FOR AGENDA

SM/06/35
Correction 1

February 9, 2006

To: Members of the Executive Board

From: The Secretary

Subject: **Philippines—Selected Issues**

The attached factual corrections to SM/06/35 (1/31/06) have been provided by the staff:

Page 13, line 2: for "in the absence of welfare or unemployment benefits"
read "given limited welfare benefits and in the absence of unemployment benefits"

Page 17, Figure 4, 2003 pie chart: revised.

Page 18, para. 14, last line: for "infrastructure projects."
read "infrastructure projects and boosting social spending."

Questions may be referred to Mr. Brooks (ext. 36236) and Mr. Ishi (ext. 38034) in APD, Mr. Seshadri, PDR (ext. 36793), and Ms. Zakharova, FAD (ext. 37166).

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output is at its potential, assuming average elasticity for the period 1990–2004.[9] It is assumed that given limited welfare benefits and in the absence of unemployment benefits in the Philippines, expenditure is largely independent of cyclical developments and therefore cyclically adjusted expenditures are equal to actual expenditures.[10]

7. **The fiscal stance is then defined as the first difference in the CAB.**[11] The fiscal stance can be a useful measure of the impact of fiscal policy on aggregate demand and can be employed to determine whether the fiscal policy is procyclical or counter-cyclical. A positive correlation between the fiscal stance and the output gap in a particular period indicates that fiscal policy was procyclical during that period.

8. **Procyclicality of fiscal policy may have important implications for macroeconomic stability and fiscal sustainability.** A recent IMF study concludes that procyclical fiscal policy exacerbates economic fluctuations, with adverse consequences for savings, investment, economic growth, and welfare. It also suggests that a stronger procyclical bias in the upturn may result in a deteriorating fiscal position over time, since deficits and debt built up during bad times are in general not offset during good times.[12]

C. Findings

9. **Analysis of the CAB indicates that the deterioration in the underlying fiscal position predates the Asian crisis.** Developments in cyclically-adjusted revenues and expenditures suggest that fiscal policy was loosened from 1995, prior to the Asian crisis (Figure 2). Cyclically-adjusted revenues fell, despite the tax reforms undertaken in the early and mid-1990s (Box 1), while primary spending increased substantially. Fiscal policy was also procyclical during the crisis.

10. **The decline in the cyclically adjusted revenues prior to crisis can be attributed to a number of factors.** Although the fiscal reforms helped to substantially boost tax receipts in the first half of the 1990s, the increase in revenues may have fallen short of potential because a number of structural weaknesses were not addressed. In particular, the reforms failed to

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[9] Potential output is calculated by de-trending time-series data of real GDP, using the Hodrick-Prescott (HP) filter. Sensitivity analysis shows that the results are generally robust with respect to elasticity assumptions.

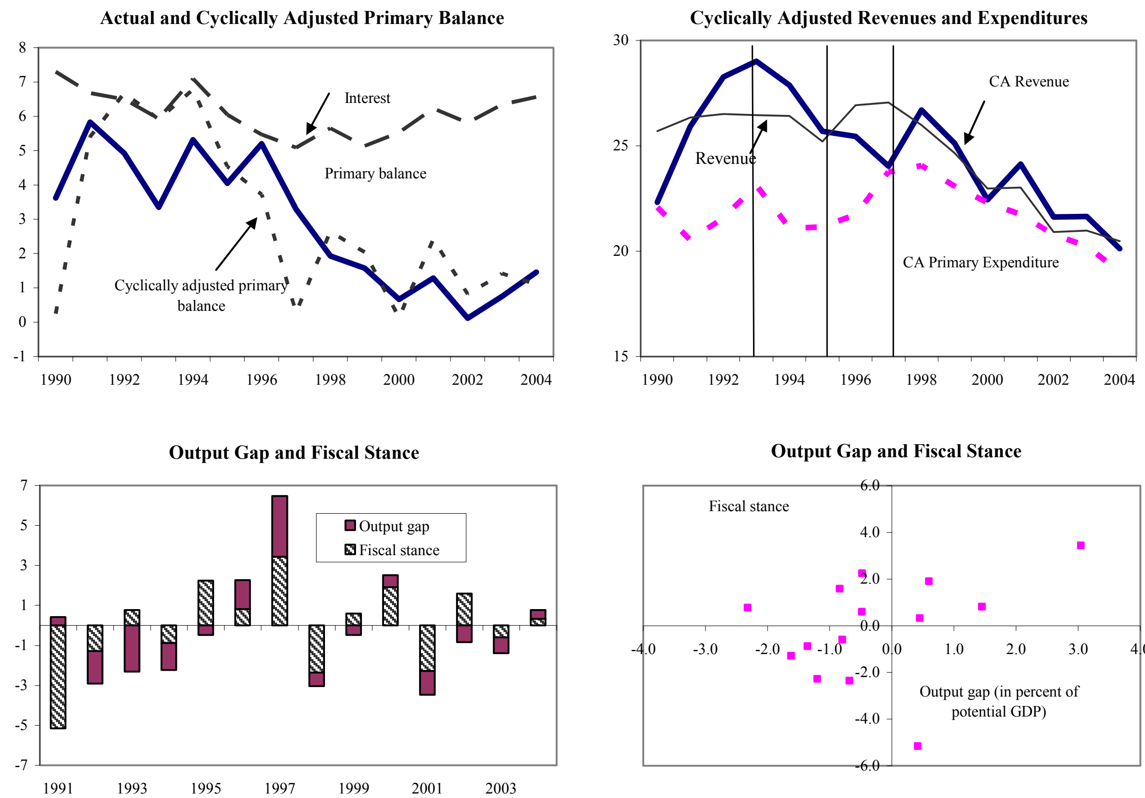
[10] The formula used to calculate the CAB in year t is: $CAB_t=R_t(Y^p_{t}/Y_t)^{\alpha}-E_t$, where R is actual revenue; Y^p is potential output; Y is actual output; α is the average elasticity of revenue with respect to Y^p/Y for the period 1990–2004; and E is the actual expenditure.

[11] A negative number implies a reduction in the CAB.

[12] For further details on causes and consequences of procyclicality in fiscal policy see FAD 2005.

rein in extensive tax incentives and did not tackle weaknesses in tax administration.[13] In addition, the operating receipts of the Government Owned and Controlled Corporations (GOCCs) declined following the privatization in 1994 of the oil refining and distribution company Petron—a subsidiary of the Philippine National Oil Company (PNOC).

Figure 2. The Philippines: Cyclically Adjusted Balance and Output Gaps, 1990-2004
(In percent of GDP)



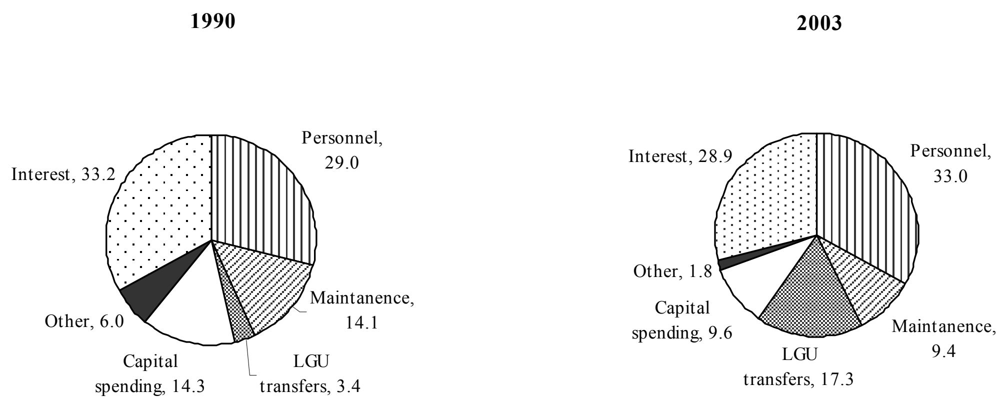
Source: Philippine authorities; and Fund staff estimates.

11. **Spending policy was stimulative on average in the first half of the 1990s, including in the years immediately preceding the crisis, when output was above potential.** Budget allocations favored increases in statutory outlays—including government wages and transfers to the local governments—over spending on infrastructure and maintenance. Primary expenditure expanded by almost 2 percentage points of GDP during 1995–97, with personnel outlays increasing by over 1½ percentage points of GDP.

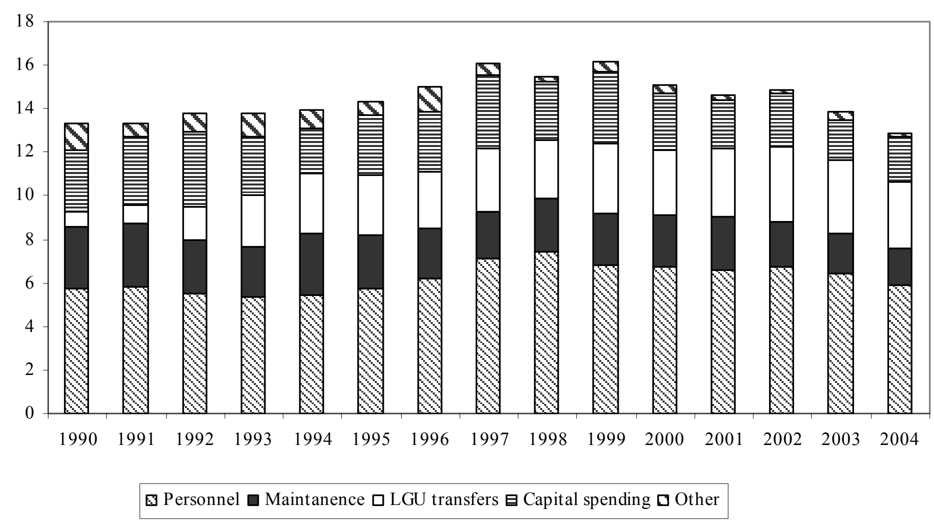
[13] For the discussion of the drawbacks of the fiscal reforms undertaken in the early and mid-1990s, see Kostial and Summers (1999).

including electronics;[16] (iii) the revenues lost from trade liberalization were not replaced; and (iv) specific excises were not indexed to inflation. Third, tax administration weaknesses persisted and were not addressed.[17] And finally, the weak financial position of public enterprises, including the state power company (NPC), contributed to the decline in the NFPS revenues.

Figure 4. The Philippines: NG Expenditure Composition
(In percent of total expenditure; unless stated otherwise)



The Philippines: NG Primary Expenditure Composition, 1990-2004
(Percent of GDP)



Source: The Philippine authorities; and Fund staff estimates.

[16] For a description of tax incentives in the Philippines, see Chalk (2001).

[17] For an analysis of revenue trends in the Philippines since the Asian crisis, see Inchauste (2002).

D. Making Fiscal Consolidation a Success

14. **Since taking office in mid-2004, the administration has made important progress in addressing the fiscal problem.** To this end, the government has launched a comprehensive fiscal reform program. The cornerstone of this program and the measure with the highest revenue potential is the VAT reform that extends the VAT base to energy products and allows for an increase in the VAT rate from 10 to 12 percent in early 2006. The authorities plan to spend a portion of the revenue proceeds from the VAT reform on funding priority infrastructure projects and boosting social spending.

15. **Other measures will support the fiscal consolidation.** Excise taxes on alcohol and tobacco products were increased by 30 percent on average at end-2004, although not fully indexed to inflation. The authorities are also actively pursuing a government rationalization program that should make the civil service leaner and more effective and improve government service delivery. Finally, significant progress has been made in containing the deficits of public enterprises, including by increasing electricity tariffs—a measure that has more than halved NPC's deficit.

16. **Considerable fiscal gains have already been achieved following the introduction of these reforms, but it will be important to lock in and build up on these gains.** In this regard, findings from the recent literature on the link between the composition of fiscal adjustment and its sustainability can be used to identify possible strategies for making the ongoing fiscal consolidation effort a long-lasting success.

17. **Recent empirical research finds that the composition of fiscal adjustment is crucial for its sustainability.** In particular, sustainable fiscal consolidation episodes typically involve cutting unproductive expenditures, while durable revenue reforms tend to focus on broadening the tax base and increasing revenue productivity. Studies of fiscal adjustment episodes in OECD countries found that fiscal consolidations based on tax increases and cuts in capital spending tend to be shorter-lived than those that rely primarily on reducing outlays on transfers and the wage bill (Alesina and Perotti, 1995 and 1997). A more recent study of emerging market economies suggests that, in addition to cuts in wasteful spending, durable revenue mobilization and robust capital spending are also important components of a sustainable fiscal consolidation (Gupta, et al., 2003).

18. **A simple intuitive explanation can be offered to support these results**. Spending cuts in politically sensitive expenditure categories, such as wages, pensions, and subsidies, require strong political will and public backing, signaling a sound commitment to fiscal consolidation in countries that managed to successfully carry out these reforms. Similarly, durable reforms on the revenue side, such as introducing new taxes and expanding the base of existing taxes, usually require legislative amendments that are more difficult to reverse than administrative or executive orders, resulting in a longer lasting fiscal consolidation. In contrast, procyclical fiscal policies that encourage exuberant spending in good times may make it difficult to undo the deficits and debt built up during economic downturns.