Philippines: Towards a Better Development Outcome

The Philippines can sharply reduce poverty and improve social indicators by 2010 and establish a more rapid development pattern in which per capita growth is 4 percent per annum. Now, at the beginning of a new government term, and while the global economic environment remains favorable, is an ideal time to put in place the actions needed to do this. Achieving such an improved development outcome calls for bold immediate actions to strengthen public finances by increasing public revenue and reducing power sector losses. This improvement in public finances is critical to start rebuilding confidence and policy credibility and begin triggering a virtuous development cycle Then, this needs to be complemented by actions to improve the investment climate and make development more inclusive to establish a virtuous cycle of falling public debt as a share of GDP, increased investment and competitiveness, rapid growth and expanding employment, and rapid poverty reduction. A business as usual approach at this time coupled with the risk of rising global interest rates and sustained higher oil prices, could result in a vicious cycle with deteriorating public finances and slower development.

A. Context

A.1 Rapid development is possible.

By 2010 the Philippines could reduce poverty by at least 25 percent and improve social indicators to be ahead of schedule with all the Millennium Development Goals. The number of people living on less than $2 per day could be reduced from the current 40 percent of the population to less than 30 percent, so over 15 million more Filipinos would have incomes of more than $2 per day. The percentage of people living on less than $1 per day could be reduced from the current 9 percent to below 5 percent, thus greatly reducing the depth of poverty. Per capita GDP could increase to over USD 1,350, compared to its current level of USD 1,080. Health outcomes could be sharply better with further reductions in infant and child mortality rates malnutrition and maternal mortality. Access to safe drinking water would stop falling and rise from the 80 percent rate of 2002. And the Philippines would regain its status as a location of high quality education.

The key to this is sustaining growth of 5-6 percent per year with rapid employment growth, a goal that is achievable with bold policy action over the next few years. This is no more than Thailand, Malaysia and the Republic of Korea have achieved on a continuing basis over the past few decades through sound macroeconomic management, high saving and investment rates and rapidly expanding exports. In fact, when combined with effective and fiscally sustainable programs to improve employment opportunities and access of the poor to critical services such as health, education and infrastructure, poverty could be reduced even more rapidly.

A.2 Right time for reform.

The government currently has a unique window of opportunity to depart from the past relatively slow development pattern and put the Philippines on this type of higher more rapid development path. First, the elections offer a new chance to formulate an aggressive reform program and forge the working relationships with Congress and civil society required to see it through. There is a widespread recognition of the need for change and reform so the central issue is how to achieve the needed change. Markets are looking for bold actions to tackle the longstanding problems in the Philippines economy.

Second, economic growth and the external environment are as good as they are likely to be for quite some time. The impressive 6.4 percent growth of the Philippines economy during the first quarter of this year is unlikely to be sustained for the remainder of 2004 due to an increasingly unfavorable external environment. Global interest rates are likely to rise, putting pressure on the peso and domestic rates. China's economy, which has contributed significantly to Philippines' recent export performance, is slowing. Equally worrisome, oil prices have risen substantially—breaking even the USD 40/barrel level at one point—and are likely to remain high.[1] The International Energy Agency recently indicated that global oil demand is set to rise at the fastest rate in 24 years. Procrastination would therefore only compound the difficulty of implementing the needed reforms. By contrast, an aggressively implemented reform program with strong upfront actions to strengthen public sector finances could place the Philippines on a higher development path.

B. Issues and Options

What is the right strategy to move the Philippines onto a higher development path? A successful development strategy will rest upon at least three pillars. First and foremost, risks need to be reduced, and confidence and policy credibility rebuilt, by strengthening public sector finances. Failure to do this would in fact increase the economy's vulnerability to shocks. Improvements in public finances would also increase investor confidence and provide much needed resources to expand public services. Second, growth needs to be increased and this will require an improved enabling environment for the private sector and measures to strengthen the overall investment climate**.** Third, ensuring that this growth rapidly reduces poverty necessitates actions to make the development process more inclusive**.** While all three are ultimately needed to establish and sustain a higher development path, the first—strengthening public finances—is a necessary precondition and the highest priority. Sustaining any improvement in public finances over the long term, though, requires a sound combination of macroeconomic and sectoral policies. For example, inappropriate infrastructure policies could undermine fiscal stability both directly by increasing off-budget losses and indirectly by reducing growth through weakening the investment climate. Similarly, appropriate rural, human resources, and social policies can help long-term sustainability of public finances indirectly by fostering (pro-poor) growth and inclusion, and directly by allowing for better development outcomes for the poor to be achieved without greater recourse to additional public resources**.**

All three reform pillars are also needed to maintain the kind of broad support required to sustain the reform program. While essential, measures to improve public finances are politically challenging. They will therefore need to be complemented by measures to improve the investment climate and inclusion to generate sustained growth and ensure that the benefits of such growth are widely shared, thus reinforcing public support for reforms.

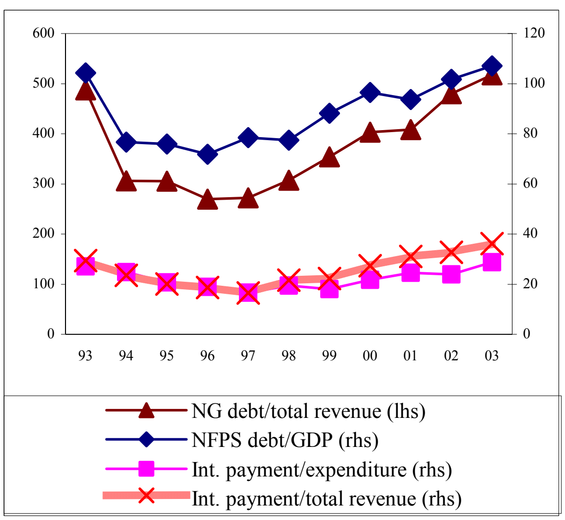
B.1 Reducing risks by strengthening public sector finances.

Continued large government and public enterprise deficits, coupled with a rise in public debt to 107 percent of GDP, has increased uncertainty regarding the sustainability of public finances and hence macroeconomic management (figure 1). Macroeconomic instability is the constraint most frequently rated by firms as a severe or

[1] If past oil price booms are any indication, prices could go significantly higher. Oil prices increased by about 98 percent in real terms between December 2001 and May 2004. Between December 1998 and November 2000, they increased by nearly 190%.

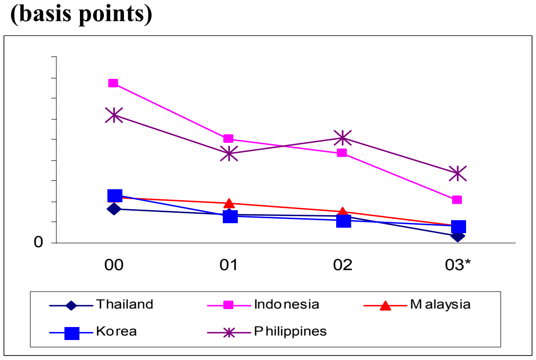
major impediment to their expansion (figure 5). Concern regarding the sustainability of public finances increases uncertainty for investors and entrepreneurs in general, thus increasing the expected return needed to attract investment capital, and risks crowding out the needed increase in private investment. Moreover persistent large public sector borrowing puts upward pressure on interest rates and increases the cost of borrowing for the private sector. The continued weakness of the Peso while other currencies have strengthened and relatively high bond spreads on external debt are a clear signal that financial markets perceive economic risks in the Philippines to be greater than those for other countries in the region (figure 2).

Figure 1. Rising public sector debt.



Source: Department of Finance

Figure 2. Bond spreads stay relatively large (basis points)



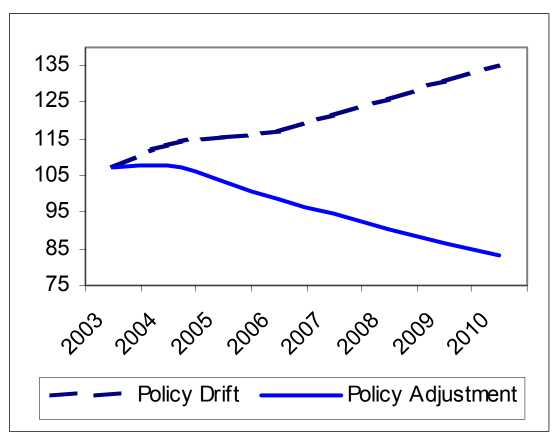
* Note 2003 data are end November

Source: Bloomberg, Datastream, Haver, International Financial Statistics

Meanwhile, falling revenues and rising debt servicing demands squeeze the amount of public resources available for poverty-reducing developmental programs. Public education, health, social security and infrastructure are all starved of the finance needed to increase inclusion and support growth.

Strengthening overall public finances necessitates quick and decisive action to generate a sizable primary fiscal surplus and severely limit off-budget losses. If the nominal growth rate and the nominal interest rate are offsetting, a modest primary surplus is sufficient to begin reducing the public-debt-to-GDP ratio, as long as it is not undermined by off-budget losses. (figure 3). However, if growth languishes, protracted uncertainty creates a gap between growth and the interest rate, and off-budget losses continue to lead to new debt, then modest primary surpluses would not be sufficient to ensure fiscal sustainability. This illustrates the fact that reversing the recent deterioration in fiscal management requires urgent action to increase public revenues and contain off-budget losses, especially in the power sector.

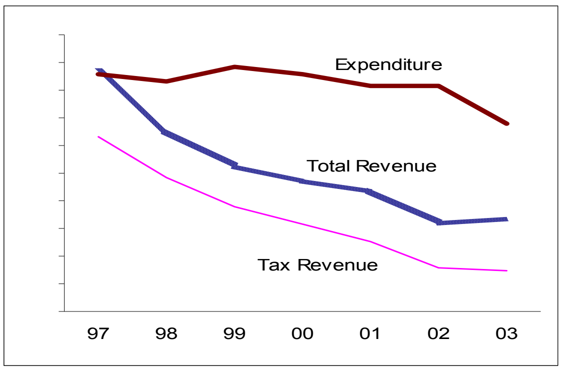
Figure 3. Fiscal Scenarios: Non-financial public sector debt (percent of GDP)



Source: Department of Finance, World Bank staff estimates

Over the past five years the core weakness in public finances has been falling tax revenue as a share of GDP (figure 4 and table 1). Though this slide was halted in 2003 through a concerted administrative effort, this on its own has not generated a recovery in revenues, and rising power sector losses are now adding to the strain on overall public finances. The tax revenue to GDP ratio needs to be increased through a blend of policy reforms and further progress with administrative improvements. And power sector losses need to be sharply reduced.

Figure 4. National Government Revenue And Expenditure (in percent of GNP)



Source: Department of Finance

Table 1. Sources of National Government Revenue (% of GNP)

	1993	1998	2003
Total revenues	17.2	16.5	13.4
Tax revenues	15.2	14.9	11.5
Net income & profits	4.9	6.6	5.2
Excise tax	2.0	2.2	1.2
Import duties	5.4	2.7	2.3
Value added tax	1.5	1.7	1.8
Other taxes	1.4	1.6	1.0
Nontax revenues	2.0	1.6	1.9
Total revenues (in Php bn)	260	463	627
GNP (Nominal, in Php bn)	1510	2802	4685

Source: Bureau of Treasury, NSCB

Contingent liabilities arising from the pensions funds (Social Security System (SSS) and Government Service Insurance System (GSIS)) also need to be contained. In particular, SSS losses are expected to grow rapidly in the medium term unless corrective actions are taken soon.

Recent efforts to constrain the growth of public expenditures also need to continue as part of efforts to generate larger primary fiscal surpluses. Continued progress with the implementation of the new Procurement Law, a strengthened audit program, performance budgeting, the Medium Term Expenditure Program and civil service reform are all important parts of this. However, the recent compression of capital expenditures has reached its limits.

A series of concerted efforts to place public finances on a sustainable footing could begin with a substantial upfront fiscal adjustment, on the order of around 2.5 percent of GDP by end-2005. While the modality of the adjustment will need to be worked out by government, any adjustment will require significant measures across all areas, especially in power and taxes. As part of such a fiscal adjustment scenario, for example, power sector losses could be reduced by around 1 percent of GDP through tariff and other measures. The bulk of the remaining adjustment could be through various tax revenue measures (e.g., adjusting excises on petroleum, alcohol, tobacco; VAT base and other measures). While expenditure-related measures could also help, the compression of non-wage, non-interest expenditures makes substantial expenditure reductions over the near term difficult.

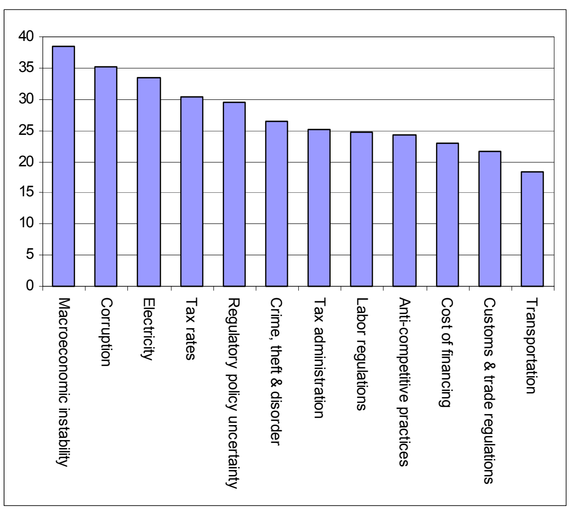
B.2 Improving the investment environment to increase growth.

Modest economic growth and high population growth have meant that per capita growth has averaged less than two percent per annum for the past 5 years, among the slowest in the region, and that new employment opportunities are not being adequately generated for the rapidly expanding workforce (about 3.4 percent per annum), resulting in high unemployment (13.7 percent) and underemployment (17.5 percent).[2]

[2] Preliminary National Statistical Coordination Board data for April 2004.

Increasing growth and employment will require measures to improve the overall investment climate and increase investment, which has generally lagged the region. Between 1990-2003, investment (gross fixed capital formation) as a share of GDP averaged around 21 percent for the Philippines, lower than Indonesia (25 percent), Thailand (32 percent), and Malaysia (33 percent). A recent Investment Climate Assessment survey of 647 firms in the Philippines indicated that firms consider the following to be the most major constraints (figure 5): macroeconomic instability, corruption, regulatory policy uncertainty, crime, theft and disorder, tax rates and tax administration, and infrastructure (electricity and transport).

Figure 5. Important Investment Constraints (% of firms)



Source: Investment Climate Survey, ADB & World Bank, preliminary data, 2004.

Improving infrastructure will require increasing infrastructure investments – both public and private – which amounted to only 2.7 percent of GDP in 2002, and ensuring efficiency of investments Given the constraints facing public sector finance, much of this will need to come from private sources in the Philippines, thus further highlighting the importance of strengthening the investment environment.

The relatively poor business environment for investment in infrastructure is due to the "four Cs" – inadequate Cost-recovery, lack of Competition, eroding Credibility of institutions, and high Corruption. Cost-recovery remains an elusive goal, with political intervention in water and power keeping tariffs low and revenues unable to even meet operations and maintenance costs. Lack of competition prevents much-needed efficiency gains from materializing. In shipping, despite deregulation that more than doubled the number of shipping companies – from 223 in 1997 to 585 in 2001 – the industry remains highly concentrated with only 5 shipping lines accounting for 90 percent of passenger and cargo markets and almost all the primary and secondary shipping routes. The credibility of regulatory institutions is undermined by a lack of insulation from short-term political pressures, and by conflicts of interest arising from inadequate separation between policy, regulatory, and operational functions.

Results from the recent Investment Climate Assessment survey also illustrate that regulatory uncertainty and corruption are still major concerns for private investors (table 2).

Table 2. Firm's Perspectives on Uncertainty and Corruption (%)

Uncertainty:	
Interpretations of regulations consistent and predictable (% disagree)	24.9
Confidence in the judiciary (% disagree)	16.5
Corruption:	
Percentage of revenue needed for informal payments	1.9
Percent of firms saying gift/payment required for:	
(a) a mainline telephone connection	2.4
(b) an electrical connection	3.9
(c) a construction permit	16.0
(d) an import license	19.9
(e) an operating license	15.0

Source: Investment Climate Survey, ADB & World Bank, preliminary data, 2004.

Consistent and transparent application of the rule of law is important to keep transactions costs down, thus enhancing competitiveness.

Efforts are already under way to reform the Judiciary, making it more efficient and effective are an important part of this. So are current efforts to improve corporate governance. It is essential that good and reliable information be readily available and that contract enforcement over time be predictable and dependable to contain investment risks. Corruption increases the cost of doing business and must be reduced as part of the improved rule of law to keep costs down.

The consistent protection of property, investor and creditor rights is critical for private sector development. However, the cost of dispute resolution is relatively high in the Philippines leading firms to prefer contracting and partnership arrangements that restrict exposure and lower the cost of exit. A consequence of this is lower levels of technology transfer, lower supply of capital and slower integration into production networks. This problem also affects the flow of capital and expertise in restructuring situations. Investors are less likely to invest in troubled companies when they have doubts about the sanctity of contracts or ability to restructure operations via mergers, acquisitions and securitization. A vulnerable banking sector and an underdeveloped domestic corporate bond market have also been undermining the sustained expansion of credit necessary for higher economic growth.

B.3 Increasing inclusion and sharing benefits.

The underperformance in pro-poor growth has meant that further progress in reducing poverty and inequality and improving social outcomes is needed. The percentage of people living on less than $1 per day or on less than $2 per day remains high relative to comparator countries (table 3). Inequality remains high.[3] The richest 5 percent of Philippine families receive about 30 percent of national income; the poorest 25 percent receive only 6 percent. Social outcomes have been mixed with reasonable progress on most of the Millennium Development Goals (e.g. participation in education and gender equality in education) except malnutrition among 0-5 year-old children[4] and maternal mortality[5].

Table 3. Slow Poverty Reduction (headcount index, in percent)

	$1/day		$2/day	
	1998	**2003**	**1998**	**2003**
Philippines	12.1	11.1	45.2	44.1
Indonesia 1/	12	6.2	65.1	50.1
Malaysia	< 0.5	< 0.5	12.9	8.7
Thailand	3.3	1.6	34.1	23.7
Korea, Rep of	< 0.5	< 0.5	< 0.5	< 0.5
China	16.1	11.7	49.8	34.8

1/ Indonesia data are for 1999, rather than 1998.
Note that data for 2003 are estimates and depend on the distribution of growth.
Source: World Bank Staff Estimates

Greater inclusion is important to ensure that the more rapid growth resulting from improvements in public finances and the investment climate lead to more rapid poverty reduction and better social outcomes. Achieving this depends very heavily on the effective provision of public services to the poor and the expansion of opportunities for the poor.

Education attainment is an important determinant of poverty with 50 percent of those without education in the Philippines being poor. And it influences the depth of poverty too, as the consumption shortfall for the uneducated poor is twice that of the poor who had primary education and five times that of the poor with high school education.

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[3] The Gini coefficient (an indicator of the inequality, with zero reflecting a perfectly equal distribution of income and 100 representing the situation in which one person receives all the income) for the Philippines was 45 in 2002, compared with 42, 34, and 30 respectively for Thailand, Indonesia and the Republic of Korea.

[4] Only down from 34.5 percent underweight in 1990 to 32 percent in 1998.

[5] Down from 209 maternal deaths per 100,000 live births in 1990 to 172 in 1998.

Moreover, the quality of education attained by the workforce is important because it affects the international competitiveness of firms, and unfortunately, the quality of education in the Philippines has been falling behind that of other countries in the region (table 4).

Table 4. Uncompetitive education

Countries	Average Scale Score
Taiwan	569
Singapore	568
Korea	549
Hongkong	530
Malaysia	492
Thailand	482
Indonesia	435
Philippines	345
Intl. Ave. Score	488

Source: Trends in International Mathematics and Science Study, 1999

The provision of effective public health service and basic transport and water infrastructure for the poor depend on making decentralization work effectively, as these are devolved functions. Public health services need to focus on the needs of the poor as improved health outcomes for the poor are critical for them to participate more fully in the benefits of national development. At present the infant mortality rate among the poorest quintile is 2.3 times that of the richest quintile, while the under-5 mortality is 2.7 times higher. And access to pharmaceutical products by the poor is still suppressed by high prices resulting from limited competition in the market.

Infrastructure needed by the poor to make their participation in markets possible, as sellers of goods and their labor, remains very varied across local government units and deficiencies limit opportunities for the poor. For example, the fact that few of the poor have good-quality piped water not only exposed them to added health risks but also deprives them of time needed to engage in income earning activities. Lack of secure access to land by the poor in rural areas limits investment and productivity. Lack of clarity with regard to land tenure by the poor in rural and urban areas limits their use of land as a foundation for access to credit markets.

For the poor and disadvantaged, inclusion also calls for initiatives to provide social protection and improve natural resource management. This suggests that it will be important to maintain financing for efficient well targets subsidies to ensure health service and school attendance by the poor. Declining quality of natural resources - land, water, air, coastal waters and forests in particular – exposes the population to increased health risks and threatens the sustainability of development.

C. Suggestions

To take full advantage of the current window of opportunity provided by a fresh electoral mandate and achieve a better development outcome for the Philippines, the government should move aggressively to put in place a strong reform program. Weak implementation and the slow pace of reform in the past has undermined credibility. To address these weaknesses, enhance credibility and establish a virtuous development cycle, the government could:

- Immediately implement a few critical, bold actions upfront in areas of immediate priority, thus demonstrating both commitment and capacity to reform;
- Establish a time-bound process for refining and then implementing an integrated rolling program of reforms to maintain the development momentum; and
- Monitor implementation progress on a timely basis and make adjustments as needed to maintain credibility of reform program with markets and hence sustain a virtuous cycle.

A time line of possible actions to establish and sustain a virtuous cycle and a better development outcome is summarized in table 5. These individual suggestions are generally not new. In fact, the need for them is widely acknowledged and generally shared by government. Thus the challenge is as much in how to get reform implemented as it is in identifying what reform is needed.

As discussed earlier, the most immediate need is for a blend of bold policy and administrative actions to increase tax revenues as a share of GDP plus price and structural reforms to reduce power sector losses. These actions would not only strengthen public finances but it would send a clear signal that the Government (Executive and Legislature together) is serious about reform and engender a favorable market response.

An immediate increase in excise taxes for alcohol, tobacco and petroleum products to restore their real value to their 1997 levels and then index them to avoid future erosion due to inflation is clearly needed. So are policy actions to curtail tax exemptions and to broaden the coverage of the VAT. And impressive as the recent tax administration effort has been, it needs to be continued and deepened to yield a higher share of potential tax from existing policies. For example, benchmarking for VAT is valuable, along with more effective audit provisions. Aggressively implementing the type of administrative reforms being proposed by the Civil Service Commission for BIR would be one option. Moving to a new Internal Revenue Authority is another option. Either could be made to work effectively. The important thing is to decide on a course of action to complement policy changes with further improvements in tax administration and pursue these efforts with all possible vigor.

Second, the sharp increase in power sector losses of recent years could be reversed through a blend of price adjustments, transferring debt to the National Government, and better regulations and increased private sector involvement as part of structural reforms to improve efficiency. Any further delay will only make the needed adjustment more difficult, though care will be needed to minimize the adverse effects on the poor and on the competitiveness of Philippine industry.

Once these top priority reforms to begin strengthening public sector finances are in place, they need to be complemented by follow up actions to improve the Philippines investment climate and expand inclusion in development (see table 5 for a summary of additional suggestions). Because the reforms to strengthen public finances will be politically difficult, sustaining support for the overall reform program will also require attention to reforms that generate broad public benefits without undermining the fiscal program, e.g., performance management measures to improve the delivery of public services.

Success will depend critically on strong ownership by national leaders and consensus, and institutional and governance improvements. Without strong ownership and consensus it will be difficult to actually get reforms implemented and the credibility of reforms would remain subject to question. For example, a greater sense of shared vision and partnership between the Executive and Legislative Branches of government is needed to achieve sustained improvement in public sector finances. Similarly the effective delivery of the services that are so critical to expand inclusion of the poor, depends on the capacity of public institutions, including that of local governments.

In this context it could be valuable for government to immediately articulate an integrated program of reforms, maybe in the form of a government "white paper", to solidify commitment, consensus and support. This paper could be subject to broad consultations and would need to be endorsed by the legislative branches of government as well as the Executive, but this needs to be done quickly.

During implementation it will be necessary to monitor progress and adjust as needed to ensure the desired development outcome. Successfully implementing a time-bound action plan which was publicly announced by government and has the backing of other key stakeholder white paper could maintain credibility of the reform program and a sustained improvement in market sentiment. However, as unforeseen events can disrupt progress or offset benefits, it would be important to regularly review the outcome of actions and to design and implement further reforms as needed to secure the desired development outcome. If something threatens the virtuous cycle, it will need to be effectively addressed and dealt with. In essence, it will be necessary to continuously monitor the emergence of constraints on development and effectively tackle them.

"Business as usual" would be unusually risky. There is an urgent need to take advantage of the present opportunity to introduce bold reforms. As noted above, the domestic and global environment are as conducive as they are likely to be for quite some time. Procrastination would likely result in a vicious cycle of declining investment and growth, stagnant public revenues and rising debt, waning confidence and a weakening peso—and would increase vulnerability to a crisis triggered by the reluctance of investors to continue financing the government. Reforms—difficult enough in the best of circumstances—would then have to take place against a backdrop of a shrinking economy, limited confidence, and diminished political capital, with a much reduced chance for success.

TABLE 5. SUMMARY OF SUGGESTED ACTION TO ACHIEVE A BETTER DEVELOPMENT OUTCOME

Immediate	Short Term	Medium Term
A. Actions to strengthen public sector finances and reduce risks		
• Increase tax revenues by increasing excise taxes on alcohol, tobacco and petroleum products, curtail tax exemptions and broaden VAT • Continued administrative effort (audits, benchmarking etc, to improve tax yields) • Price and structural reforms to reduce power sector losses, while shielding the poor • Outline plan for ensuring the financial sustainability of pension funds and implement next steps	• Further tax policy changes to increase the tax to GDP ratio • Institutional reforms to improve tax yields • Design and implement action programs to contain and then eliminate all GOCC losses and make any remaining GOCC delivered social protection programs explicit • Cease giving fiscal incentives • Professionalize the civil service to increase efficiency, combat corruption and contain costs • Review local government financing and introduce incentives for LGUs to raise revenue	• Implement actions to progressively reduce the public debt to GDP ratio • Fully implement actions to ensure the financial sustainability of pension funds • Ensure transparency by fully costing all future policy changes prior to them being agreed • Limit contingent liabilities • Implement and maintain comprehensive and transparent public debt management system • Ensure increased LGU reliance on their own tax efforts
B. Additional actions to generate and then sustain more rapid dynamic private sector lead growth		
	• Approve the new Corporate Recovery Bill and the Securitization Bill to complement the Special Purpose Asset Vehicle law • Design and begin implementing actions to improve infrastructure – especially power, water and transport • Amend the BSP and PDIC provisions to ensure adequate authority and protection for staff. • Continue to increase transparency and strengthen property rights and implementation of rules and regulations to reduce business cost and uncertainty • Continue vigorous efforts to implement judicial reforms, increasing access and public trust	• Continue with actions to ensure the reliable and competitive provision of physical infrastructure • Maintain a transparent and market oriented investment environment to facilitate competitive private sector development • Deepen and broaden capital markets
C. Additional actions to ensure broad inclusion in development		
	• Continue implementing public expenditure and procurement reforms to prioritize, protect expenditures on education, health and social welfare, ensure efficiency of resource use and contain expenditure increases	• Design and begin implementing actions to improve the quality of education • Improve natural resource management to ensure environmental sustainability for water, land, air, forestry and coastal waters • Strengthen health services for the poor and ensure that reproductive choice is readily available • Strengthen institutions (including LGUs) to improve service delivery