/ | 16,430 | 2,652 | 61,277 | 43,541 |
| **Net loss before gov/t subsidy as % of GDP** | 0.35 | 0.28 | 1.36 | 0.84 |

Note: *a/ net external and domestic financing*
*Source:* DOF

Third, unlike that of most government employees, the pensions of members of the military, the police and the judiciary are tax-funded and are budgeted as part of the

General Appropriations Act. At present, there are proposals to convert this scheme to a contributory program.

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