

Restoring Fiscal Sustainability

Philippine public debt has grown to a level that constrains both public and private investment, undermining the quality and sustainability of economic growth. The resulting large public sector financing requirements render the country particularly vulnerable to shifts in investor sentiment and increase the risk of financial market volatility and crisis. The enactment of a credible fiscal adjustment package is therefore urgently needed—and the start of a new administration offers a fresh opportunity for the Government to articulate the nature of the problem and highlight the rationale for adjustment. The elements of such a package include measures to: reverse the decline in tax revenue since 1997; improve the quality of public expenditure management, including through civil service reform; reduce burgeoning deficits in the power sector; address impending losses in government-run pension funds; and instill greater discipline in the management of contingent liabilities and in recourse to borrowing by public entities.

Background

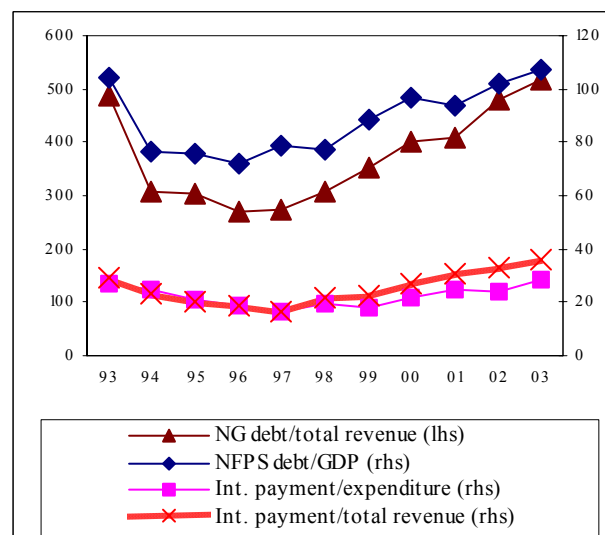
Public sector debt in the Philippines has grown at an unsustainable pace in recent years. This is the consequence of large nonfinancial public sector (NFPS) deficits, which in 2003 reached an estimated 6.3 percent of GDP, primarily the result of national government and power sector deficits, the calling of numerous contingent claims on the Government, bailouts of public enterprises, and real depreciation of the peso.

In 2003, NFPS debt reached about 107 percent of GDP;¹ debt of the national government was more than five times its revenue; and national government interest obligations had reached 36 percent of the revenue it collected, accounting for 27 percent of its expenditure. These ratios have each been on a rising trend since the mid-1990s (figure 1), and are high relative to other emerging markets: the average public debt/GDP ratio among emerging markets was about 70 percent, which in turn is much higher than recommended for such economies in a recent paper by the IMF.²

¹ This figure is overstated to the extent that it does not net out all intra-public sector debt, though, as discussed below, it does not include significant contingent liabilities.

² See “Public Debt in Emerging Markets: Is it Too High?”, IMF, *World Economic Outlook*, September 2003.

Figure 1. Selected Fiscal Ratios (%)



Source: Department of Finance

The growth of public debt since 2001 has been particularly high, even by historical standards. During 2002-03, public debt is estimated to have increased by P1.22 trillion to nearly P4.7 trillion whereas cumulative public sector deficits reported in the same period amounted to about P543 billion. About P200 billion of the increase in debt measured in pesos can be attributed to depreciation of the peso against currencies in which foreign debt is held—underscoring the major impact that exchange rate depreciation can have on debt dynamics. But this and other factors, such as borrowing to cover contingent claims or to finance the

accumulation of public sector assets, do not appear to fully account for the rapid recent increase in public debt; a full accounting of the factors underlying the debt increase, particularly since 2001, would hence be useful for policy purposes.

The magnitude of presently recorded public debt reflects not only past deficits, but also the calling of numerous contingent claims on government and bailouts of government owned financial and nonfinancial corporations. But the above debt figures do not include contingent liabilities of the Government arising from a number of commitments, including (i) direct guarantees on government owned and controlled corporation (GOCC) loans, (ii) guarantees on risks associated with build-operate-transfer contracts, (iii) future obligations of the government-run contractual savings system, (iv) currency risks of foreign loans intermediated by government financial institutions, and (v) through the provision of liquidity support to troubled banks. The Government's official series on contingent liabilities estimates the direct guarantees on GOCC loans. However, it does not incorporate the other contingent liabilities noted above, and the end-2003 estimate of P708 billion represents a fraction of the total, if contingent liabilities in pensions and banking are included.

Issues and Options

Large public sector deficits and a rising public debt burden have generated a number of adverse economic and social repercussions:

Reduced resources for human development and infrastructure. The rising public debt trend has been particularly burdensome as it has coincided with a steady deterioration in government revenue performance by over 5 percent of GDP since 1997. As a result, rising interest payments—amidst relatively stable personnel expenditure and rising transfers to local government units (LGUs)—have crowded out other

expenditures: since 1997, real per capita spending by the National Government on education and health fell by 19 percent and 43 percent, respectively (PIDS, 2003);³ and the resources available for public investment and maintenance are among the lowest in the region, amidst a large backlog of unmet needs.

Adverse impact on investor confidence and private investment. It is not just public investment that has suffered. The above trends have not been favorable for private investor confidence, particularly as they have coincided with a sense that the political process has not been conducive to achieving a fiscal turnaround. Private rating agencies have downgraded their ratings of Philippine bonds and private banks have raised warning signals about higher default probabilities. Spreads on Philippine foreign currency bonds have risen significantly in recent months, particularly in relation to the emerging market bond index (EMBI), and this has been mirrored in the peso debt market—which has resulted in more rejections by the Treasury of bids and a shortening of maturities. And the peso has been one of the few currencies weakening against the US dollar. Higher costs of domestic and external borrowing only accentuate the adverse debt trends noted above.

Without an adequate policy response, the vicious cycle of higher debt, higher borrowing costs, and higher deficits can escalate into a crisis in which capital market access becomes prohibitively expensive or impossible. Moreover, financing difficulties triggered by fiscal concerns can spill over to the banking sector since domestic banks are major creditors to the Government in both the peso and foreign exchange markets. Even if a crisis is avoided and access to the capital markets is retained, the maintenance of a public debt/GDP ratio at current or higher levels would represent an ongoing

³ Philippine Institute of Development Studies, Discussion Paper Series No. 2003-17.

drag on the economy, detracting from the ability to attract the investment to facilitate private sector-led growth and from the ability to provide adequate government resources for the maintenance of existing investment and for new public investment.

Increased Vulnerability to Shocks. It is worth noting that the recent deterioration in fiscal indicators has occurred in a benign environment for government borrowing characterized by ample liquidity in both domestic and external markets. Global interest rates are unlikely to remain at present low levels much longer, and as they rise, liquidity in emerging market bonds can be expected to tighten as investors find greater opportunity in their domestic markets. Continued high world oil prices, too, could put significant pressure on the balance of payments. More generally, a large public debt burden renders the country more susceptible to external shocks, with the primary transmission mechanisms of higher interest costs, exchange rate depreciation, and capital outflow each damaging to the goal of restoring fiscal sustainability. And if there is an external shock, the constrained discretionary funding capacity renders the National Government less able to protect those most vulnerable to the repercussions of such a shock.

The rising cost of government borrowing and the weak peso, of course, have also reflected the uncertainty associated with the May elections. A resolution of this uncertainty could well foster a recovery in financial markets. But if, in the months following the elections investors were to conclude that the new administration offered little prospect of meaningful fiscal reform, the costs of borrowing could actually increase relative to the preelection period and the peso could come under increased pressure—as investors perceive the prospect of six more years of fiscal policy drift.

Strategic Considerations. A comprehensive effort is thus needed to improve fiscal sustainability. Markets will closely observe

how the Government will face up to this issue, and it will be important to establish credibility as soon as possible. The first step is to acknowledge the scope of the problem and convince the public and Congress that the Philippines does indeed face a serious fiscal problem, which will require sacrifice to resolve, but that ignoring the situation is not a viable option. It may be productive to convene a respected group of politicians, economists, and business leaders to articulate the problem and propose solutions. An important byproduct of such a meeting can be to build a coalition to implement the tough measures that in the past have been resisted by influential vested interests.

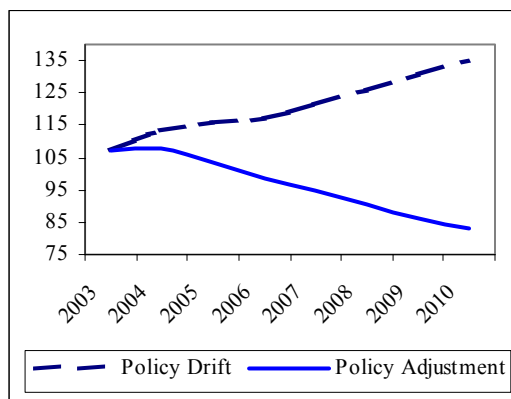
As there are clearly political costs in implementing a substantial fiscal adjustment package, it is preferable for the administration to bear these costs early in its tenure—so that it can reap the benefits of improved fiscal management in terms of higher growth and reduced vulnerability for the bulk of its period in office. Moreover, the path to fiscal sustainability will be attained not only through fiscal adjustment but also through improved investor perceptions that in turn are reflected in a stronger currency, lower interest rates, and stronger growth. Hence, actions that are viewed as a clear break from the past would be valued by investors; to the degree that they strengthen the financial markets, the extent of fiscal adjustment ultimately required may also be contained.

Orders of Magnitude. How much fiscal adjustment is needed to return to a sustainable fiscal path? There is rarely a definitive, or static, answer to this question as it depends on a range of dynamic factors (as noted above). Given the explosive growth of debt in recent years, front loading the fiscal adjustment would improve the prospect of establishing credibility with investors at the outset of the adjustment phase. But the speed of embarking on a fiscal adjustment path will also depend on how well the new administration can build a consensus for such an adjustment, and how

well the mechanisms for protecting the poor from the brunt of the adjustment can be strengthened.

A couple of illustrative scenarios (figure 2) indicate that the stakes could be high. In the “policy drift” scenario the major policy variables (tax revenue, current and capital national government expenditure) are not adjusted from their 2003 levels, and the power sector deficit jumps in 2004 and remains above its 2003 level so that the NFPS deficit/GDP ratio rises initially and remains above its 2003 level through the end of the decade, and this pushes public debt to an unsustainable path.. Also in this scenario, adverse financial market sentiment raises the cost of borrowing, weakens the peso, slows growth relative to 2003, and renders the Philippines vulnerable on a sustained basis to financing disruptions or crises. An implication of this scenario is that, given the susceptibility of financial markets to deterioration, a lack of adjustment—rather than further policy slippage—can suffice to give rise to serious economic and financial difficulties.

Figure 2. Fiscal Scenarios: NFPS Debt (% of GDP)



Source: Department of Finance, World Bank staff estimates

In contrast, a “policy adjustment” scenario that significantly strengthens the tax effort, reduces the growth of current spending, curtails power sector deficits, and limits new contingent liabilities can generate a virtuous

cycle of lower real cost of government borrowing, a stable peso in real effective terms, and increased fiscal space to finance higher public investment and deliver stronger economic growth. This scenario assumes a primary adjustment in the NFPS deficit of about 3.5 percent of GDP by the end of the decade, with the largest adjustment occurring in 2005. In this scenario, in the latter years of the decade GDP growth would be in the range of 5–6 percent, the NFPS deficit would fall to below 3 percent of GDP, and public debt/GDP would drop to 83 percent of GDP by 2010.

Suggestions

The priorities for fiscal adjustment are well known to the Philippine authorities; in recent years, it is political and legislative constraints that have held back the implementation of these reforms. This explains the importance of the above process of engaging Congress and the broader public on the rationale for undertaking the necessary adjustments. The most important of these adjustments are now outlined.

Increasing Tax Revenue. On the tax revenue front, there is a need to prevent excise taxes on petroleum, alcohol, and tobacco from eroding with inflation and to adjust existing taxes in real terms to the levels prevailing in 1997. Increasing the value-added tax rate and curtailing VAT exemptions may also be necessary in light of the adjustment needed. Tax incentives and exemptions need to be examined to determine whether they are effective in meeting their objectives of promoting exports and investment, and whether these goals can be accomplished at lower cost in terms of the revenue forgone. As measures to raise tax revenue are implemented, it will be vital to ensure that there is no loss in the momentum to improve tax administration—as the success of tax policy measures depends in large part on the public’s perception of an improving tax administration effort.

Expenditure Management. Part of the difficulty in raising tax revenue is the public's view that a significant share of public expenditure is misspent through waste, inefficiency, or fraud. To the extent that this view can be changed, gains can be realized on both the expenditure and revenue sides. The major areas for reform and adjustment on the expenditure side include: reforming the civil service to enhance efficiency and flexibility; implementing recent procurement reforms at both the national and LGU levels; reducing and rationalizing politicians' "pork barrel" funds; and adjusting, perhaps on a temporary basis, transfers to LGUs, accompanied by incentives for LGUs to enhance their own revenue-raising efforts.

Curtailling Power Deficits. In the absence of corrective measures, cash deficits in the power sector are expected to increase significantly from 1.1 percent of GDP in 2003. It has been estimated that adjusting tariffs by about US\$0.05/kWh would be needed to eliminate these losses. Fully adjusting tariffs by such an amount may not be advisable on grounds of competitiveness and affordability. But some change to power tariffs is unavoidable to maintain the credibility of the overall adjustment effort. In particular, (i) the artificial cap on National Power Corporation (NPC) tariff adjustment for power purchase needs to be lifted and (ii) NPC needs to be adequately compensated for its natural gas supply contract (on which there is presently zero cost recovery) and for all the power purchase arrangements that it services. Two other measures are important for maximizing the revenue generated from intended privatization in the power sector: (i) adopt the Transco Franchise Bill to allow the proceeds from the privatization of Transco to be maximized, and (ii) ensure that the Energy Regulatory Commission (ERC) is able to adjust prices in a depoliticized manner based primarily on economic criteria. Without such comfort, the intended sale of generation companies to the private sector will either not materialize or

will not generate revenues to their full potential.

Strengthening Management of Publicly Owned Pension Funds. The two major pension funds managed by the Government are in need of reform, which if not forthcoming, will substantially add to public sector deficits in the future. Of pressing concern is the finances of the Social Security System (SSS), which given the present package of benefits and contributions is expected to suffer increasing losses and fully deplete its assets in about 10 years. This represents a major contingent liability for the Government. Measures to strengthen SSS finances will have to include some combination of reduced benefits and increased contributions, together with tighter investment guidelines and, possibly, private management of its assets.

Managing Contingent Liabilities. The explosion of losses in the power sector in 2003 and the prospective pension losses highlight the need for putting in place stronger processes for monitoring and managing contingent liabilities in a systematic manner. This will involve tighter guidelines and stronger enforcement for granting government guarantees to financial institutions and providers of infrastructure, as well as budget provisioning for contingent liabilities linked to reasoned assessments of risk. For the banking system, strengthening private incentives for prudent banking provides the surest means of preventing banking problems from becoming a fiscal burden. This will include strengthening the legal authority to take over failing banks without the acquiescence of existing owners and ensuring that bank supervisors can enforce existing regulations unconstrained by the threat of legal challenges when acting in good faith.

The above areas for adjustment are discussed in more depth in individual briefs on strengthening revenues, public expenditure management power sector reforms, and pensions.