

Statement PDF Working Group on Economic and Fiscal Reforms

The Philippine economy is poised at a key moment as the strong recovery from the global downturn and positive sentiment in the country provide a window of opportunity for moving ahead decisively with reforms to raise inclusive growth. The authorities' effective policy response, as well as strong external liquidity and a sound financial sector, helped to cushion the downturn and drive a strong recovery. The government's focus on addressing long-standing impediments to investment and growth and improving the livelihood of the Filipino people as envisaged in the PDP are further buoying confidence. The Philippines' sovereign credit rating was upgraded in November 2010 in recognition of its strong financial position.

Several economic milestones were achieved in 2010. The economy grew by 7¼ percent (y/y) last year, with growth being broad-based across private consumption, investment, and exports. Inflation was benign amid favorable food supply conditions and low core inflation. The national government comfortably met the deficit target, as strong spending discipline offset the effect of a revenue shortfall that reflected ambitious targets as well as revenue-eroding measures. In September the Philippines became the first emerging Asian country to issue a local-currency denominated global bond. The balance of payments surplus has remained sizable, underpinned by both the current and financial account. Asset-price bubbles are absent so far and the financial sector remains sound.

Notwithstanding the external risks, macroeconomic conditions in the Philippines remain generally favorable. In advanced countries, high unemployment, tepid household consumption, and weak financial sector balance sheets are holding back private domestic demand. Moreover, markets remain acutely sensitive to sovereign and banking sector risks. Asia's strong economic growth is leading to new policy challenges for the region. In several countries, inflationary pressures are continuing to build, while policymakers need to guard against the risks that volatile capital inflows can pose to financial stability. Despite these external risks, growth in the Philippines is converging to levels in regional peers, while the positive sentiment in the country could set the stage for a virtuous cycle to be supported once new initiatives such as public-private partnerships (PPPs) to develop infrastructure move into higher gear.

A key policy challenge for the Philippines remains to sustain the recovery and enhance the prospects for stronger and more inclusive medium-term growth. Doing so will require preserving macroeconomic stability by carefully managing the exit from stimulus policies in a complicated external environment, while moving ahead with reforms to enhance the pace and quality of growth. The government's focus on improving governance, reducing the costs of doing business, strengthening the social safety net, and addressing infrastructure bottlenecks is well placed for improving living standards and rebalancing the economy toward higher investment and growth. Further financial market development would help growth and risk diversification, and would also be helpful for effectively channeling the external inflows toward productive investment, such as infrastructure, while continuing to guard against elevated interest and concentration risk.

The government's focus on medium-term fiscal consolidation is appropriate given the need to create more fiscal space, which will strengthen the ability of the budget to respond effectively to future shocks. Consolidation could also improve medium-term growth prospects, by lowering sovereign risk and enhancing private investment, and help in managing the macroeconomic impact of inflows. The authorities' intention to reduce the national government deficit over the medium

term is a welcome marker of the policy direction and should help to anchor expectations and reduce public debt. Zero-based budgeting has enhanced the effectiveness and efficiency of government spending and could create fiscal space for higher priority spending. Under the medium-term deficit objective of 2 percent of GDP, fiscal risk would remain elevated as public debt remains relatively high (nearly 50 percent of GDP by 2015), the gross financing requirement remains substantial, and interest expenditures would still absorb a large share of the budget, suggesting that further debt reduction could be considered going forward.

In order to achieve fiscal consolidation and scale up priority spending it will be essential to raise the tax effort. In this context, the WG considers as appropriate the government's intention to strengthen tax administration and its renewed efforts to plug revenue leakages with better enforcement against tax evasion and smuggling. These efforts could be supported by a more appropriate budget allocation, improved personnel management, and a more performance based and competitive remuneration in the revenue agencies, and the introduction and publication of key performance indicators. In addition, the agenda could be complemented by early actions to address various inefficiencies and inequities in the tax system, such as the need to reform excise taxes, rationalize fiscal incentives, and streamline optional deductions. Such actions will be necessary for raising revenue in order to meet the government's objectives for fiscal consolidation and expanding priority spending such as in health, education, social protection and public investment. They would also make the tax system more equitable and easier to administer. New measures that would further undermine the tax system would present a significant setback, while exemptions granted during the global financial crisis should be reversed. Over time, once improvements in tax compliance and tax-base broadening have been achieved, a more comprehensive tax reform could be considered by reviewing the mix between direct and indirect taxation and harmonizing the tax treatment of financial transactions.

On the expenditure side, the 2011 Budget appropriately reorients spending toward sectors that support inclusive long-term growth. The 2011 NG budget was approved in December 2010 and released early and comprehensively in January, thereby providing departments and line agencies with increased funding and programming predictability than has been the case in the past. The budget emphasizes social protection and social spending, including public health and basic education expenditure that are relatively low in the Philippines. The WG supports the authorities' plans to reform the operations of GOCCs and notes that the rice and transport subsidies provided by public enterprises could instead be used to scale up targeted conditional cash transfer programs that can directly benefit the most vulnerable people. The WG also endorses initiatives at ensuring budget transparency by involving civil society organizations and the private sector in the budget process and by introducing accountability systems.

The WG welcomes the government's recent initiatives to strengthen the fiscal framework. The proposed Fiscal Responsibility Law and the recent Fiscal Risk Statement are important steps in this context. The WG supports the authorities' ongoing efforts to strengthen the chain of public financial management from budgeting to cash management to auditing, as formulated in the PFM roadmap, and welcomes the authorities' attentiveness to contingent liabilities and the implementation of a proactive debt management strategy to reduce the debt burden and foreign currency exposure while deepening the market for longer-dated peso securities to finance infrastructure projects.

February 26, 2011