

PROSPECTS

External Environment

24. **The global economic recovery—though still fragile—is on firmer grounds** (World Bank, 2010¹²). After an unprecedented 2.2 percent decline in 2009, global GDP is projected to grow by 2.7 percent in 2010 and is expected to accelerate modestly to 3.2 percent in 2011 (Table 2). As the positive impact of the unprecedented fiscal and monetary stimuli and the inventory cycle wanes, the pace of the recovery is projected to slow down. This is in part because spending is expected to be less buoyant with households and the banking sector in need of rebuilding their balance sheets. Risks to the baseline projection remain substantial, especially on the downside. In particular, a double-dip characterized by a further slowing of growth could materialize if the unwinding of the fiscal and monetary policy is too rapid and forceful. The financial system remains weak in major parts of the world with 40 percent of anticipated write-downs of US-domiciled banks and 33 percent of potential losses in major European banks yet to be recognized and provisioned for (ECB Financial Stability Review, 2010¹³).

Table 2. Global Economic Prospects
(Percent Change from previous year, except interest rates and oil prices)

| | 2007 | 2008 | 2009 ^{2/} | 2010 ^{3/} | 2011 ^{3/} |
|---|------|------|--------------------|--------------------|--------------------|
| Real GDP growth^{1/} | | | | | |
| World | 3.9 | 1.7 | -2.2 | 2.7 | 3.2 |
| High income | 2.6 | 0.4 | -3.3 | 1.8 | 2.3 |
| United States | 2.1 | 0.4 | -2.5 | 2.5 | 2.7 |
| Euro area | 2.7 | 0.5 | -3.9 | 1.0 | 1.7 |
| Developing Countries | 8.1 | 5.6 | 1.2 | 5.2 | 5.8 |
| East Asia and Pacific | 11.4 | 8.0 | 6.8 | 8.1 | 8.2 |
| China | 13.0 | 9.0 | 8.4 | 9.0 | 9.0 |
| Memorandum items: | | | | | |
| World trade volume | 7.2 | 3.0 | -14.4 | 4.3 | 6.2 |
| Commodity prices (US\$ terms) | | | | | |
| Non-energy commodities | 17.1 | 21.0 | -21.6 | 5.3 | 0.7 |
| Oil Price (US\$ per barrel) ^{4/} | 71.1 | 97.0 | 61.8 | 76.0 | 76.6 |
| Oil Price (percent change) | 10.6 | 36.4 | -36.3 | 23.1 | 0.8 |

Source: Global Economic Prospects 2010, World Bank

1/ Aggregate growth rates calculated using constant 2005 U.S. dollar GDP weights; 2/ Estimate; 3/ Forecast; 4/ Simple average of Dubai, Brent and West Texas Intermediate.

25. **Faster economic growth in East Asia will be more likely sustained** but compared to recovery from the Asian financial crisis and dotcom bust, the recovery is expected to be more muted, reflecting weaker global demand and less buoyant financial conditions. Continued strong advances in China's domestic demand, and associated imports, should play an important role in underpinning a second export-led revival phase for the remainder of the region.

¹² World Bank, 2010, *Global Economic Prospects 2010*, Washington DC, January.

¹³ European Central Bank (ECB), 2009, *December 2009 Financial Stability Review*, Frankfurt, Germany.

26. **As consumption and investment activity remain vulnerable, world trade will continue to lag behind economic activity** (WB's *Global Economic Prospects 2010*). Global investment activity fell by 9.7 percent in 2009 and is estimated to grow by only 4.9 percent in 2010. Given that investment goods are generally heavily traded, world trade will remain depressed until economic recovery picks up. Furthermore, even with trade in goods and service projected to grow by 4.3 percent and 6.2 percent in 2010 and 2011, respectively, overall volume will still be 5 percent lower than its 2008 peak as a result of the weak recovery and base effects.

27. **Commodity prices will be relatively stable over the medium term.** Crude oil prices are expected to rise only slightly as a result of the large inventory overhang from the huge drop in demand and soft economic recovery. However, prices of major metal commodities, aluminum and copper are anticipated to rise moderately as metal demand expands with the recovery and excess capacity seen during the crisis is reduced. Even with increasing production costs and rising demand for biofuels, agricultural commodities are expected to be steady due to improvements in total factor productivity. Short-term food security concerns have settled down as most countries have reversed restrictive trade policies that followed from the 2008 food price crisis.

Output and Demand

28. **The Philippine economy is projected to grow by 3.5 percent in 2010, and 3.8 percent in 2011.** Growth in 2010 is slightly higher by 0.4 percentage points compared to our earlier forecast (November 2009 *Philippines Quarterly Update*). The upward revision reflects (1) a stronger global outlook, (2) stronger than expected OFW deployment in 2009 leading to an upward revision in our remittance projections (to 6.0 percent), and (3) a looser fiscal stance in 2010 than previously anticipated (in part to reflect additional spending for post-typhoon reconstruction activities). Other important growth drivers for 2010 include a replenishment of depleted stocks, election-related spending in the first half of 2010, and the strong short-term outlook for the Business Process Outsourcing (BPO) sector. The growth uptick from 2010 to 2011 is, however, expected to be moderate given our projected slow global recovery, the projected acceleration of the unwinding of monetary and fiscal policy stimuli, and more binding constraints arising from growth bottlenecks.

29. **The magnitude of the current economic downturn and its projected short-term recovery in 2010 is aligned with past Philippines recessions** (Table 3). A simple statistical comparison of growth trends around the average of the 1991 and 1998 recessions with the 2009 downturn reveals that the peak-to-trough decline in GDP are similar then and now (6.9 versus 6.2) but the composition differs noticeably. In previous recessions, the Philippines had weaker public finances and a current account deficit (Panels a and b of Table 3). This prevented the use of a forceful fiscal stimulus (-8.6 then, +2 now) and required a stronger domestic adjustment in private consumption and investment. Interestingly, the projected strength of the recovery from 2009 to 2010 is very close to that experienced in past recessions (our 3.5 percent growth projection compares to the simulated 3.4 growth—Table 3, panel b). One notable difference concerns the medium-term part of the recovery, with our global prospects projecting a protracted and muted recovery, the recovery in 2011 will not be as strong as during the previous recoveries (the recovery's shape will change from V to square root).

Table 3. Philippines: How does the 2009 Downturn Compare with Past Recessions?

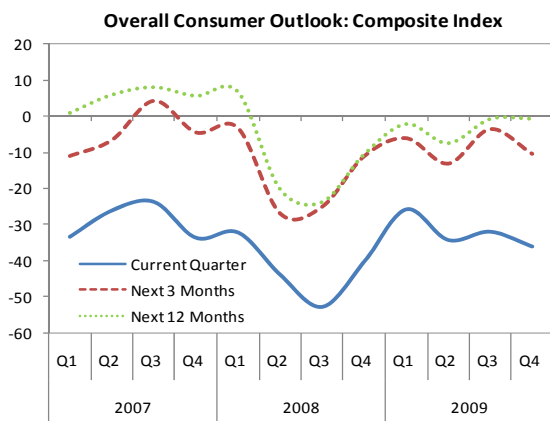
| Average GDP Growth During Crisis Years (t = 1991,1998) | | | | | | | |
|---|------|------|-------|-----|------|------|---------------------|
| | t-2 | t-1 | t | t+1 | t+2 | t+3 | Σ peak to trough 1/ |
| Private Consumption | 4.8 | 5.2 | 2.9 | 2.9 | 3.3 | 3.7 | -2.6 |
| Government Consumption | 5.6 | 5.7 | -2.0 | 2.9 | 6.2 | 0.4 | -8.6 |
| Capital Formation | 16.5 | 13.8 | -16.8 | 2.9 | 15.9 | 0.7 | -30.4 |
| Fixed Capital | 16.8 | 13.2 | -12.7 | 2.1 | 14.3 | -2.8 | -26.9 |
| Construction | 15.6 | 14.8 | -13.5 | 2.2 | 18.9 | -9.4 | -27.9 |
| Durable Equipment | 21.0 | 13.1 | -13.6 | 1.9 | 10.9 | 4.1 | -30.2 |
| Exports | 12.1 | 9.5 | -7.4 | 4.0 | 11.6 | 8.2 | -22.4 |
| Imports | 16.0 | 11.8 | -7.9 | 2.9 | 7.9 | 9.0 | -26.1 |
| GDP | 6.0 | 4.1 | -0.6 | 1.9 | 4.0 | 3.1 | -6.9 |

| Projected GDP Growth 2010-13 based on historical crisis and recovery path (t=2009) | | | | | | | |
|---|--------|------|-------|-----------|------|------|---------------------|
| | t-2 | t-1 | t | t+1 | t+2 | t+3 | Σ peak to trough 1/ |
| | Actual | | | Simulated | | | |
| Private Consumption | 5.8 | 4.7 | 3.8 | 3.9 | 4.2 | 4.6 | -2.0 |
| Government Consumption | 6.6 | 3.2 | 8.5 | 13.5 | 16.7 | 11.0 | 2.0 |
| Capital Formation | 12.4 | 1.7 | -9.9 | 9.8 | 22.8 | 7.6 | -22.3 |
| Fixed Capital | 10.9 | 2.9 | -3.5 | 11.3 | 23.5 | 6.4 | -14.3 |
| Construction | 19.4 | 4.6 | 3.9 | 19.5 | 36.2 | 7.9 | -15.5 |
| Durable Equipment | 4.5 | 1.9 | -11.4 | 4.2 | 13.1 | 6.3 | -15.9 |
| Exports | 5.4 | -1.9 | -14.2 | -2.8 | 4.8 | 1.4 | -19.6 |
| Imports | -4.1 | 2.4 | -5.8 | 5.1 | 10.0 | 11.1 | -1.7 |
| GDP | 7.1 | 3.8 | 0.9 | 3.4 | 5.5 | 4.6 | -6.2 |

Source: World Bank staff calculations.

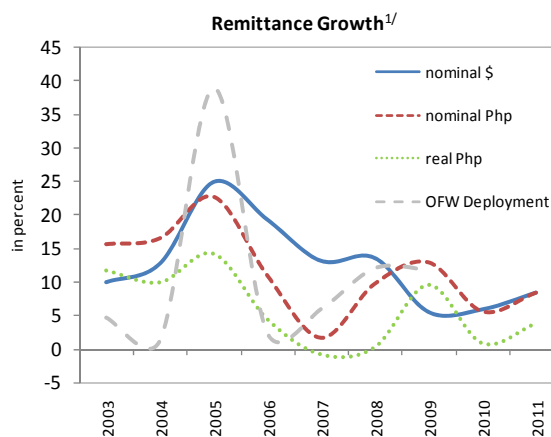
30. **Growth in private consumption is projected to hold up well in 2010 but its pace will be slower than in the pre-crisis years.** Demand is projected to benefit from increased election spending. Heightened precautionary savings that dampened spending in 2009 will more likely diminish as consumer expectation gradually over the next 12 months improve (Figure 27). The higher marginal propensity to spend is, however, projected to be partly offset by a reduced pace of remittance inflows (in real peso terms¹⁴)—Figure 28—and continued downward pressure on real wages.

Figure 27. Consumer sentiment remains cautious



Source: National Statistics Office

Figure 28. Real remittance growth



Source: Bangko Sentral ng Pilipinas

1/ Growth for OFW deployment for 2009 is only from Jan-Nov.

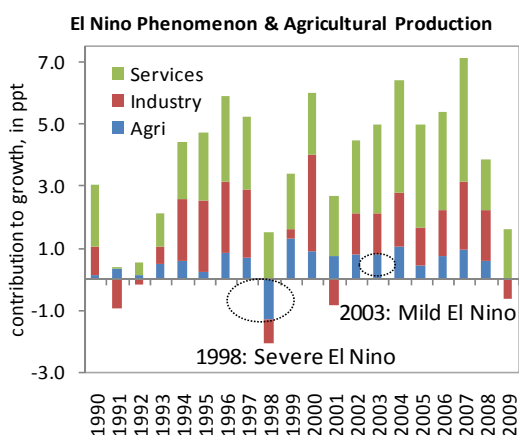
31. **Investment is projected to post a small rebound.** Capital formation is expected to remain weak, expanding by 2 percent in 2010. While restocking and some reconstruction efforts to restore lost assets during the September-October 2009 floods will provide some support, investment is projected to remain at historically low levels in 2010 as companies will want to (1) have more visibility regarding the sustainability and strength of the recovery; and (2) delay some

¹⁴ While the rate of growth of remittance inflows are projected to increase in US dollar terms, partly on account of still robust deployment of Filipino workers that took place in 2009 (12 percent growth in January to November 2009 compared to 17 percent in 2008) the impact of these inflows on consumers' purchasing power will be tempered by the expected higher increase in prices and moderate strengthening of the Peso (compared to 2009).

investment to after the May general elections before committing to long-term irreversible investment plans. On the public sector side, investment will be constrained by the election ban on the inception of new projects. With the Philippines’ global ranking in Doing Business surveys steadily declining over time, FDI inflow is expected to remain moderate.

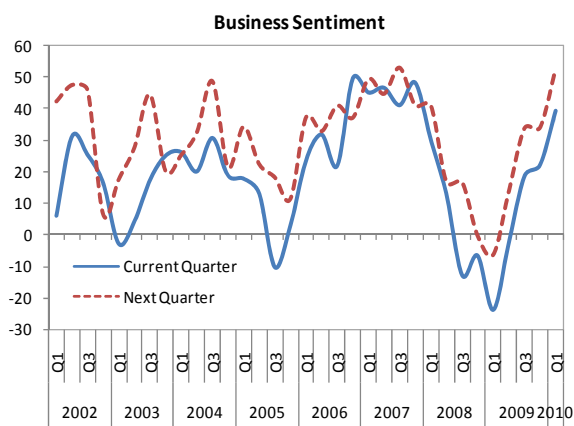
32. **On the production side, a weak but more-broad based improvement is seen in 2010,** as revealed by the overall improvement in business sentiment (Figure 30). Having been devastated by the massive flooding in the last quarter of 2009, the agriculture sector is expected to recover and grow moderately percent in 2010 from 0.1 percent. The slow growth pick up is due to the moderately strong El Niño phenomenon that is projected by the Philippine Atmospheric, Geophysical and Astronomical Services Administration (PAGASA). This will negatively impact agriculture output, and rice production in particular. A rebound in manufacturing worldwide will push overall industrial production to 3.1 percent in 2010. Backed by increased demand for transportation, communication and storage, and trade service during the election period, the services sector is projected to grow by 4½ percent this year.

Figure 29. El Niño’s impact on Agriculture and GDP



Source: National Statistics Office

Figure 30. Business sentiment is surging



Source: Bangko Sentral ng Pilipinas

33. **The outlook is subject to El Niño-related downside risk.** A worse-than-expected El Niño could significantly pull down the economy’s aggregate growth rate. Indeed, the severe 1998 El Niño phenomenon impacted agricultural output so much that the sector’s contribution to the drop in GDP was actually larger than the impact of the Asian financial crisis (Figure 29). Production would be further affected if typhoon-damaged agricultural infrastructure were not reconstructed on time. A worse El Niño could also cause supply disruptions and a resurgent food price shock. As in 2008, this could result to an uptick in inflation, reduce real income and increase the losses of the National Food Agency. The latter’s loss would be an automatic liability of the public sector.¹⁵ El Niño has already noticeably reduced the capacity of hydroelectric power plants, especially in Mindanao where this has resulted in large scale rotating power cuts. Similar but less extensive power cuts have also taken place in Manila. A worse than expected El

¹⁵ For an overview of the stark inefficiency of the NFA in providing support to the poor and the large fiscal cost involved, see Box 3 of the November 2009 *Philippines Quarterly Update*.

Niño phenomenon, through its impact on electricity supply, would significantly affect energy-intensive industry sectors, including electronics and semi-conductors that account for about 60 percent of the country's exports.

34. **Upside risks to the outlook include a stronger-than-expected global recovery.** This could have a positive impact on the domestic economy via its impact on OFW deployment, remittances and exports which could grow faster than anticipated in our baseline scenario.

Employment and Poverty

35. **The labor market is expected to improve but its structural weaknesses will remain unless reforms are introduced.** Aside from the general recovery in economic activity, the general election campaign will provide temporary employment opportunities especially for unskilled workers. Structural improvements, however, can only occur through structural reforms of the labor market. Overseas working opportunities, while somewhat reduced compared to the pre-global recession period, are projected to continue providing relief to the rapidly expanding domestic labor force.

36. **Generating inclusive growth is projected to remain a fundamental challenge for the Philippine economy; poverty incidence is estimated to remain high.** The food crisis in 2008, the economic downturn and the recent typhoons have thrown an estimated 1.4 million households into poverty, compared to a no-crisis scenario (See November 2009 *Philippines Quarterly Update* for details). While the resumption in growth is a necessary condition for poverty incidence to decrease, as the experience between 2003 and 2006 testifies, this is not a sufficient condition. The El Niño phenomenon could, in particular, be a significant source of new duress for poor and near poor households. This could also generate large increases in hunger incidence as 74.8 percent of the poor reside in rural area where self-subsistence farming is widespread (World Bank, 2010¹⁶).

Balance of Payments and External Debt

37. **The outlook on the balance of payment remains positive with the current account projected to remain in surplus thanks to remittances** (Table 4). While it is expected to be lower than the expected surplus of 5.5 percent of GDP in 2009, the current account is projected to post a robust surplus of 3.5 percent of GDP in 2010. The strong outlook hinges on the prospect of higher remittances as a result of increased deployment of Filipino workers during the crisis and the recovery in the global economy. The capital account is expected to widen, due to higher external financing needs from the public sector. To date, the issuance of global and Samurai bonds have already boosted the overall BOP balance in 2010. Total inflow of foreign direct investment is expected to moderately improve.

38. **Exports and imports are projected to recover in 2010 but would still remain significantly below pre-crisis levels.** Exports are projected to return to pre-crisis level only gradually (by 2012). With nearly 60 percent of the country's exports consisting of electronics and semi-conductors which were traditionally mostly aimed at final consumers in developed

¹⁶ See chapters 4 and 6 of *Philippines: Fostering More Inclusive Growth*, World Bank, forthcoming

countries (the US, EU, and Japan in particular), the country is expected to only benefit moderately from the strong projected growth in the East Asia region. The country's improved ranking in the World Bank's World Trade Indicators, notably in the Logistics Performance Index, is welcome and encouraging. Continued improvement in the overall investment climate would greatly help the country increase capacity and diversify its exports.

39. Continued demand for Overseas Filipino Workers ensures growth of remittances for 2010. As deployment of both unskilled and skilled workers like engineers, health workers and teachers remained strong in 2009 (growth of 12 percent through November), workers remittance inflows are projected to continue growing (by 6 percent). Demand for Filipino labor is expected to continue in 2010, albeit at a slower pace than in 2009, as the global recovery is projected to have a low job intensity in 2010.

Monetary Policy

40. Inflation is expected to accelerate modestly in 2010 but to stay within the BSP's announced target band. Well anchored inflation expectations (Figure 31), a weak labor market, a positive output gap, and a projected modest rise in global commodity prices all point to contained domestic inflation. However, some supply side bottlenecks are expected to drive up inflation slightly (to 4.8 percent in 2010). These include some localized food supply shock stemming from the El Niño phenomenon which is already being felt in 14 provinces and is expected to persist until June 2010 (PAGASA, 2010¹⁷). As a result, food prices this year are expected to rise faster than in 2009. Also, while electricity supply is constrained by lower water level in hydropower plants/dams, demand for electricity and water are expected to increase due to higher heat levels. Upside risks to our inflation forecast include the possibility, after the general election, of adjustment in politically sensitive administered prices (e.g., utilities tariffs) and in taxes. Potentially higher commodity prices also present an important upside risk.

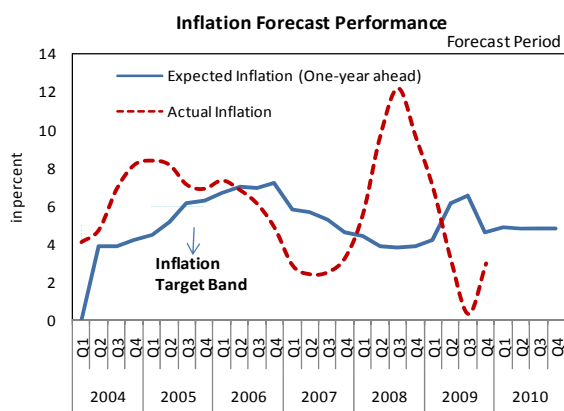
41. The central bank's exit strategy from the crisis-fighting measures is clearly and coherently articulated. The Bangko Sentral ng Pilipinas (BSP) has clearly and explicitly announced sound principles to guide its exit strategy. First, the discontinuation of liquidity-support measures contingent on the normalization of activity in the financial markets. Second, subject to maintaining the inflation outlook and inflation expectations within the BSP's target band, the central bank will continue its accommodative monetary policy stance until the economic recovery gathers pace and traction. Such a strategy is consistent and aligned with the overarching objective of achieving inclusive and sustained economic growth in the Philippines (MTPDP 2004-2010).

42. Well anchored inflation expectations and a slow elimination of the positive output gap provide some leeway for the BSP to implement its exit strategy. With inflation expectations well anchored (Figure 31), the BSP has enough room to maintain accommodative monetary policies to support the recovery. In addition, the output gap is projected to remain large and positive in 2010 and to close only in 2013. Demand-driven inflationary pressures are, therefore, expected to remain tame for some time. As far as asset-price inflation is concerned, while stock market prices have sharply rebounded and exceed their pre-Lehman Brothers level

¹⁷ PAGASA Advisory no. 6 (February, 2010)

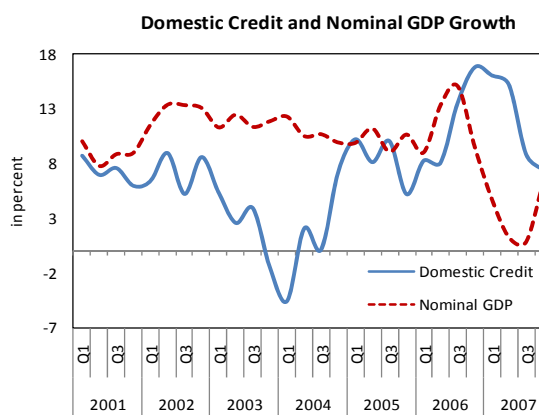
(Figure 15), stock market ownership remains limited in the Philippines (estimated at less than 2 percent of the population) so that they are not expected to have a significant macroeconomic impact on domestic demand conditions. Similarly, while domestic credit growth greatly outpaced nominal GDP growth in 2009, such rapid expansion likely reflects the low base and a catch up effects from years of below nominal GDP growth (Figure 32).

Figure 31. Inflation expectations remain well anchored



Source: Bangko Sentral ng Pilipinas

Figure 32. Credit growth lags behind nominal GDP growth over the medium-term



Source: Bangko Sentral ng Pilipinas

Fiscal Policy

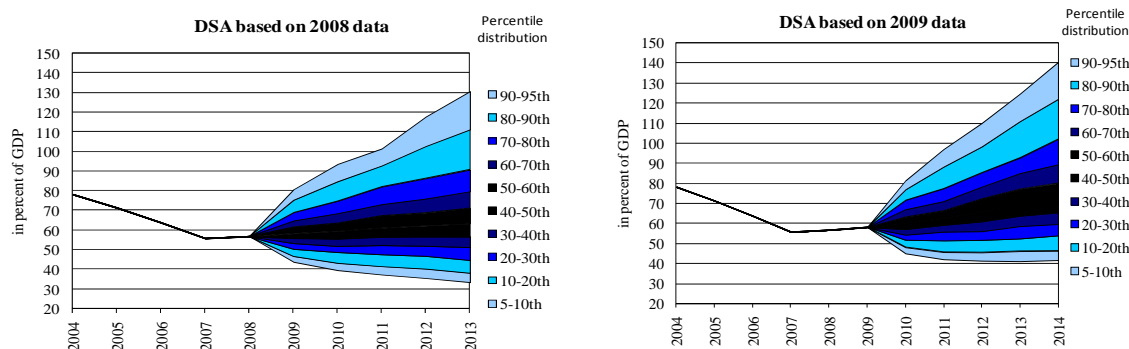
43. **Establishing and clearly disseminating a detailed and credible fiscal exit strategy is crucial to enabling a measured unwinding of the fiscal stimulus.** While the fiscal stimulus helped buffer the economic slowdown, the structural deterioration in the fiscal balance is not sustainable over the medium-term. A comparison of the prospects for the debt path of the National Government between 2008 and 2009 (“Fan chart” of Figure 33, panel a and b, respectively) reveals that probabilistic distribution of debt exhibits a notable upward shift, with far fewer likelihood of the debt ratio going down.¹⁸ A detailed and credible strategy to reduce the large structural fiscal deficit over time is therefore crucial to maintaining investor, entrepreneur, and consumer confidence which is necessary to generate inclusive growth. Such a strategy could, for instance, lay out specific measures that would be used, both on the revenue and the expenditure side to achieve the stated goal of reaching fiscal balance by 2013. Some countries have found that pre-announcing the timing of some of these measures can be used both to instill confidence in the exit strategy itself but also to boost current consumption (e.g., this would be the case with a pre-announced increase in taxes on consumption).

44. **Nesting the planned unwinding of the fiscal stimulus within a detailed medium-term fiscal framework would enhance credibility.** A specific medium-term plan and path for unwinding the fiscal stimulus would minimize a fiscal crisis risk. While the Government aims to

¹⁸ For example, as of 2008, the probability that the NG debt-to-GDP ratio would reach or exceed 80 percent by 2013 was a relatively low 15 percent. By 2009, that probability has increased to 30 percent (Figure 33).

achieve an overall fiscal balance by 2013, accompanying this commitment with detailed measures (and their likely timing and yield) and embedding them within a medium-term fiscal framework and a medium-term expenditure framework would be desirable. Undertaking and publishing (say, as an annex of the annual NG budget document) a statement of fiscal risks surrounding the National Government budget would also help in improving the transparency and credibility of fiscal policy.¹⁹

Figure 33. The National Government debt sustainability prospects deteriorated between 2008 and 2009



Source: World Bank staff calculations based on Celasun et al. (2006), “Primary Surplus Behavior and Risks to Fiscal Sustainability in Emerging Market Countries: A “Fan-Chart” Approach,” IMF Staff Papers, Vol. 53(3), pp3-34. The “fan chart” approach builds on the baseline debt path projected in a standard debt sustainability analysis (using the baseline macroeconomic scenario shown in Table 4) by adding confidence intervals around this central projection (the confidence interval is constructed by drawing on the joint distribution of historical shocks to key macroeconomic variables—e.g., economic growth, the exchange rate, domestic and foreign interest rates). The fan chart reveals that while the baseline scenario (50th percentile) projects a debt path that is broadly stable, there is significant uncertainty surrounding this projection. See Chapter 2 of the *2009 Philippines Development Report* for further details on the methodology and its application to the Philippines.

45. **Creating a strong revenue base is crucial to increasing fiscal space needed to support a sustained and inclusive growth.** With no new revenue-increasing policy measures to boost tax collection and a few to erode it, the tax effort is projected to reach 13.0 percent of GDP in 2010, only marginally higher than in 2009 (Table 5). The rebound in the tax effort from high-elasticity taxes such as the corporate income tax is expected to be offset with (1) the loss carry forward stemming from the 2009 economic downturn and the Ondoy and Pepeng typhoons²⁰ and the new tax eroding measures such as the selective VAT exemption for senior citizens. On the expenditure side, the salaries of government employees will continue to increase (by 50 percent over four years starting in July 2009) as a result of the Salary Standardization Law III (the total cost is budgeted at P125.6 billion or 1.6 percent of 2009 GDP). Capital spending is projected to shrink as a ratio of GDP compared to 2009 as a large part of the 2009 increase was related to the fiscal stimulus plan. The fiscal deficit (GFS definition) is projected to reach 3.8 percent of GDP

¹⁹ See the forthcoming *2009 Philippines Development Report* for an overview of fiscal risks in the Philippines.

²⁰ The tax impact of the typhoon will also arise from VAT input refunds that companies are entitled to. The extent of the actual refunds is unclear, however, as such refunds are surprisingly low in the Philippines. One reason is that such requests require extensive administrative paperwork and trigger an automatic audit of the company seeking such a refund. The refund process takes several years (far exceeding the legally mandated six months) and, even when granted, the funds would seldom be given in cash but be provided in the form of a tax credit certificate. A lack of a well functioning input credit refund process fundamentally destroys the neutrality and efficiency of the VAT—whereas these are precisely the advantages of relying on a VAT.

in 2010 from 4.1 percent in 2009. Barring new reform measures, the deficit—which is mostly of a structural nature (Figure 26)—is expected to remain sizeable over the medium term.

46. The following measures could be considered to efficiently and equitably strengthen the revenue base:²¹

- *Tax policy:* (1) A moratorium on new tax eroding policy measures until the tax effort has returned to, at least, its 2008 level, (2) the rationalization of fiscal incentives, which would broaden the base, eliminate tax redundancies (estimated at 1 percent of GDP), improve horizontal equity among firms, not distort capital allocation, and facilitate tax administration and governance, (3) implementation of a law that limits deductions to core business expenses (as provided in some versions of the SNITS), and (4) increased excises on tobacco, alcohol, and gasoline. This last measure has the best revenue potential because it is efficient, highly progressive, and easy to collect; Box 1).
- *Tax administration:* such reforms would both help with short-term revenue gains and pave the way for long-term improvement in administrative efficiency. Through improved tax compliance they would also improve horizontal and vertical equity. The renewed focus of the BIR leadership to strengthen its Large Taxpayers Service (LTS) is commendable. At the same time, ongoing tax compliance and collection reform measures need to be pursued forcefully.³¹ Focus on these compliance-improving measures is warranted by a provision in the 2009 budget to institutionalize the RATE, RATS, and RIPS programs as permanent offices in the BIR, BOC, and DOF respectively. Improving performance monitoring and evaluation in BIR and BOC would help strengthening accountability, professionalism, and transparency of the Bureaus.

47. **Rationalizing expenditure, including off-budget spending could also help increase the spending efficiency.** To increase fiscal space and make room for more effective and targeted spending, reforms aimed at streamlining costly and non-targeted social spending programs such as the rationalization programs of the NFA and NIA should be a priority.²² While these programs mostly operate off-budget, they generate losses that affect the public sector fiscal balance.

²¹ These recommendations are detailed in the *2009 Philippine Development Report* (forthcoming).

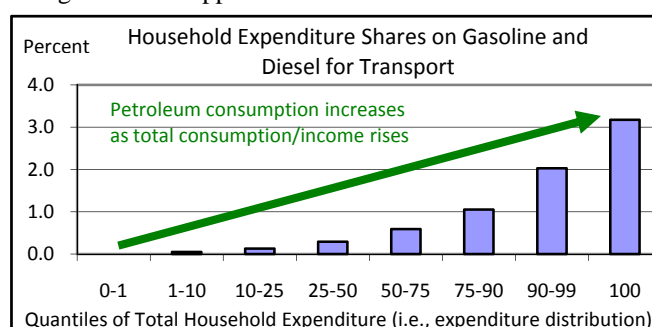
³¹ These include expanding the tax base via third party information sharing and strengthening enforcement via the Run After Tax Evaders (RATE), Run After the Smugglers (RATS), and Revenue Integrity Protection Service (RIPS) programs. See the November 2008 *Philippines Quarterly Update* for details.

²² See Box 3 of the November 2009 *Philippines Quarterly Update* for a comparison of the efficiency and cost-effectiveness of the NFA and the CCT program as social safety net programs. The analysis concludes that, by reallocating the fiscal transfers from the NFA to the CCT, 100 percent of the poor would receive coverage, against 25 percent, with each poor household receiving 7 times the benefits it receives with the NFA.

Box 1. Petroleum Taxation in the Philippines

Tax collection from gasoline and diesel excises has plummeted since 1997; the beneficiaries have been the most well-off Filipinos. From 1997 to 2009, excise collection (in percent of GDP) has been reduced by 1.8 percentage points of GDP. The sum of the annual losses in excise collection since 1997 reaches a staggering 18.2 percentage points of GDP (P1,400 billion; \$30 billion) once interest costs are included.^{1/} Maintaining the 1997 excise effort level, or the real value of excises, would have resulted in a drastically lower public debt (currently exceeding 60 percent of GDP). Such a relatively high level of debt requires about 4 percent of GDP in annual debt service payment; this money could have been allocated for the much needed priority spending on infrastructure, health, education, and social protection, thereby benefiting the poor. Petroleum excises on gasoline and diesel are among the most progressive taxes in the Philippines—i.e., the tax rate increases as your income increases (Figure 34). However, with the real tax rate decreasing steadily over time, this has eroded the *effective* progressivity of tax system in the country. Hence, the richer the household, the larger the benefit received from lower excises on petroleum products... at the expense of the budget.

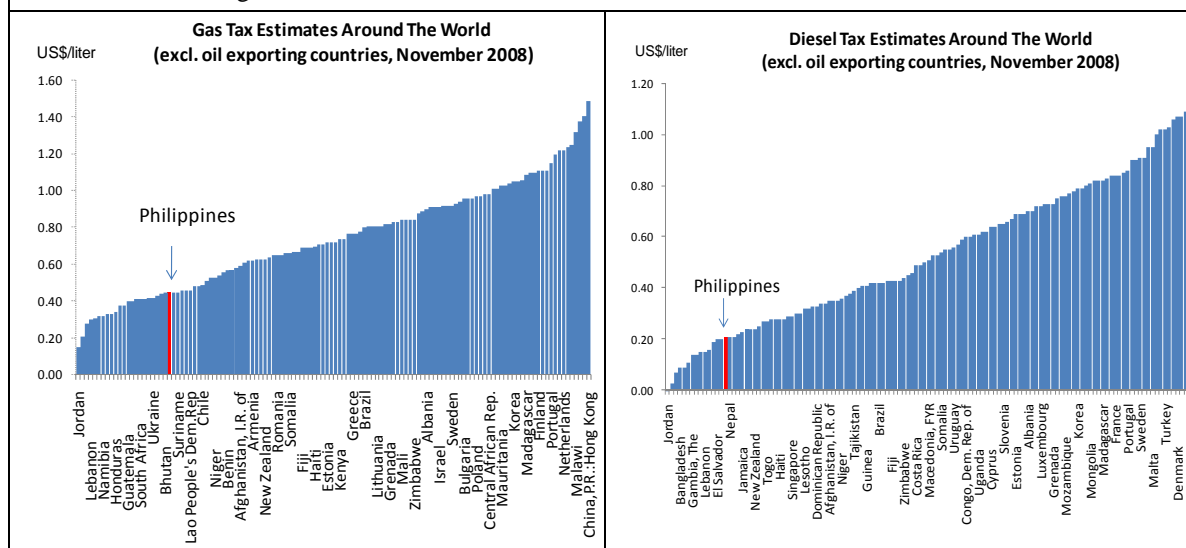
Figure 34. Philippines: Petroleum Taxation and the Poor



Source: FIES 2006 and World Bank staff calculations.

Gasoline and diesel taxation in the Philippines is low by international standards—Rich consumers in most countries pay higher taxes than rich Filipino consumers (especially for diesel)—Figure 35. The range of countries with higher petroleum taxation ranges from emerging markets (e.g., Turkey) to low income (e.g., Bangladesh, Mauritania) and developed countries (e.g., Japan, Hong Kong, Korea, Singapore).

Figure 35. Gasoline and Diesel Tax Estimates Around The World, 2008*



Source: OECD, International Energy Agency, “Energy Prices and Taxes”.

* Excluding oil exporting countries. Data as of November 2008.

1/ Since the fiscal balance has been in deficit, the foregone revenue was financed through debt issuance.

Box 1 (Continued). Petroleum Taxation in the Philippines

Raising revenue through petroleum excises has several economic and social advantages. First, excises on petroleum products satisfy two key tax policy principles: efficiency and equity.^{2/} They are efficient since they are imposed on goods with low short-term elasticity of demand. They are vertically equitable since the share of gasoline and diesel consumption in total household consumption sharply increases with income. Provided smuggling activity can be controlled, they are also comparatively horizontally equitable since avoiding the excise on petroleum products is less easily available to taxpayers than, say, avoiding corporate profits. Second, petroleum excises are introduced to correct negative externalities—i.e., bad side effects—created by the consumption of petroleum products (e.g., traffic congestion, accidents, but also pollution which creates health hazards and environmental damages). As the Philippines is systematically affected by major natural disasters, one would expect the country to internalize more—and certainly not less—than others the environmental impact of gasoline consumption; as Figure 35 reveals, this is not the case. Third, they are easy to administer since excises are levied at the border when goods are imported (an effective border control and anti-smuggling operation is important).

Preliminary estimates reveal that, for each 5 percent increase in retail pump prices of gasoline and diesel, tax revenue would increase by 0.1 percent of GDP. Hence, an increase in excises generating a 25 percent increase in retail pump prices would enable to raise 0.5 percent of GDP in tax revenue (both through excises and the associated higher VAT). Such an increase would offset most of the structural deterioration of the fiscal balance observed in 2009. This would increase petroleum excise collection to half its 1997 level of 1.2 percent of GDP. To further increase the progressivity of such a measure, the revenue raised (from the most well off citizens) could be partly allocated to pro-poor spending and partly contribute to the goal of balancing the budget by 2013.

Governments around the world have introduced large increases in petroleum excises either in one step or progressively but according to credible, simple and automatic mechanisms. In the latter case, international experience shows that asymmetric adjustment mechanisms have many desirable features that make them socially and politically acceptable. One such mechanism could have the following features:^{3/}

1. Each month, the excise level would be automatically adjusted according to the following formula:

$$E_{t+1} = \min \left(E_t + \frac{1}{2} (P_t - P_{t-1}) * D, E^* \right), \text{ where } D = \begin{cases} -1 & \text{if } P_t - P_{t-1} < 0 \\ 0 & \text{if } P_t - P_{t-1} \geq 0 \end{cases} \text{ and } E \text{ is gasoline excise (in peso per liter), } t \text{ stands for time (expressed in month), } P_t \text{ is the pre-tax retail price the end of period } t \text{ (in peso per liter), and } E^* \text{ is the target level of excise to be achieved (in peso per liter).}$$
2. Once the target level of excise is achieved, this target level should be automatically adjusted with inflation, preferably semi-annually but, at a minimum, annually.

To conclude, increasing petroleum excises would generate revenue from the richer Filipino households and would enable to provide resources for pro-poor pro-growth spending; evidence shows it need not be politically infeasible. Raising petroleum excises should rank high among priority policy measures considering that (1) revenues are crucially needed to finance needed priority spending on health, education, social protection, and infrastructure, especially given the 2009 deterioration of the structural fiscal balance, (2) petroleum excises are strongly progressive in the Philippines with the poor hardly consuming gasoline and diesel, (3) the rich are lightly taxed on their petroleum consumption in the Philippines compared to the rest of the world, (4) the Philippines under-taxes (compared to the rest of the world) a major source of global warming and natural disasters to which the country is severely exposed. The 2008 large increase in retail pump prices of petroleum products (accompanied with a cash transfer program to protect the poor) in Indonesia reveals that raising retail pump prices need not be politically costly as President Yudhoyono was re-elected in 2009.

2/ The efficiency arises as they are imposed on goods with a low elasticity of demand such as petroleum products; as a result, they create limited tax distortions. Vertical equity is said to occur when lower earning taxpayers pay lower effective tax rates than higher income ones while horizontal equity arises when taxpayers with similar incomes face similar effective tax rates (where “effective” refer to the actual tax paid, not the statutory one; in practice, weak tax compliance and corruption can drive a large wedge between the two).

3/ More complex formula can be designed, however, political economy considerations as well as public understanding and support of such reforms favor relatively simple adjustment mechanisms.

Box 2. Philippines: Revisions to the National Income Accounts

The National Statistical Coordination Board (NSCB) will soon release a new GDP series that adopts some of the recommendations of the 1993/2008 SNA.

The system of national accounts consists of a coherent and integrated set of macroeconomic accounts and tables based on internationally agreed concepts, classifications, and accounting rules. It provides a systematic statistical framework within which economic data can be compiled and presented for the purposes of economic analysis and policy making. Regular updates in the methodology are needed to better capture changes in the economy and improve accuracy of the estimates.

Currently, the Philippine System of National Accounts (PSNA) is still largely based on the 1968 SNA but to a certain extent has adopted some recommendations of the 1993 SNA and uses an outdated base year of 1985. The NSCB is now embarking on a major revision and rebasing of the PSNA to enhance its relevance.

The revised and rebased PSNA features include the following:

- New base year of 2000
- Use of the amended 1994 Philippine Standard Industrial Classification and the 2004 Philippine Standard Commodity Classification
- Highlighting of the following subsectors in agriculture, industry and services: mango, pineapple, coffee, cassava, rubber, steam, BPO, among others
- Use of the Classification of Individual Consumption by Purpose (COICOP) for PCE items that used to be under Miscellaneous Expenditures, such as: health, transport, communication, recreation, education, restaurants and hotels
- Highlighting of a new set of principal merchandise exports and imports of the Philippines
- Use of updated data and new data
- Use of updated parameters and price/price indices
- New concepts/definitions due to the adoption of the 1993/2008 SNA international guidelines for the compilation of national accounts, such as:
 - Extension of gross capital formation to include military equipment, computer software and database, research and development
 - Treatment of monetization of gold as financial asset and excluded from exports
 - Valuation of merchandise exports and imports at Free-on-Board (FOB)
 - Transfer of freight and insurance from imports of merchandise goods to exports of services
 - Transfer of motor vehicle repair from other services to trade
 - Transfer of public education and public health services from government services to other services
 - Transfer of business activities from other services to real estate, renting and business services.

NSCB is targeting to release the rebased/revised annual and quarterly national accounts for the years 1998-2008 in May 2010 and the rebased annual gross regional domestic product by September 2010. The rest of the series (i.e., 1946-1997) will be revised and rebased by May 2011.