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# PHILIPPINE ECONOMIC UPDATE

## INVESTING IN THE FUTURE
## SHARING GROWTH AND JOB OPPORTUNITIES FOR ALL

**August 2014**

Macroeconomics and Fiscal Management Global Practice
Philippine Country Office
East Asia and Pacific Region

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# PREFACE

The *Philippine Economic Update* provides an update on key economic and social developments as well as policies over the past 6 months. It also presents findings from recent World Bank studies on the Philippines. It places them in a longer term and global context, and assesses the implications of these developments and policies on the outlook for the Philippines. Its coverage ranges from the macro-economy and financial markets to indicators of human welfare and development. It is intended for a wide audience, including policymakers, business leaders, financial market participants, and the community of analysts and professionals engaged in the Philippines.

The *Philippine Economic Update* is a report of the World Bank's Macroeconomics and Fiscal Management (MFM) Global Practice Team. The macroeconomic sections were prepared by Paul Mariano (Research Analyst and Task Team Leader), Joseph Louie Limkin (Research Analyst), Christina Epetia (Research Analyst), and Christine Ablaza (Research Assistant) under the guidance of Karl Kendrick Chua (Senior Country Economist), Rogier van den Brink (Lead Economist and Program Leader), and Mathew Verghis (Practice Manager). The medium-term reform agenda section was prepared by Karl Kendrick Chua. Secretarial and publication support by Maria Consuelo Sy (Program Assistant) and Ayleen Ang (Team Assistant) are gratefully acknowledged.

The Manila Communications Team, comprising Leonora Gonzales (Senior Communications Officer), David Llorito (Communications Officer), Justine Letargo (Online Communications Officer), and Geralyn Rigor (Program Assistant), prepared the media release, dissemination, and multimedia products for the web.

The report benefited from the advice, comments, and views of various stakeholders in the World Bank, the Government, business, labor, academe, and civil society. The team is very grateful for their time and inputs.

The findings, interpretations, and conclusions expressed in this *Update* are those of World Bank staff and do not necessarily reflect the views of its management, Executive Board, or the governments they represent.

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For information about the World Bank and its activities in the Philippines, please visit www.worldbank.org/ph.

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# EXECUTIVE SUMMARY

*This edition of the Philippine Economic Update (PEU) builds on the March 2014 edition of the PEU by providing a brief update on first quarter performance and recent policy developments. For more discussion on the underlying developments, assumptions, and policy recommendations, the reader is referred to the March 2014 edition of the PEU.*

**After recording strong growth in the last 2 years, Philippine economic growth decelerated to 5.7 percent in the first quarter of 2014 (Q1 2014).** On the supply side, the services sector continued to be the main driver of growth while agriculture remained weak. On the demand side, growth was driven by private consumption, durable equipment, and infrastructure spending. Moreover, the recovery of net exports after 5 quarters of contraction contributed to growth. Their contribution, however, was muted by weak government consumption and the decline in private construction.

**After many years of slow poverty reduction, poverty incidence declined by 3 percentage points (ppt) between 2012 and 2013 to 24.9 percent, uplifting 2.5 million Filipinos out of poverty.** For the first time in the country's history, the Government released comparable poverty estimates for 2 consecutive years instead of with the usual three-year gap. Stronger job creation in the first half of 2014 (H1 2014) suggests that faster poverty reduction is expected to continue.

**Given the slow start in Q1 2014, lower government spending in Q2 2014, and monetary policy tightening, baseline growth projections are revised downwards from 6.6 to 6.4 percent for 2014 and from 6.9 to 6.7 percent for 2015.** Strong domestic demand would continue to drive overall growth. Private consumption is expected to contribute more than half of GDP growth, supported by strong inflow of remittances. Ongoing and recently awarded public-private partnership projects equivalent to around 1.5 percent of GDP are also new sources of growth. Finally, an acceleration of reconstruction spending can support growth at above 6 percent.

**A number of external and domestic factors could pose risks to growth.** External risks could come from disorderly policy normalization in high-income countries, a disorderly adjustment in China's property market, political tensions in the Middle East and Eastern Europe, and territorial disputes in the region. On the domestic side, the main sources of risk are slow reconstruction spending and domestic reform lags, in particular reforms to raise tax revenues needed to raise infrastructure and social services spending.

**Strong liquidity and credit growth, as well as higher food and energy prices, continue to exert some risks to price and financial stability.** CPI inflation is projected to reach 5 percent this year from 3 percent last year. These factors have led to some monetary tightening in the first 7

months of 2014. Further monetary policy tightening and greater use of macroprudential measures may be warranted to manage risks to price and financial stability.

**In the medium-term, growth can be sustained and made more inclusive by pursuing structural reforms and investing more in human and physical capital.** A projected negative output gap by 2017 makes investments even more urgent. Key structural reforms include protecting property rights, promoting more competition, and simplifying regulations. These are discussed in the recently launched Philippine Development Report "Creating More and Better Jobs." The Government's planned doubling of infrastructure spending to 5 percent of GDP, as well as significant increases in health and education spending, requires new sources of revenues. This can be achieved through a package of tax policy and administrative reforms. There is scope to increase tax revenues by broadening the base to making the tax system simpler, more efficient, and more equitable, while also lowering certain tax rates to increase the political feasibility of such a package.

**The Aquino Administration has successfully raised tax effort by 1.2 ppt of GDP in the last 3 years through the sin tax reform, improved tax administration, and higher growth.** Accelerating the current reform momentum would help the country yield additional tax revenues to create the fiscal space needed to enhance growth in the coming years.

**These reforms can help the country become more competitive, and in the process create more and better jobs, and accelerate poverty reduction.** With further economic reforms, especially in areas which will have more impact on the lives of the poor, the Government can help put the country on an irreversible path of inclusive growth and meet the jobs challenge.

# RECENT ECONOMIC AND POLICY DEVELOPMENTS

## Output and demand

1. **Philippine economic growth decelerated to 5.7 percent in  in the first quarter of 2014 (Q1 2014), but continued to outperform other countries in the region.** After sustaining growth of above 6 percent for 8 consecutive quarters, growth slowed down due to weak government consumption and private construction on the demand side, and weak agricultural production on the supply side. While overall public infrastructure spending rose significantly, Typhoon Yolanda-related reconstruction had a slow start. The country's growth rate compares favorably to other countries in the East Asia region, surpassed only by China (7.4 percent) and Malaysia (6.2 percent) (Figure 1).

2. **GDP growth remained consumption-led, while investments provided some support despite the contraction in private construction** (Figure 2). Private consumption grew by 5.8 percent and contributed 4 percentage points (ppt) to overall growth. It was supported by large inflows of remittances, which accelerated by 6.6 percent in Q1 2014. The growth of overall investment at 7.7 percent was driven mainly by domestic investment, as foreign investment declined.[1] The key drivers of investment were public infrastructure and durable equipment spending, with significant purchases of vehicles, airplanes, and machineries. Private construction, however, contracted by 6 percent. The number of building permits issued declined in 3 out of the past 5 quarters (Figure 3).[2] This suggests that the real estate boom may be around its peak.

3. **Net exports recovered for the first time in 5 quarters and contributed 1.8 ppt to overall growth.** The recovery of electronics exports and the robust performance of services exports, which includes the fast growing business process outsourcing (BPO) industry, drove overall exports growth to 12.6 percent. This sharp recovery offset the 8.6-percent acceleration of imports, resulting in a lower trade deficit. This, together with strong inflow of remittances, resulted in a current account surplus of 3.1 percent of GDP, up from 2.7 percent during the same period last year.

4. **On the supply side, the services sector remained the main driver of growth, while the performance of agriculture was constrained by recent disasters** (Figure 4). The services sector grew by 6.8 percent and accounted for 3.8 ppt of overall growth. All services subsectors grew, led by the real estate, renting, and business activities subsector. Meanwhile, manufacturing growth slowed down to 6.8 percent from 10.3 percent in 2013 as food manufacturing contracted. Its full impact was offset by higher growth in furniture and fixtures, and electronics,

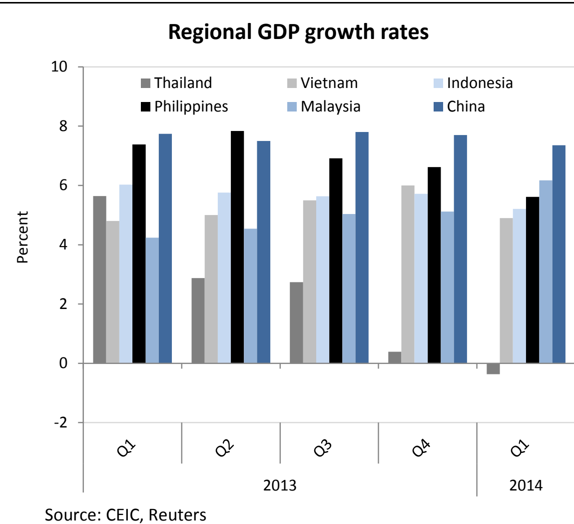
[1] Foreign direct investment fell by 11.6 percent to USD 1.9 billion in Q1 2014.

[2] Private construction had been decelerating for 5 quarters, from growth of over 40 percent in Q4 2012 to less than 2 percent in Q3 2013 before entering negative territory by Q4 2013.

owing to the recovery of exports. In contrast, agriculture grew by 0.9 percent as the sector suffered from extensive damages brought about by various weather-related disasters in 2013.

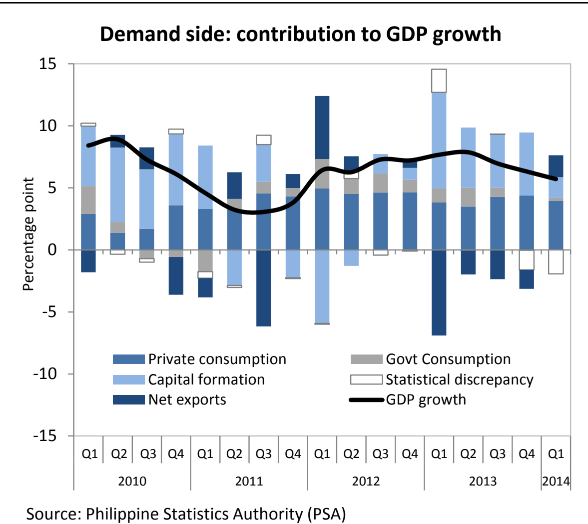
5. **Government consumption grew by only 2 percent.** This was caused by government consumption in Q1 2013, which was much higher due to "one-time, non-recurring" expenditures such as i) the last of 4 tranches of salary increases under the Salary Standardization Law III, ii) expenditures in the run-up to the 2013 general elections, and iii) lower tax expenditures and subsidies for government-owned and controlled corporations (GOCCs).

**Figure 1. The Philippines remained one of the fastest growing countries in the region, despite its lower-than-expected growth.**



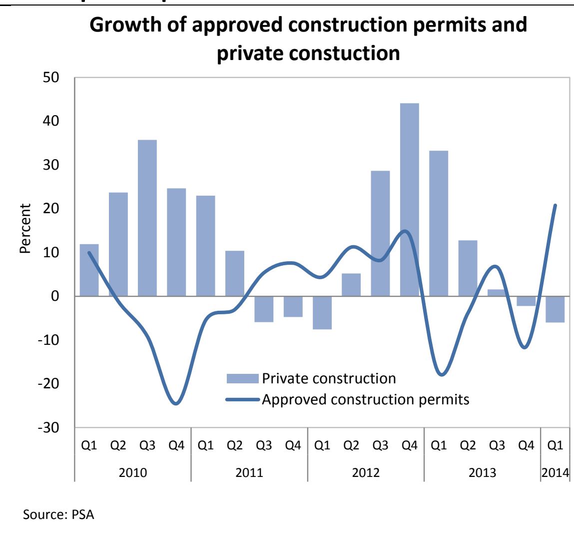

Source: CEIC, Reuters

**Figure 2. As in previous quarters, private consumption drove growth in Q1 2014, while investment and net exports provided support.**



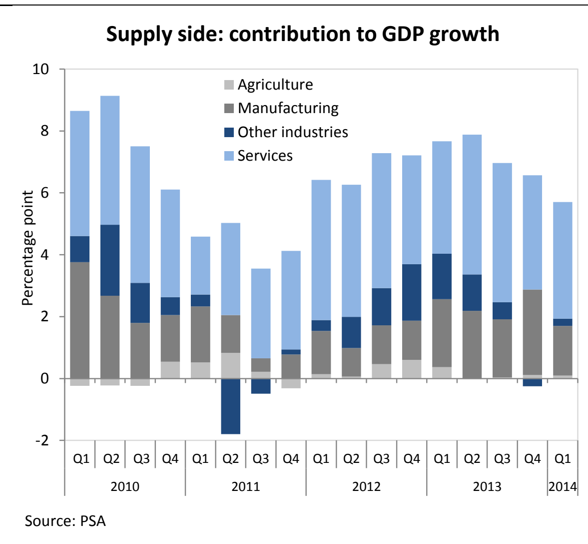

Source: Philippine Statistics Authority (PSA)

**Figure 3. Private construction slowed down, as approved construction permits contracted in 3 out of the past 5 quarters.**




Source: PSA

**Figure 4. On the supply side, the services sector continued to drive up growth, while agriculture remained weak.**




Source: PSA

## Typhoon reconstruction

6. **Areas affected by Typhoon Yolanda have moved from relief to reconstruction efforts**. After tackling the initial relief phase, the focus has now shifted to accelerating the implementation of reconstruction spending. The Government responded quickly to the typhoon when it rolled out immediate humanitarian aid and rapidly preparing by end-2013 the "Reconstruction Assistance on Yolanda (RAY)," a strategic plan to guide recovery and reconstruction in affected areas. A core principle guiding the reconstruction effort is the commitment to "build back better." This takes into account the "new normal" of climate-change aggravated weather related shocks.

7. **The National Government (NG) has secured adequate fiscal space (PHP 162 billion or around 1.4 percent of GDP) in the 2013 and 2014 budgets to support the reconstruction phase for areas affected by Typhoon Yolanda, the Bohol Earthquake, and other smaller disasters**. The challenge now is to rapidly bring reconstruction projects on stream and to implementation status. Bottlenecks include i) the need to work across spheres and sectors of the Government, ii) the sheer magnitude of demand for technical appraisal, iii) the need for major land clearances, especially given vulnerabilities to surge and fault line areas, and iv) contractor capacity limitations. The challenge going forward will be to scale-up delivery in line with available fiscal space to stimulate demand and jobs in affected areas, while building resilience to future risks.

8. **To transparently track the reconstruction effort, the Government has launched openreconstruction.gov.ph**. It aims to provide a comprehensive and timely overview of proposed, approved, and ongoing reconstruction projects. Through May 2014, the Department of Budget and Management (DBM) released PHP 32 billion, with physical works to ramp up considerably in H2 2014. At present, DPWH has PHP 1 billion of reconstruction projects under implementation in Yolanda-affected areas.

## Poverty and employment

9. **After many years of slow poverty reduction, the share of the poor in the population declined significantly between 2012 and 2013** (Figure 5). For the first time in the country's history, the Government released comparable poverty estimates for 2 consecutive years, instead of with the usual three-year gap.[3] In the first half of 2013 (H1 2013), poverty incidence

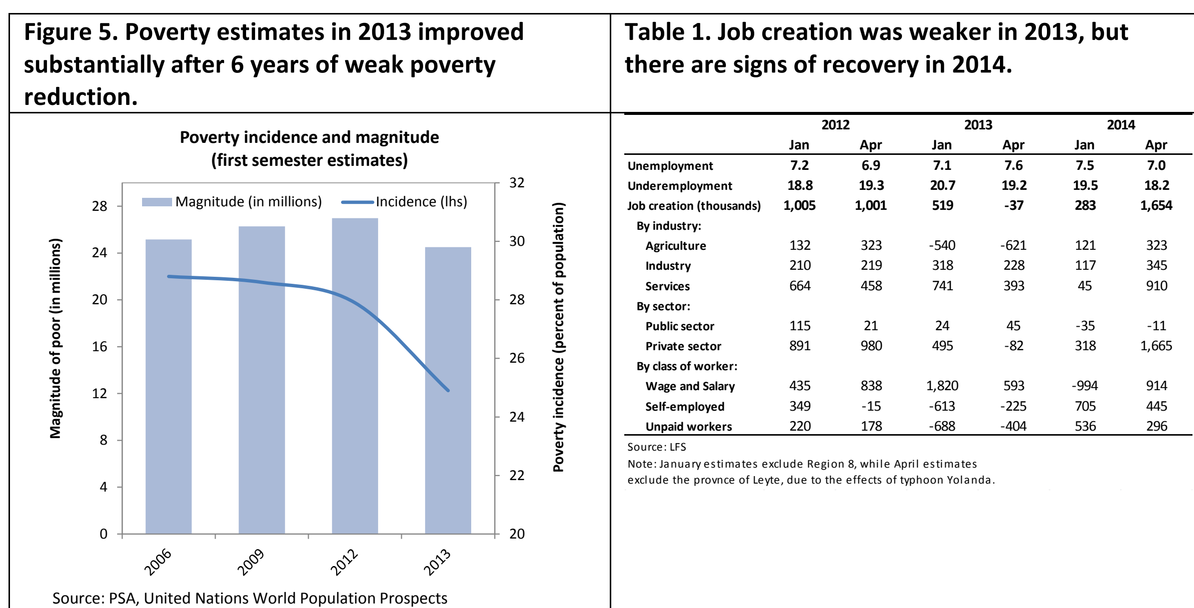
[3] In 2013, the Government announced a policy to release poverty estimates annually. The source data of the 2013 poverty incidence is the Annual Poverty Indicators Survey (APIS), while the source data of the 2012 poverty incidence is the Family Income and Expenditure Survey (FIES). Both surveys share the same income module. The FIES is conducted every 3 years, while the APIS is conducted in between FIES years. However, there are some limitations in the annual estimates. For instance, poverty incidence is only available for the first semester of the year and is therefore not comparable to the earlier series. Second, the sample size of the APIS is only a fourth of

among the population fell by 3 ppt to 24.9 percent, down from 27.9 percent in the same period in 2012. This represents around 2.5 million Filipinos uplifted from poverty. This significant reduction in poverty in 2013 came after many years of weak poverty reduction when it averaged only 0.2 ppt annually between 2006 and 2012.

10. **The reduction in poverty in 2013 appears to be driven by non-job income, given slower job creation in the period covered by the household survey.** In January 2013, job creation was moderate, and in April 2013, job destruction was observed (Table 1).[4] This suggests that the decline in poverty might be largely driven by other sources of income, such as foreign and domestic remittances, subsidies (e.g., Conditional Cash Transfers [CCT]), or election-related transfers.[5]

**Figure 5. Poverty estimates in 2013 improved substantially after 6 years of weak poverty reduction.**

**Table 1. Job creation was weaker in 2013, but there are signs of recovery in 2014.**




| | 2012 | | 2013 | | 2014 | |
|---|---|---|---|---|---|---|
| | Jan | Apr | Jan | Apr | Jan | Apr |
| **Unemployment** | **7.2** | **6.9** | **7.1** | **7.6** | **7.5** | **7.0** |
| **Underemployment** | **18.8** | **19.3** | **20.7** | **19.2** | **19.5** | **18.2** |
| **Job creation (thousands)** | **1,005** | **1,001** | **519** | **-37** | **283** | **1,654** |
| By industry: | | | | | | |
| Agriculture | 132 | 323 | -540 | -621 | 121 | 323 |
| Industry | 210 | 219 | 318 | 228 | 117 | 345 |
| Services | 664 | 458 | 741 | 393 | 45 | 910 |
| By sector: | | | | | | |
| Public sector | 115 | 21 | 24 | 45 | -35 | -11 |
| Private sector | 891 | 980 | 495 | -82 | 318 | 1,665 |
| By class of worker: | | | | | | |
| Wage and Salary | 435 | 838 | 1,820 | 593 | -994 | 914 |
| Self-employed | 349 | -15 | -613 | -225 | 705 | 445 |
| Unpaid workers | 220 | 178 | -688 | -404 | 536 | 296 |

Source: LFS
Note: January estimates exclude Region 8, while April estimates exclude the provnce of Leyte, due to the effects of typhoon Yolanda.

11. **There are also signs of positive developments on jobs in 2014.** In April, there was net job creation of 1.7 million, driven by the services sector, followed by almost equal contributions from agriculture and industry. In the services sector, wholesale and retail trade led job creation and generated 580,000 new jobs. However, the vast majority of these jobs are in the informal sector. In the industry sector, manufacturing and construction generated around 175,000 jobs

the sample size of the FIES. This means that poverty incidence is only available at the national level. Third, differences in the survey questionnaires could be a source of differences in poverty estimates.

[4] Results of the January and April Labor Force Surveys (LFS) for both 2013 and 2014 are not directly comparable to previous periods since Region VIII, which was devastated by Typhoon Yolanda, was not included in the January round, and the Province of Leyte in Region VIII was not included in the April round. No survey was conducted in those areas during those periods given Typhoon Yolanda. For the results in this Update to be comparable across periods, January 2012 figures were adjusted to exclude Region VIII while April 2012 figures were adjusted to exclude Leyte.

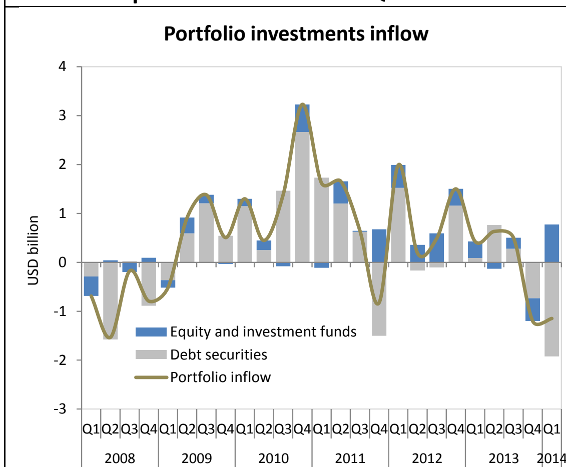
[5] A detailed analysis of job creation and income sources by decile is currently hindered by the unavailability of the APIS public use file.

each, while agriculture rebounded with 323,000 jobs. These figures suggest that poverty in 2014 could decline further.

## Financial markets

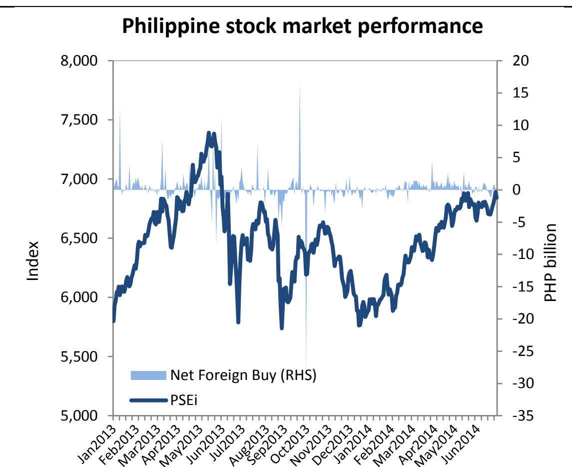
12. **The Philippines experienced large capital outflows in Q1 2014, resulting in a large balance of payments (BOP) deficit and a decline in reserves.** The tapering of US monetary policy and developments in emerging markets, including slower growth and default risk in shadow banking in China, the devaluation of the Argentine peso, and increased political tensions in several middle-income economies, resulted in a significant outflow of portfolio investments in Q1 2014 (mostly in January). Net foreign selling of bonds was sizable (Figure 6), causing the BOP to reach a deficit of USD 4.5 billion (7 percent of GDP), the highest since the 2008 Global Financial Crisis. The outflow of capital also resulted in lower gross international reserves (GIR) by USD 3.2 billion, because the central bank intervened to smooth out excessive currency fluctuations. Nonetheless, the level of GIR at USD 80 billion remains at comfortable levels. Reserves are enough to cover around 11 months of imports or 6.8 times the value of short-term external liability by residual maturity. With strong capital outflow, the peso depreciated by around 10 percent between Q1 2013 and Q1 2014 before regaining its strength beginning Q2 2014. Despite recent depreciations, the peso remains as one of the strongest currencies in real effective terms. Box 1 gives an overview of recent movements of the peso.

**Figure 6. US monetary tapering and adverse developments in emerging markets resulted in increased portfolio outflows in Q1 2014.**




Source: *Bangko Sentral ng Pilipinas* (BSP)

**Figure 7. Given positive outlook on the economy, the Philippine stock market returned to the 6,900 level.**



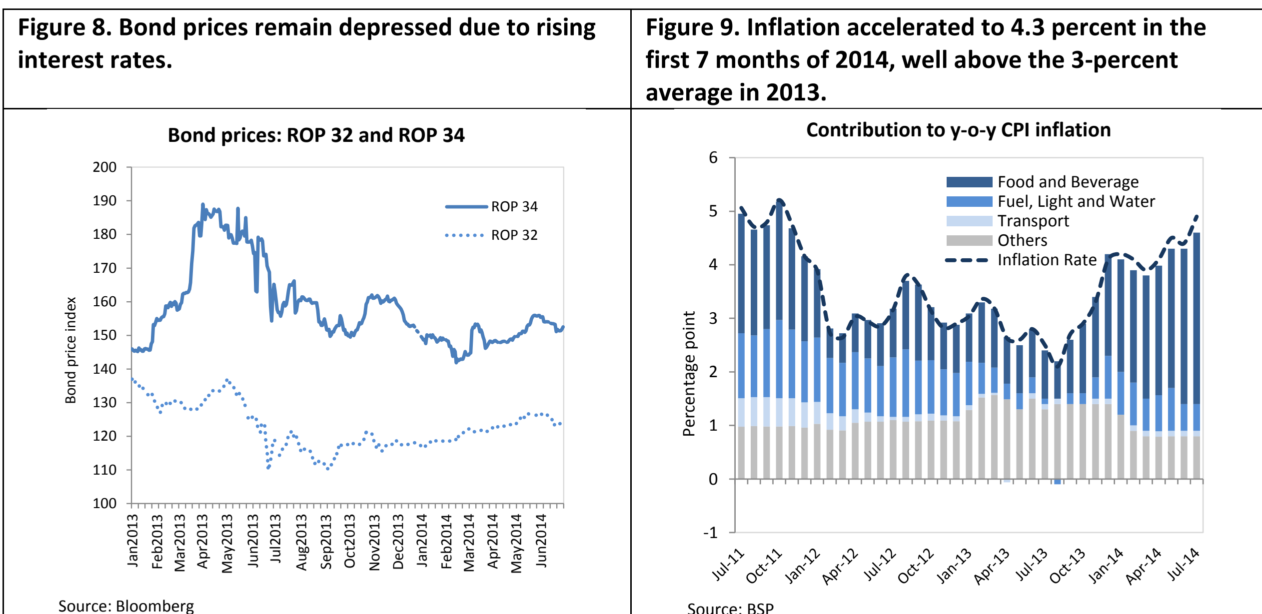

Source: Philippine Stock Exchange

13. **Capital inflow accelerated in Q2 2014 as overall investor sentiment continued to improve.** The resurgence in portfolio investment was driven by equity investment. In August, 2014, the Philippine Stock Exchange index (PSEi) returned to the 6,900 level from 5,900 at the start of 2014, a 17-percent gain (Figure 7). This was driven by net foreign purchases, which totaled PHP 49 billion from February to June, 57 percent higher than the same period last year.

On the other hand, bond prices[6] remained depressed given rising interest rates (Figure 8). In May, Standard & Poor's raised the Philippines' credit rating, putting the country 1 notch above the minimum investment grade level.[7]

**Figure 8. Bond prices remain depressed due to rising interest rates.**

**Figure 9. Inflation accelerated to 4.3 percent in the first 7 months of 2014, well above the 3-percent average in 2013.**




## Box 1. Movement of the peso

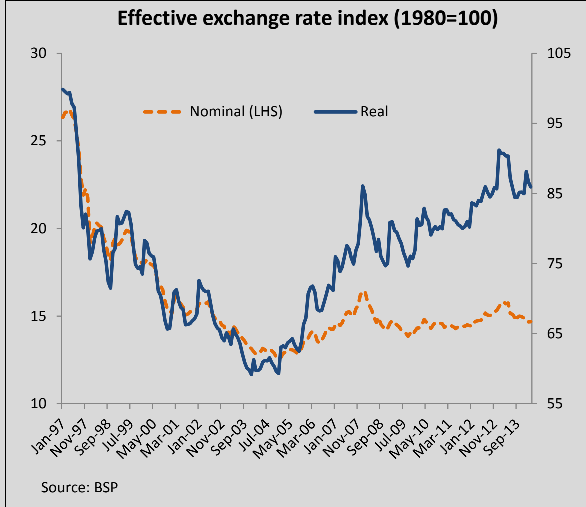
Financial and public sector reforms since 2005, global developments, and increasing migration of Filipinos have caused the peso to appreciate. Following the peso's sharp depreciation between 1997 and 2004, the peso began to appreciate rapidly in the last decade from a high of PHP 56/ USD to a low of PHP 40/ USD, a 40-percent appreciation. On the domestic front, this is attributed to macroeconomic stability and the expansion of new growth engines, such as the BPO industry. Underlying this turnaround were financial sector reforms instituted after the Asian financial crisis and public finance reforms, notably the VAT reform. On the external front, the rising current account deficit of the US and significant outmigration of Filipinos have also contributed to the peso's appreciation.

The trends in the nominal and real effective exchange rates also follow the trend of the nominal PHP/USD exchange rate. Both the nominal (NEER) and real effective exchange rate (REER) indices have risen since 2005, appreciating by 17 and 37 percent, respectively (Box Figure 1.1). Despite some depreciation in the second half of 2013, the Philippines's low inflation at 3 percent has kept the real value of the peso high. The Philippine REER has moved in tandem with its Asian counterparts but grew faster than Indonesia, Malaysia, and Thailand. The peso has also become one of the strongest currencies in East Asia in real terms, which could affect the competitiveness of merchandise exports (Box Figure 1.2).

[6] This refers to the benchmark Republic of the Philippines (ROP) Government external debt papers.

[7] The country's long-term sovereign credit rating was raised from "BBB-" to "BBB." Outlook was maintained at "stable," indicating that the rating is unlikely to change in the next 12 months.

**Box Figure 1.1. The NEER and REER have been generally appreciating since 2005.**




**Box Figure 1.2. Since 1991, the peso has become one of the strongest currencies in Asia.**

## Prices and monetary policy

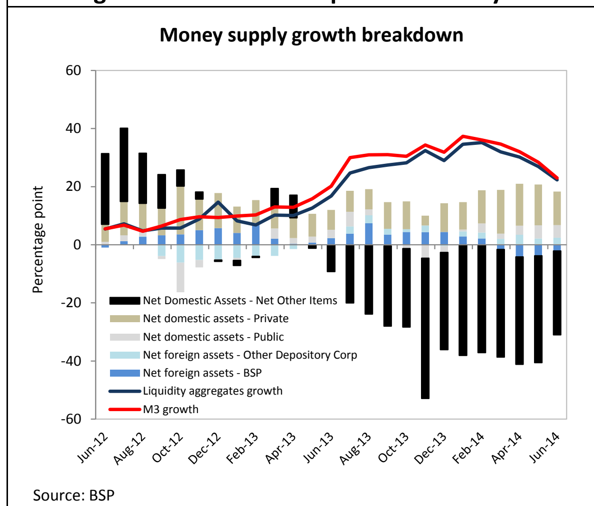
14. **Inflation accelerated to 4.3 percent in the first 7 months of 2014, from 3 percent in 2013.** Higher food, electricity, and petroleum prices led to an acceleration of CPI inflation (Figure 9). In July, inflation accelerated to 4.9 percent, the highest since November 2011. Food inflation reached 8.2 percent and was driven by increasing rice prices. Since June 2013, retail rice prices have increased by 24 percent due to tight supply, weather-related disturbances, and delays in rice importation that was meant to fill production gaps. Meanwhile, non-food inflation was driven by higher electricity prices due to the simultaneous shutdown of several generation plants and weak reserve capacity. Prices of imported products, such as petroleum products, also increased due to the peso depreciation and higher commodity prices. Core inflation, on the other hand, was lower at 3 percent.

15. **Strong liquidity and credit growth continue to exert upward pressure on inflation.** After 10 consecutive months of over 30 percent growth, money supply (M3) growth dipped below 30 percent in May and continued to ease through June at 23 percent. (Figure 10). Strong credit expansion of over 21 percent in the real estate sector, continued to drive lending growth in Q1 2014, not including lending from shadow banks.[9] Higher lending to real estate increased the real estate exposure of banks to PHP 1 trillion in Q4 2013 (around 9 percent of GDP). Given increasing real estate exposure, the central bank has required all banks to undergo stress tests to ensure that they have sufficient capital to absorb any possible shock on their credit

[9] See Philippine Economic Update (PEU) March 2014 edition for more discussion on shadow banking.

exposures.[10] Apart from macroprudential measures to contain exposure to real estate, other banking sector reforms are underway. The most notable reform is the full liberalization of the banking sector, which allows up to 100 percent foreign participation in the domestic banking industry.

**Figure 10. Money supply growth is still high but has begun to ease from the peak in January 2014.**




Source: BSP

16. **Although inflation has been higher, the central bank expects it to stay within range.** Some policy tightening were enacted between January and August 2014. To help mitigate risks from strong liquidity growth, both the reserve requirement ratio (RRR) and the special deposit account (SDA) rate were increased. The RRR was increased by 2 ppt to 20 percent while the SDA rate was increased by 25 bps to 2.25 percent. In July, policy rates were increased by 25 bps to 3.75 and 5.75 percent for the overnight borrowing and lending rates, respectively.

## Fiscal policy

17. **NG revenue collection continued to improve, allowing the Government to sustain the increase in infrastructure and social services spending.** In Q1 2014, total tax collection reached PHP 355 billion (equivalent to 12.4 percent of GDP), 12.2 percent higher than the same period last year, which recorded a tax effort of 12 percent of GDP. In the absence of tax policy reform, the presence of built-in erosion from excise taxes and fiscal incentives, and slower GDP growth in Q1 2014, the increase in tax effort can be largely attributed to improvements in tax administration. The Government has stepped up its regular media campaign against industries suspected of evading taxes. Moreover, a new revenue regulation now mandates all withholding agents, including banks, to report passive income earned. The reorganization in the Bureau of

[10] Under this framework, universal and commercial banks must meet the requirement of 10 percent capital adequacy ratio of qualifying capital. Their subsidiary thrift banks are also required to maintain a common equity tier 1 level of at least 6 percent of qualifying capital.

Customs (BOC) as well as more stringent requirements for import accreditation appear to be producing results, as its collection improved by 25.7 percent.

18. **The fiscal stance of NG remained broadly sustainable given low fiscal deficit and a manageable debt profile.** Higher revenue provided more fiscal space for NG to increase overall spending, notably in infrastructure. With 12-percent growth in spending, fiscal deficit in Q1 increased to PHP 84 billion (3 percent of Q1 2014 GDP), compared to PHP 66 billion (2.5 percent) a year ago. In recent months, weaker government spending amid rising revenues resulted in a lower deficit of PHP 54 billion. NG debt, on the other hand, rose by 3 ppt of GDP in Q1 2014 to PHP 5.63 trillion, equivalent to 48.7 percent of 2013 GDP. The increase was driven mainly by the 7.4-percent growth in domestic borrowings. Foreign currency denominated debt also increased by PHP 90 billion mainly due to the depreciation of peso.[11] However, the overall debt trajectory continues to trend downwards and remains sustainable.

[11] The share of foreign debt declined from 44 percent in 2009 to 35 percent in 2013.

## PROSPECTS, RISKS, AND POLICIES

19. **Strong macroeconomic fundamentals, along with sound fiscal and monetary policies, would continue to support growth in the near-term while further structural reforms would allow the country to sustain growth at above 6 percent in the medium-term.** The Philippines' strong macroeconomic fundamentals continue to provide an environment that is conducive to growth, despite the weak global economy and the impact of recent natural disasters. Building on this achievement through deeper structural reforms would allow the country to sustain its current high GDP growth rate, achieve more inclusive growth, create more and better jobs, and reduce poverty at a much faster rate.

20. **Given the slow start in Q1 2014, lower government spending in Q2 2014,[12] and some monetary policy tightening, baseline growth projections are revised downwards from 6.6 to 6.4 percent for 2014 and from 6.9 to 6.7 percent for 2015.** These revised growth projections are contingent on the ability of the Government to fully implement planned spending for typhoon reconstruction and planned expenditure programs. Delays in typhoon reconstruction and lags in the planned doubling of infrastructure spending to 5 percent of GDP by 2016 would hold back growth. In the worst case scenario, GDP growth in 2014 could decline to 5.5 percent should infrastructure spending growth fall below 10 percent and government consumption remain at its Q1 2014 growth of 2 percent (Table 2).

**Table 2. Impact of government spending on 2014 growth**

| (in percent) | Worst case | Low case | Base case |
|---|---|---|---|
| Infrastructure spending | 8.6 | 13.4 | 20.5 |
| Government consumption | 2.0 | 5.7 | 8.7 |
| **GDP Growth** | 5.5 | 6.0 | 6.4 |

Source: World Bank staff estimates

21. **As in previous years, strong domestic demand would continue to drive overall growth.** Private consumption is expected to contribute more than half of the country's growth, supported by strong inflow of remittances. A temporary depreciation of the peso following more moderate capital inflows would increase the value of remittances in peso terms, thereby raising the value of private consumption. Timely implementation of ongoing and recently awarded public-private partnership (PPP) projects, with a total value of around PHP 174 billion (1.5 percent of GDP),[13] could more than offset the contraction in private construction over the

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[12] In Q2 2014, preliminary data from the Bureau of Treasury show that nominal government spending grew by 9.8 percent, lower than Q1 growth of 12 percent. In real terms, these are around 7.9 and 5.5 percent, respectively, for Q1 and Q2. For projected 2014 growth to remain at 6.6 percent, much higher public spending is needed in Q2-Q4 (around 13 percent in real terms). Given that Q1-Q2 real spending growth was around 6.7 percent (average of 7.9 and 5.5 percent), Q3-Q4 public spending growth must be at least 16.7 percent in real terms, if all other growth assumptions remain unchanged.

[13] As of July 10, 2014, projects that have been awarded are the i) Daang Hari-SLEX Link Road, ii) School Infrastructure Project (Phases I and II), iii) NAIA expressway Phase II, iv) Modernization of Philippine Orthopedic

next 2 years. Finally, an acceleration of the planned reconstruction spending to cover at least 50 percent of the total reconstruction cost in the next 3 quarters can limit the decline in 2014 growth.

22. **Global recovery would help exports recover but long-term export growth depends on the ability of the country to raise its competitiveness.** Global growth is projected to accelerate to 2.4 percent in 2014 and 3.1 percent in 2015, led by high-income countries (Table 3). Exports of developing countries, such as the Philippines, are expected to benefit from the revival of growth in high-income countries.

23. **A number of domestic and external factors could pose risks to growth.** On the domestic side, the main sources of risk are slow reconstruction spending and domestic reform lags, in particular reforms to raise tax revenues.[14] The planned infrastructure investments are ambitious and will require sustained growth in revenues. External risks could come from a disorderly policy normalization in high-income countries and a disorderly adjustment in China's property market. Finally, political tensions in the Middle East and Eastern Europe, and territorial disputes with China can dampen external demand and FDI, and raise the country's import bill.[15]

**Table 3. Global growth projections**

| | | | Forecast | | |
|---|---|---|---|---|---|
| | **2012** | **2013[e]** | **2014** | **2015** | **2016** |
| World | 2.5 | 2.4 | 2.8 | 3.4 | 3.5 |
| US | 2.8 | 1.9 | 2.1 | 3.0 | 3.0 |
| EU | -0.6 | -0.4 | 1.1 | 1.8 | 1.9 |
| Japan | 1.4 | 1.5 | 1.3 | 1.3 | 1.5 |
| China | 7.7 | 7.7 | 7.6 | 7.5 | 7.4 |
| High-income countries | 1.5 | 1.3 | 1.9 | 2.4 | 2.5 |
| Developing countries | 4.8 | 4.8 | 4.8 | 5.4 | 5.5 |
| Developing East Asia excluding China | 6.3 | 5.3 | 5.0 | 5.6 | 5.5 |

Source: World Bank Global Economic Prospects (June 2014)

Center, v) Automatic Fare Collection, and vi) Mactan-Cebu International Airport. Total costs for these projects amount to PHP 62.6 billion. Projects for implementation, which include i) NLEX-SLEX Connector Road, ii) Skyway Stage 3, and iii) MRT Line-7, cost around PHP 111 billion. Finally, projects under bid evaluation, such as i) the Cavite-Laguna Expressway, and ii) LRT Line 1 Cavite Extension, are worth PHP 100.3 billion.

[14] The reader is referred to the March 2014 edition of the Philippine Economic Update for more discussion on risks to growth.

[15] The main economic linkages between the Middle East and the Philippines are remittances and oil imports. The region is one of the top sources of remittances of the country, accounting for 20 percent of total remittances. China and the Philippines are linked through trade and tourism. See the Special Focus for more discussion. Meanwhile, the economic linkage between the Philippines and Eastern Europe is minimal.

24. **Given concerns about the external environment, capital flow reversals and volatilities cannot be ruled out.[16]** Emerging markets, such as the Philippines, remain vulnerable to headwinds from global financial sector adjustments. Tighter global financial conditions over the next 5 years is inevitable given monetary policy normalization in high-income economies. This implies weaker financial flows and rising costs of capital for developing countries. Moreover, political tensions discussed above are also sources of capital volatility for the Philippines.

25. **Monetary policy tightening and greater use of macroprudential measures would be warranted to buffer risks to price and financial stability.** CPI inflation is projected to reach the ceiling of the central bank's 3 to 5 percent target. Upward inflationary pressures would come from strong credit expansion and rising food and fuel prices. Food supply could remain tight throughout 2014 due to poor harvests on account of weather-related disturbances and could be exacerbated by droughts due to El Niño. In addition, because rice is a basic consumption necessity with inelastic demand, mistiming the importation of rice, which is controlled by the Government, could result in sharp increases in rice prices even in the presence of relatively small production shortfalls. Moreover, short-term depreciation of the peso and higher fuel prices are sources of inflation.

26. **Medium-term growth is dependent on the ability of the country to raise investment and implement structural reforms to boost potential growth.** Like other developing countries, Philippine output gap is close to zero,[17] which suggests limited capacity to sustain growth of above 6 percent in the medium term. Expanding potential output requires more investments in human and physical capital. In this regard, the Government's resolve to double infrastructure spending from 2.5 to 5 percent of GDP by 2016 is welcome. Moreover, the Philippine Development Report "Creating More and Better Jobs" estimates that the country needs to spend an additional 5 percent of GDP on health and education to boost labor productivity and the competitiveness of Filipino workers. This incremental increase in infrastructure and social services spending of 7.5 ppt of GDP would bring the NG spending level to around 25 percent of GDP, which is more in line with the spending patterns of the country's neighbors, and facilitate the creation of good jobs.[18]

27. **Financing these investments would have to come from a combination of tax policy and administration reforms.** Reforms to broaden the tax base and reduce tax rates to make the tax system simpler, more efficient, and more equitable are discussed in detail in the medium-term section on tax reforms. The Aquino Administration has successfully raised tax effort by 1.2 ppt of GDP in the last 3 years through the sin tax reform, improved tax administration, and higher

[16] The reader is referred to the June 2014 edition of the Global Economic Prospects for more discussion on the external environment.

[17] In 2013, potential GDP growth was estimated at 5.5 percent while actual GDP growth reached 7.2 percent. As a percent of potential GDP, the gap between potential and actual GDP has declined from 6 percent in 2009 to 2.4 percent in 2013, and is projected to reach 1.8 percent in 2014 and 0.1 percent in 2016. This suggests that there is less room for higher growth in the medium-term unless the country accelerates investment.

[18] See the Philippine development report entitled "Creating more and better jobs" for more discussion.

growth. Accelerating the current reform momentum would help the country yield additional tax revenues to create the fiscal space needed to enhance growth in 2014 and beyond.

28. **In addition, accelerating reforms to protect property rights, promote more competition, and simplify regulations are also needed.** With these reforms (discussed also in the Philippine Development Report), the private sector will have the incentive to invest more and create jobs, and the country can attract more investments as the economic rebalancing in the world's most dynamic region takes place. In particular, China's growing linkages with the Philippines present significant opportunities for the Philippines. As the Special Focus argues, China's slowdown and rebalancing will still benefit the Philippines. The country needs to prepare very well for the opportunities that lie ahead.

# MEDIUM-TERM AGENDA: TAX REFORM PACKAGE FOR MORE INCLUSIVE GROWTH[19]

**Why raise tax revenues?**

29. **The Philippine economy has managed to sustain higher growth for over a decade now.** From 2004 to 2013, average growth of GDP per capita reached around 3.4 percent, much higher than the historical average growth rate of 1.4 percent from 1950 to 2003. The medium-term growth prospects for the Philippines are good. The country has weathered the impact of the financial crisis and global slowdown quite well in the last 5 years, given its strong macroeconomic fundamentals—the result of past and ongoing reforms in the financial and public sectors. The country's strong growth record, robust external accounts, low and stable inflation, and improving fiscal condition (Figures 11 to 14) have brought back investor confidence and were globally recognized with credit rating upgrades to investment grade in 2013.

30. **However, until recently higher growth has not translated into more and better job creation and poverty reduction.** The rates of unemployment and underemployment remain stubbornly high at around 7 and 20 percent, respectively. Poverty between 2006 and 2012 was slow to decline, only falling substantially in 2013. Real income and productivity were also slow to rise. Around 75 percent of Filipino workers have at least one attribute of informality, such as the lack of a written contract, social or health insurance, and protection from dismissal.

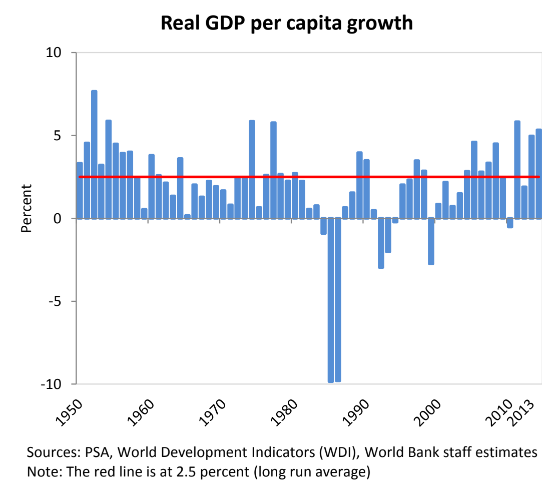
31. **In the medium-term, the jobs challenge facing the Philippines is enormous** (Figure 15). With almost 10 million unemployed or underemployed Filipinos as of end-2012 and around 1.15 million potential entrants to the labor market each year, the country faces the enormous task of providing good jobs to 14.6 million Filipinos by 2016. Sustaining GDP growth at above 5 percent under the current economic structure will be able to provide good jobs to around 2.2 million Filipinos between 2013 and 2016 (or double the current performance). However, by 2016, that will still leave 12.4 million Filipinos with no other option but to work abroad, work in the informal sector, or create jobs for themselves.[20] Meeting the jobs challenge requires expanding formal sector employment even faster while rapidly raising the incomes of those informally employed.[21]

[19] This section provides the executive summary of a forthcoming report on tax policy.

[20] Self-employment is not bad per se but the vast majority of self-employed in the Philippines are vulnerable to income and price shocks.

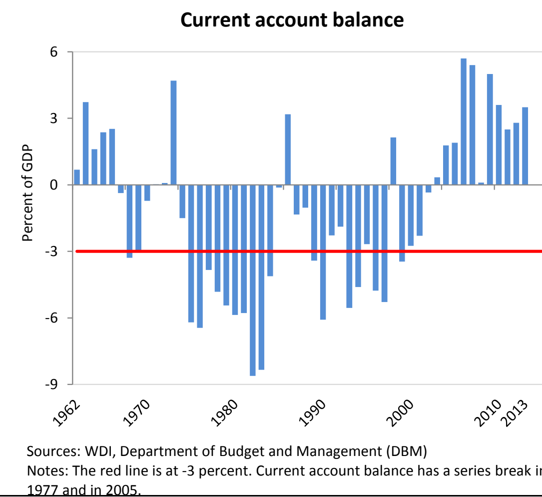
[21] Informal workers are operationally defined to include all self-employed workers (excluding employers), unpaid family workers, and wage workers with no written contract, social insurance, or protection from dismissal using the 2008 Informal Sector Survey (ISS) of the National Statistics Office (NSO).

**Figure 11. Growth was higher in the last decade.**



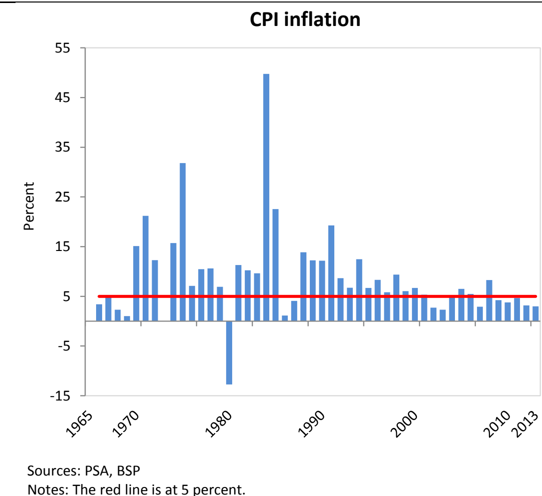

Sources: PSA, World Development Indicators (WDI), World Bank staff estimates
Note: The red line is at 2.5 percent (long run average)

**Figure 12. Current account surplus was maintained in the last decade.**



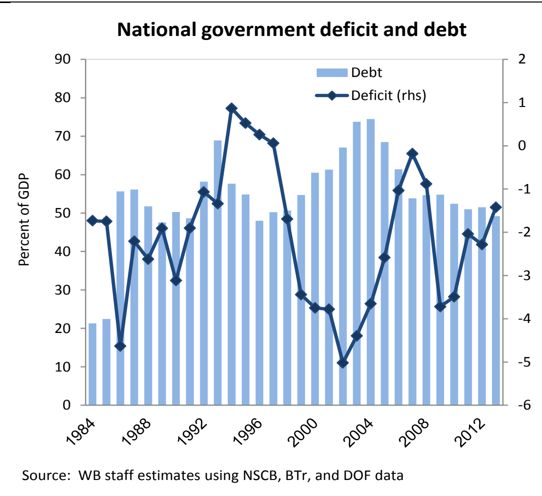

Sources: WDI, Department of Budget and Management (DBM)
Notes: The red line is at -3 percent. Current account balance has a series break in 1977 and in 2005.

**Figure 13. Inflation has been low and stable in recent years.**




Sources: PSA, BSP
Notes: The red line is at 5 percent.

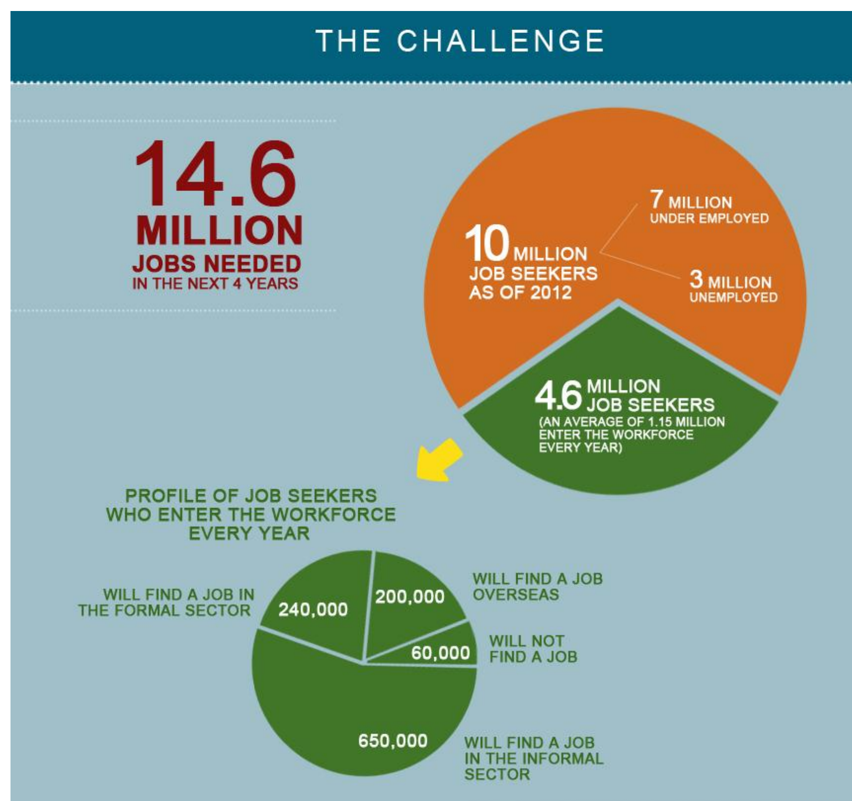
**Figure 14. Debt and deficit levels have been declining.**




Source: WB staff estimates using NSCB, BTr, and DOF data

32. **Moving forward, the Government needs to give more attention to generating more inclusive growth—the type that creates more and better jobs and reduces poverty.** With stronger economic reforms, the Philippines can attain sustained growth of above 7 percent in the medium-term and make it more inclusive. To create more and better jobs, a comprehensive reform agenda needs to be implemented across a range of sectors to create a business environment conducive to private sector job creation by firms of all sizes.

**Figure 15. Going forward, the country faces an enormous jobs challenge.**




33. **More and better jobs can be created by accelerating reforms that protect property rights, promote more competition, and simplify regulations, while sustainably ramping up public investments in infrastructure, education, and health.**[22] However, fiscally sustainable increases in investment levels are possible only through a combination of more efficient government spending, increased revenues from new tax policies, and improved administrative measures. With these reforms, the private sector will have the incentive to invest more and create jobs, and the Philippines can attract more investments from within and outside the country.

34. **A unique window of opportunity exists today to accelerate reforms that will help create more and better jobs.** The country is benefiting from strong macroeconomic fundamentals, political stability, and a popular Government that is committed to improving the lives of the people. It also stands to benefit from the global economic rebalancing and strong growth prospects of the East Asia region. Several reforms have successfully started, notably in public financial management, anti-corruption, and social service delivery.

[22] See the Philippine development report entitled "Creating more and better jobs" for more discussion on these reforms.

35. **Efforts now need to shift from ensuring macroeconomic stability to promoting shared prosperity.** The Government has done a good job securing macroeconomic stability through expenditure rationalization and prudent debt management in the last decade. It is now time to take advantage of this period of stability and high growth to raise revenues equitably and efficiently to finance the inclusive growth agenda of the Government and to create enough fiscal space to combat future economic slowdowns.

**The investment deficit**

36. **One of the major reasons why the country has not created more and better jobs is its low levels of investment in human and physical capital, alongside the lack of technological improvement**. A simple growth decomposition analysis covering the period 1961 to 2000 shows that the contribution of physical capital to Philippine growth is only 0.9 ppt compared to an average of 2.4 ppt in East Asia (Table 4). The contribution of human capital at 0.4 ppt is comparable to the regional average of 0.5 ppt but this figure does not capture large differences in the quality of the labor force. The contribution of total factor productivity was negative at 0.3 ppt.

37. **In the past 4 decades, the overall investment trend was largely stagnant or falling.** From close to 30 percent of GDP in the 1970s, investments declined to 19.4 percent of GDP in 2013 (Figure 16). In the public sector, low tax effort and weak public investment management limited NG spending on infrastructure to an average of less than 2 percent of GDP annually (Figures 17 and 18). This in turn made the country far less competitive. In addition to recurring bouts of political and macroeconomic instability, the country's dire state of infrastructure was one of the reasons why it was generally bypassed by many foreign investors in the last 3 decades. Weak transport infrastructure and the high cost of cargo handling and shipping have translated into high logistics costs, further making the country less competitive. In the last 3 years, underspending was exacerbated by weak absorptive capacity of implementing agencies.

38. **Another area of underinvestment is education.** As mandated by the 1987 Constitution, the biggest share of the NG budget goes to basic education. However, because of perennially low revenues, the level of education spending has been lower than in some neighboring countries (Figure 19). Annually, Malaysia and Thailand spends between 1.2 and 2.5 ppt of GDP more than the Philippines, respectively. In real per-student terms, the country's spending on basic education was either stagnant or declining as school-age population grew more rapidly than available resources for education. Until recently, this amounted to only around PHP 5,500 (USD 110) per student per year using 2000 prices.[23] Though the Department of Education announced that the backlogs in textbooks, classrooms, and teachers existing since 2010 are

[23] This low level of per capita spending also reflects the country's fast-growing population, which makes it very hard for public resources to catch up. With education and health services spread too thinly, many poor but deserving Filipino students are deprived of the skills necessary to make them globally competitive.

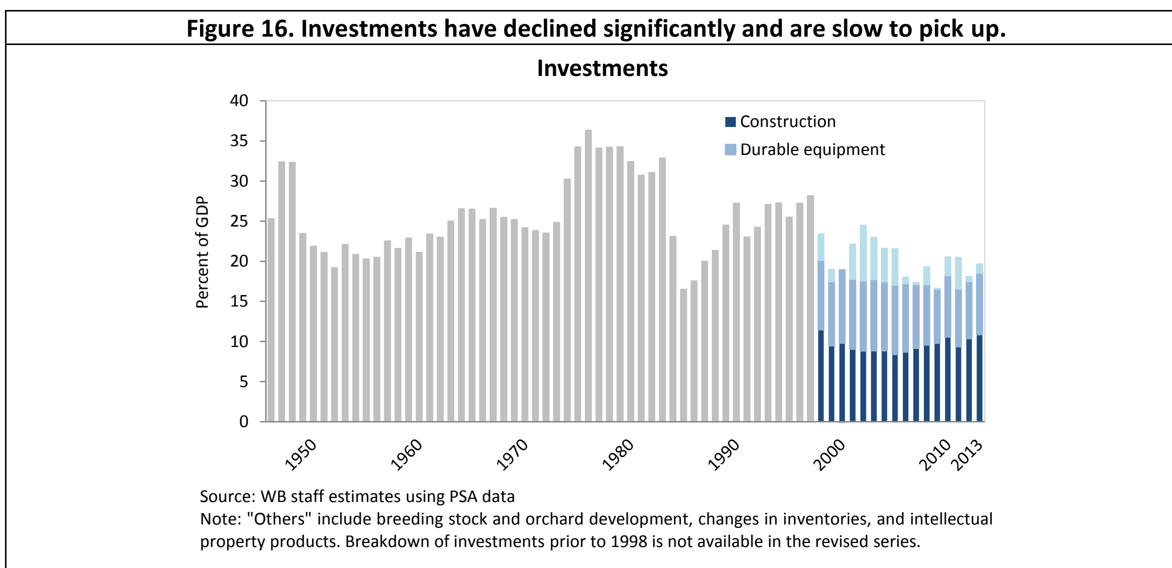
already met, there is still congestion in classrooms in certain areas, particularly in the National Capital Region, and the quality of education requires further upgrading.[24] This has begun with the K-12 Program.

**Table 4. Sources of growth in East Asian countries**

| | Growth in output per worker | Contribution to growth of | | |
|---|---|---|---|---|
| | | Physical capital | Human capital | TFP |
| Philippines | 1.0 | 0.9 | 0.4 | -0.3 |
| East Asia | 4.4 | 2.4 | 0.5 | 1.4 |
| China | 4.8 | 1.7 | 0.4 | 2.6 |
| Indonesia | 3.0 | 1.8 | 0.5 | 0.6 |
| Korea | 4.8 | 2.8 | 0.7 | 1.2 |
| Malaysia | 3.6 | 2.2 | 0.6 | 0.8 |
| Singapore | 5.0 | 3.0 | 0.5 | 1.5 |
| Taiwan | 5.8 | 3.0 | 0.6 | 2.1 |
| Thailand | 4.1 | 2.5 | 0.4 | 1.2 |

Source: World Bank (WB) staff estimates using data from 1961 to 2000

**Figure 16. Investments have declined significantly and are slow to pick up.**




Source: WB staff estimates using PSA data
Note: "Others" include breeding stock and orchard development, changes in inventories, and intellectual property products. Breakdown of investments prior to 1998 is not available in the revised series.

39. **This low level of spending has led to lower quality of education.** Before 2013, the Philippines fell behind almost all countries in the world in terms of the number of years of basic education — 10 years compared with 12 years in almost all other countries.[25] The average

[24] See the news article entitled "Summer vacation ends| DepEd all set for opening of 2014-15 school year" published in Interaksyon.com.

[25] Most Filipinos are graduates of the 10-year public education system and are not fully prepared for higher education. To bridge this gap, tertiary schools have to offer additional courses in basic subjects such as Math and English. The consequence of this is that many college students have less time to concentrate on their majors, making them less prepared for high-skill jobs and less competitive compared to their peers in other countries.

achievement level remained poor for mathematics and science. According to the 2003 Trends in International Math and Science Study, the average test score of Filipino eighth graders was 378 in mathematics compared to an average of 466 in participating countries and 377 in science as against the international average of 473. While enrollment among eighth graders is high at 91 percent of all 14-year-olds, less than 40 percent have some knowledge of whole numbers, decimals, operations, and basic graphs, compared with 50 percent in Indonesia, 70 percent in Thailand, and 80 percent in Malaysia.[26] The quality of tertiary and vocational education is also an issue.[27] Many colleges and universities continue to fall below international standards, and many of their students are not prepared for skilled work as evidenced by low passing rates in professional examinations and low acceptance rates in several industries, such as BPO.

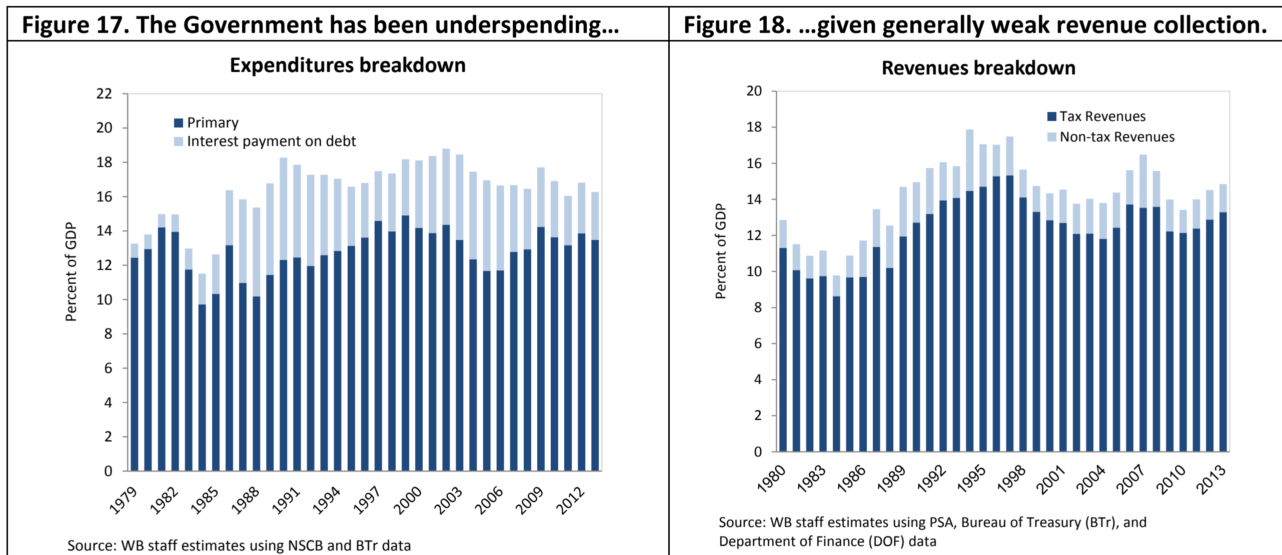



**Figure 17. The Government has been underspending…**

**Figure 18. …given generally weak revenue collection.**

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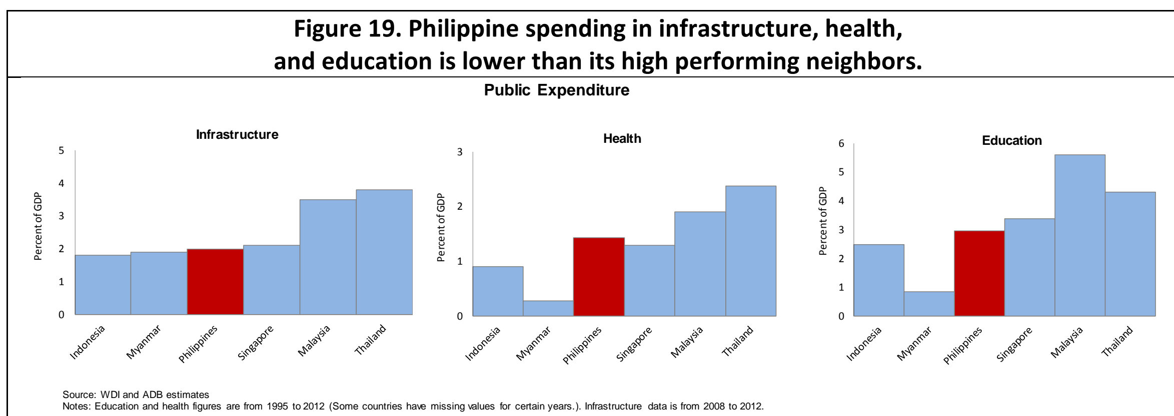
[26] Sources include the United Nations Educational, Scientific, and Cultural Organization (UNESCO) Institute of Statistics, World Bank Edstats, and Mullis et al. (2008).

[27] Apart from getting a small budget, vocational schooling is generally a less regarded and less preferred mode of education, as many perceive it to be of lesser quality and prestige compared to a college degree. There is therefore a bias toward getting a college degree compared to getting a vocational degree. This inherent bias is one reason why the country has been unable to meet industry demand for technical jobs.

**Figure 19. Philippine spending in infrastructure, health, and education is lower than its high performing neighbors.**




40. **Low public health spending has contributed to weak health outcomes.** For instance, real per capita public health expenditures declined between 1997 and 2006 while out-of-pocket health spending rose. As a result, although infant and maternal mortality rates have declined, they continue to be much higher than in comparable countries. Progress toward meeting health Millennium Development Goals (MDGs) is mixed. Prospects are good for achieving the infant and child mortality MDG and in combating HIV/AIDS and malaria, but only moderate for reducing the prevalence of underweight children and poor for reducing maternal mortality.

**Raising tax revenues efficiently and equitably**

41. **Higher and more efficient public spending, underpinned by increased revenue mobilization, is needed to raise physical and human capital and sustain inclusive growth.** A high-case scenario calls for spending an additional 2.5 ppt of GDP in infrastructure and an additional 5.5 ppt of GDP in social services, for a total of 8 ppt of GDP over the next decade. This will bring the NG spending level to around 25 percent of GDP and more in line with the spending patterns of the country's neighbors, allowing the Government to reduce poverty and help create jobs at a much faster pace. Between 2010 and 2013, tax effort improved by 1.2 ppt from 12.1 to 13.3 percent of GDP (Figure 19), reducing the revenue gap from 8 ppt to around 6.8 ppt.

42. **The current strong leadership in the Government, strong gains in tax effort between 2010 and 2013, and the country's past experience of successful tax reforms suggest that attaining this feat is possible.** The Secretary of Finance has publicly stated his desire to see revenue effort at over 16 percent of GDP by the end of the Aquino Administration (i.e., June 2016) and has put the spotlight on key sources of revenues to achieve this objective.

43. **Higher revenues do not necessarily mean higher tax rates as tax administration can be improved substantially.** For instance, in 2013, the Bureau of Internal Revenue (BIR) announced a campaign to boost tax collection from self-employed and professionals (SEPs) such as doctors, lawyers, and traders. The Government estimates that only about 403,000 out of 1.8 million

SEPs paid taxes and the average income declared by SEPs was not far from the income of a minimum wage worker. According to the Government, successful implementation of this campaign can generate up to 2 percent of GDP in tax revenues without raising tax rates.

44. **However, relying solely on tax administration reforms may not yield the expressed revenue target by 2016, making the country fall short of its development targets.** The Aquino Administration has laudably collected around 1.2 ppt of GDP in additional taxes from improved administration and higher growth in the last 4 years. Assuming that high growth is sustained and the pace of administrative effort accelerates over the next 2 years, the Government will be able to collect another 1 ppt of GDP in taxes without tax policy reform (Table 5). While this would easily count as a significant accomplishment, tax effort would still fall short of the expressed target of 16 percent of GDP by 2016. More importantly, it will still fall short of the tax revenue target needed to sustain inclusive growth (i.e., 20 percent of GDP).

**Table 5. Accounting for the tax effort accomplishment and the remaining challenge**

| | **Tax effort (percent of GDP)** |
|---|---|
| **Baseline tax effort in 2010** | **12.1** |
| **Mid-term tax effort in 2013** | **13.3** |
| Change between 2010 and 2013 | **1.2** |
| Contribution of excise tax reform | 0.4 |
| Contribution of built-in erosion from petroleum and fiscal incentives | -0.4 |
| Contribution of tax administration reform and economic growth | 1.2 |
| | |
| **Target tax effort for 2016** | **16.0** |
| Tax effort needed between 2013 and 2016 | 2.7 |
| Expected contribution from tax admin reform and economic growth | 1.0 |
| Balance that needs to be sourced from tax policy reform | 1.7 |
| | |
| **Target tax effort for 2020** | **20.1** |
| Tax effort needed between 2016 and 2020 | 4.1 |
| Expected contribution from tax admin reform and economic growth | 2.8 |
| Balance that needs to be sourced from tax policy reform | 1.3 |
| | |
| **Total tax revenues needed between 2014 and 2020** | **6.8** |
| Expected contribution from tax admin reform and economic growth | 3.8 |
| Balance that needs to be sourced from tax policy reform | 3.0 |

45. **It is for this reason that the Government needs to effectively prioritize and sequence tax policy reforms.** A two-phased approach can be consider. The first phase should focus on raising tax revenues. The second phase can consider lowering tax rates and further broadening the base.

46. **Following the passage of the excise tax law in December 2012, the following revenue-enhancing tax policy reforms could be considered in 2014 for implementation beginning in 2015:**

i. Rationalize tax incentives by making them more transparent, performance-based, and temporary, and enact a tax expenditure ceiling to plug systemic leakages in the tax system, level the playing field, and raise revenues.
ii. Reduce the number of VAT exemptions (e.g., cooperatives, power transmission, and selected inputs and imports) to reduce leakages and improve the administration of the VAT. Vulnerable groups can be better protected using the national household targeting system for poverty reduction.
iii. Centralize the valuation of real properties and, if needed, levy a national surtax of up to 2 percent on real properties to improve the equity of the tax system. The increased burden of this tax can be reduced by eliminating the estate tax, which is very hard to collect in practice, and reducing the transfer tax.
iv. Index petroleum excise taxes (which are frozen since 1996) to boost revenues and improve the overall progressivity of the tax system, as the top 10 percent of the population consumes almost 60 percent of total petroleum.[28] In the short-term, given high fuel prices, a formula-based approach can be used to automatically raise excise taxes once fuel prices fall below a pre-determined retail price (e.g., PHP 50 per liter).

47. **By 2015, only after revenue-enhancing measures are in place, a comprehensive tax reform to broaden the base and reduce the rate can be considered.** This would help simplify and improve the efficiency and equity of the tax system. The end goal is to make the tax system more responsive to investment and job creation.[29] With political feasibility in mind, this package of reforms could include the following:

i. Reduce the corporate income tax rate from 30 to 25 percent while increasing the gross income earned (GIE) tax from 5 to 7.5 percent (a first best option would be to eliminate the GIE) to improve horizontal equity of the income tax system between firms receiving incentives and firms not receiving incentives.
ii. Reduce the highest marginal tax rate for personal income tax from 32 to 25 percent and reduce the number of brackets to at most 5.
iii. Harmonize all tax rates of capital income at around 15 percent to reduce distortions.
iv. Consolidate all laws and regulations on tax incentives into one code to improve their administration.[30]
v. Simplify the tax regime for micro and small firms (e.g., turnover of less than PHP 2 million) to reduce the cost of doing business and spur job creation. This could involve harmonizing the income tax, VAT, percentage tax, and the local business tax into a single tax on turnover.

[28] Social protection is needed to protect disadvantaged groups should this reform be implemented. This could come in the form of limited and time-bound subsidies and discounts to public utility vehicles.
[29] Certain tax policy regimes are both inefficient and detrimental to job creation. Enforcing the current weak tax design may yield more revenues but will have adverse impacts on jobs.
[30] Weaknesses in the tax system are currently resulting in major tax leakages. For example, the Philippines is one of the few countries that allows tax expenditures to take place outside the tax code.

48. **While gains from a comprehensive tax reform will not be realized overnight in the Philippines, the Aquino Administration can make significant progress towards realizing around half of the needed tax improvement effort.** The country's experience between 1985 and 1997, which saw tax effort grow by 5.7 ppt of GDP on account of strong tax administration and policy reforms,[31] clearly shows that a large increase in tax revenues is possible with strong political commitment and public support for the reform. This large additional revenue would enable the Government to significantly increase investments in human and physical capital to improve competitiveness, create more and better jobs, and allow more people to benefit from higher and sustained growth.

49. **The political support for tax policy reform will largely depend on the public's perception of an improving tax administration and quality of public spending.** In this regard, tax policy reforms need to form part of a comprehensive reform program to improve tax administration and strengthen the transparency and accountability of the budget process.

50. **On tax administration, measures to improve tax compliance and reduce revenue corruption could include the following:**

i. Reengineer and simplify procedures and processes required of micro and small enterprises, followed by full automation of all tax processes to facilitate taxpayer compliance and improve governance.
ii. Strengthen real-time monitoring of revenue performance at disaggregated levels to minimize tax leakages.
iii. Issue an executive order mandating all government agencies and selected private sector groups (e.g., electric and phone companies, as well as professional associations) to provide third-party data to the BIR and BOC to improve tax audits.
iv. Further enhance the integrity of revenue officials by, for example, requiring the public posting of top revenue officials' net worth on official websites (following the example of the Department of Labor and Employment and the National Labor Relations Commission[32]) to send a strong signal to the public that the revenue agencies are committed to good governance.
v. Enhance the Commission on Audit's (COA) internal and external audits of BIR and Bureau of Customs (BOC) activities, in particular the adherence of the BIR and BOC to their own audit rules, to improve transparency and accountability of tax administration.[33]

[31] Tax effort could have increased further after 1997 if not for the 1997 tax reform which eroded some 4 ppt of GDP in revenues, mostly due to the non-indexation of excise taxes and the granting of several fiscal incentives.
[32] See, for example, data posted on the websites of DOLE (http://www.dole.gov.ph/fndr/bong/files/2010%20SALN%20OF%20OFFICIALS%20(WEBSISTE)%207-15-11.pdf) and NLRC (http://nlrc.dole.gov.ph/?q=node/91).
[33] An existing executive order (EO 38 of 1998) authorizes COA to audit the BIR's compliance with its own audit rules. This law needs to be enforced.

vi. Institutionalize the recording and public reporting of key performance indicators to allow the public to track the performance of the BIR and BOC.
vii. Strengthen BOC's efforts to curb smuggling by inspecting all outward movements of goods from special economic zones.

51. **Ongoing reforms to improve public financial management (PFM) need to be strengthened and institutionalized.** The Government has embarked on several reforms to institutionalize evaluation of government programs and budget items (e.g., CCT, lump sum funds), improve agencies' absorptive capacities, and enhance transparency and accountability of the budget process, such as public posting of budget reports, harmonizing the budget chart of accounts across agencies, and promoting open data. These reforms need to be further strengthened and institutionalized.

52. **Successful PFM reforms would allow the public to see more tangible improvements in governance and convince them that their taxes are being spent wisely. This crucial reform would help make a better case for tax policy reforms.** Successful implementation of public sector reforms would allow the country to increase public investment and pro-poor spending and take advantage of new opportunities arising from the global economic rebalancing, given rising production costs in the rest of the region, including China.

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# SPECIAL FOCUS

## China's slowdown and rebalancing: How the Philippines can still benefit

### China's impressive growth record and its recent slowdown

1. **Over the last 3 decades, China's economic performance was unprecedented both in terms of pace and scale.**[34] Following market reforms that started in 1978, its economy grew by an average of 10 percent per year between 1980 and 2010, and reached a peak of 15.2 percent in the mid-1980s. China was able to sustain rapid and sustained growth by investing significantly in infrastructure and social services, and opening up its economy. Between 1978 and 2007, gross capital formation averaged nearly 40 percent of GDP, the highest among East Asian economies. Capital spending remained exceptionally high even after the 2008 Global Financial Crisis, as the Government sought to offset weak external demand through increased infrastructure spending. Its successful policy of attracting FDIs also contributed to its "miracle" growth. The impact of China's impressive growth record is rising living standards, as evidenced by increasing per capita income and rapid poverty reduction.

2. **As the world's second largest economy, China's influence on other countries has increased significantly.** Trade, investment, income transfers, and tourism are the main transmission channels to other countries. Indirectly, China's huge demand for world products has also influenced prices. China's rise presents both opportunities and challenges to the rest of the world. For instance, resource rich countries have benefited from rising demand and hence higher commodity prices given China's resource-intensive growth, while it has hurt the terms of trade of non-resource rich countries. Moreover, while China's production of cheaper manufactured goods has expanded the consumption basket of many countries, it has also created competitive pressure for importing countries' domestic industries and exporting countries' external markets (World Bank 2013b).

3. **In recent years, China's economic growth has begun to slow down.** After reaching a decade-high growth of 14 percent in 2007, China's growth declined to below 10 percent beginning in 2011. As China rebalances from investment and manufacturing-led growth to consumption and services-led growth, growth is expected to decline to 7.5 percent in the near-term[35] and to 5 percent by 2030.[36]

4. **Naturally, many countries accustomed to China's high growth are concerned about the impact of its decelerating growth on their welfare.** This special focus section examines the impact of China's deceleration on the Philippines through the trade, investment, remittance,

[34] See Zhu (2012) for more discussion.
[35] See the World Bank Global Economic Prospects, June 2014.
[36] See the World Bank's Economic Premise: A Changing China: Implications for Developing Countries.

and tourism channels. It ends by discussing the opportunities of China's deceleration for the Philippines.

## The Link between China and the Philippines

*Exports and imports*

**5. Exports to China have been increasing over time, both in relative and absolute terms.**[37] Prior to joining the World Trade Organization (WTO) in 2001, China's share of Philippine exports was very small, averaging 1.3 percent between 1978 and 2000. Beginning 2002, China rose to become one of the largest export markets of the Philippines (Figure 20). It has consistently ranked among the top 5 export destinations of the Philippines beginning 2004. In 2013, Philippine exports to China reached more than USD 6 billion, accounting for nearly 12 percent of total exports.

| Figure 20. China has emerged as one of the key destinations of Philippine exports, next to the US, Japan, and Singapore. | Figure 21. Electronic parts and components account for the largest share of Philippine exports to China. |
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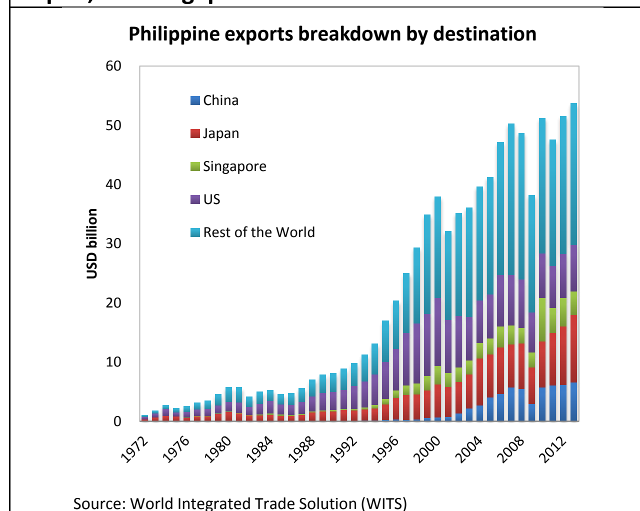
|   Source: World Integrated Trade Solution (WITS) | Source: WITS |

**6. Philippine exports to China have shifted from primary exports to manufactured goods, dominated by electronic parts and components, which are used for the assembly of electronic products** (Figure 21). In 1995, mineral fuels accounted for nearly half of the total merchandise exports to China, while machinery and transport equipment, which is comprised largely of electronic parts and components, accounted for only about 4 percent. However, with increasing demand for electronic products from high-income countries, the Philippines has become an

[37] Since the mid-1990s, the US, Japan, and Singapore have consistently ranked as the top export markets of the Philippines. On average, these 3 countries collectively account for nearly 50 percent of the country's total exports. Other recurring export markets are the Netherlands, Germany, Malaysia, Korea, and Thailand.

important source of electronic parts and components for China. Exports of these products grew by 83 percent between 2005 and 2009, and contributed 50 percent of total exports to China.

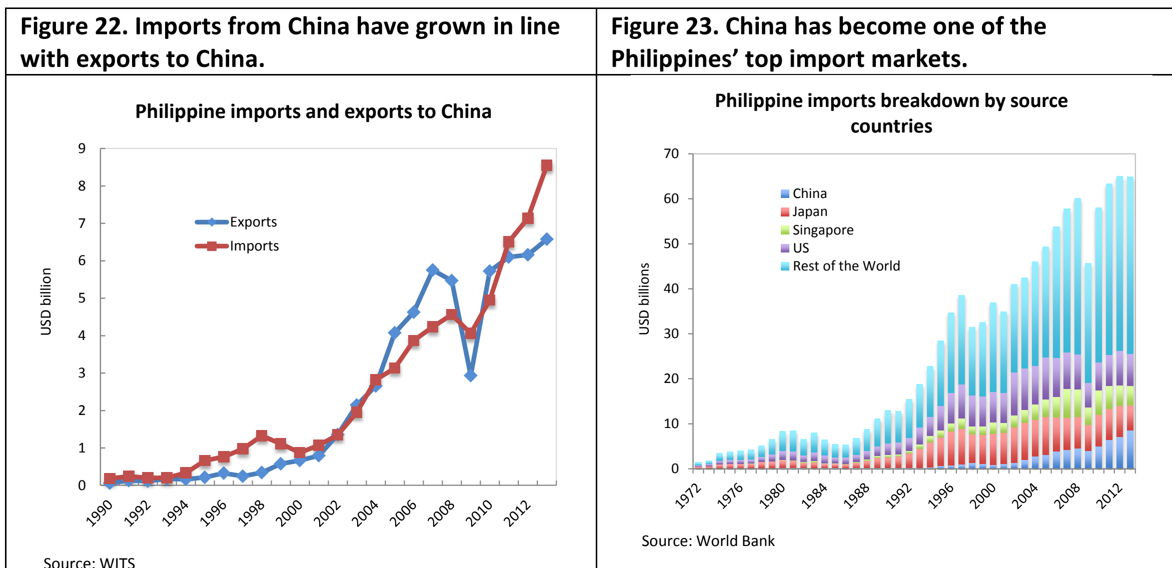


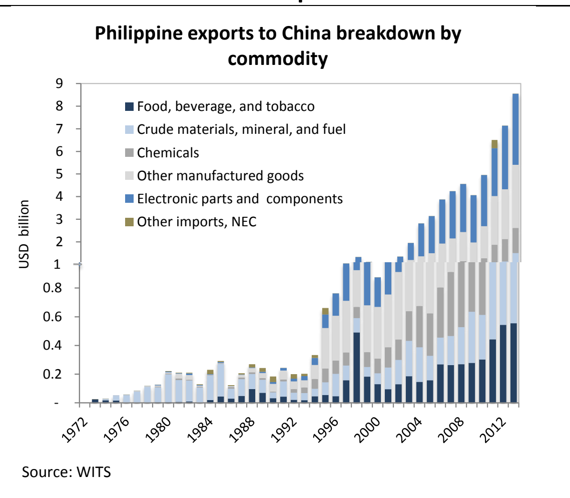
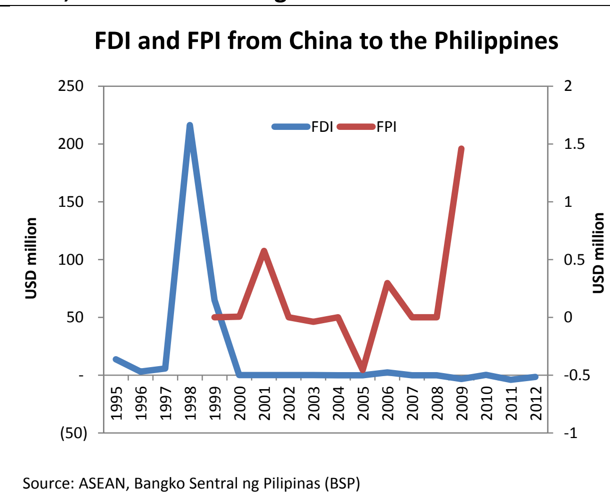

**Figure 22. Imports from China have grown in line with exports to China.**

**Figure 23. China has become one of the Philippines' top import markets.**

**7. Philippine imports from China have also increased in line with exports to China** (Figure 22). Between 2001 and 2010, merchandise imports from China grew by an average of 20 percent. By 2005, China rose to become one of the top 5 import markets of the Philippines, with a share to total imports of 6.3 percent from just 3.1 percent in 2001 (Figure 23). In 2012, it became the second largest import market next to the United States.[38]

**8. Philippine merchandise imports from China have shifted from mineral fuels to intermediate and capital goods.** Since 1995, manufactured goods and machinery and transport equipment have gradually become the country's major import product (Figure 24). The combined share of both goods increased from 53 percent in 1995 to 61 percent in 2012. Within these categories, electronic parts and telecommunications equipment comprise the bulk of imports. Imports of these 2 goods have increased from USD 40 million in 1995 to over USD 1 billion in 2013. Mineral fuels, chemicals, as well as raw textiles are also among the country's major imports from China. The share of mineral fuels to total imports reached a high of 91 percent between 1977 and 1978, but significantly declined in recent years. In 2013, mineral fuels comprised just 10 percent of total imports from China.

[38] In the same period, the US, Japan, and Singapore were the top 3 importers to the Philippines. They collectively account for 40 percent of the country's total imports (Figure 23), while Korea, Malaysia, and other Asian countries also have sizable shares.

| Figure 24. Intermediate and capital goods account for the bulk of imports. | Figure 25. The highest FDI from China was recorded in 1998, but has turned negative since 2009. |
| --- | --- |
|  |  |



Source: WITS



Source: ASEAN, Bangko Sentral ng Pilipinas (BSP)

*Investments*

**7. Foreign direct investment (FDI) from China accounts for a very small share of total FDI inflows to the Philippines.** [39] In contrast to other ASEAN countries, which have been receiving significant FDI from China, the Philippines received on average USD 4 million per year, equivalent to 1.2 percent of total outbound FDI from China to ASEAN. The highest FDI from China was recorded at USD 216 million in 1998, the same year that total FDI to the Philippines reached a peak of 3.2 percent of GDP (Figure 25). Between 2009 and 2012, net FDI from China turned negative.

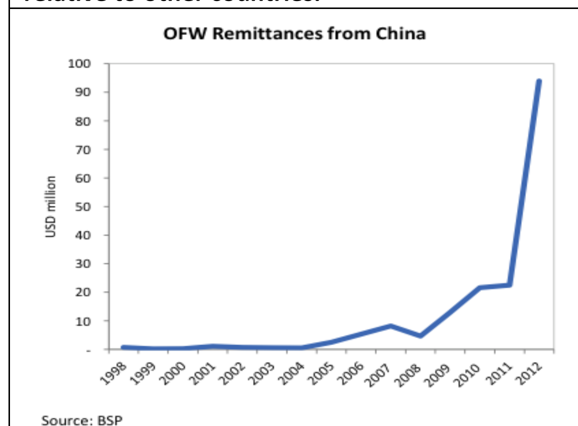
**8. In recent years, inflows of portfolio investments from China to the Philippines have increased, although the size remained relatively small.** Up until the mid-2000s, net foreign portfolio investments (FPI) to the country were generally flat. However, beginning in 2005, the FPI inflows began to increase, driven largely by the US, EU, and other ASEAN countries. The contribution of China has been very minimal. Between 2000 and 2008, net FPI from China, composed largely of equities, averaged less than USD 50,000 per year. After the 2008 Global Financial Crisis, inflows from China picked up to USD 1.5 million as investments in higher-yielding developing countries increased (Figure 25).

[39] FDI to the Philippines increased over the past 3 decades, although the size remains small relative to other ASEAN countries. Since 1995, the US has been the biggest source of FDI for the Philippines, averaging about USD 434 million per year. Japan is another major source of FDI, contributing around USD 287 million annually. There is also a significant amount of FDI coming from other ASEAN countries and the EU.

*Overseas worker remittances*

**9. Unlike the US and the Middle East for instance, China is not a major source of remittances for the Philippines.** Between 1998 and 2008, remittances from Overseas Filipino Workers (OFW) in China averaged only USD 2.3 million per year. This is equivalent to only 0.02 percent of total remittances received during the same time period. However, since 2008, there has been a significant increase in workers' remittances from China (Figure 26). The biggest increase occurred in 2012 when remittances grew more than three-fold from USD 23 million to USD 94 million. The surge in remittances was driven by strong demand for skilled and professional workers, such as teachers and engineers, as well as artists and performers. Improved banking facilities also helped drive the increase in remittances which are channeled through banks.

**Figure 26. Remittances from China picked up beginning in the late 2000s, but remain small relative to other countries.**




*Tourism*

**10. China is fast becoming a major source of foreign tourists for the Philippines.** Tourist arrivals from China increased exponentially from 14,724 in 2000 to 243,137 in 2011 (Figure 27). Beginning 2006, it has been one of the top tourism markets for the Philippines, along with Korea, the US, Japan, and Australia (Figure 28). The latest data (May 2013) show that tourist arrivals from China accelerated by 108 percent, despite prevailing territorial disputes. This marked improvement was due to the expansion of flights[40] between China and the Philippines,

[40] Weekly airline seat capacity from the Philippines to China more than doubled from 5,000 in March 2004 to almost 11,000 in September 2012 (sources: Center for Aviation and News Guangdong).

as well as increased cruise ship calls[41] to the Philippines. The estimated amount of revenues from Chinese tourist arrivals is around USD 218 million in 2013.[42]

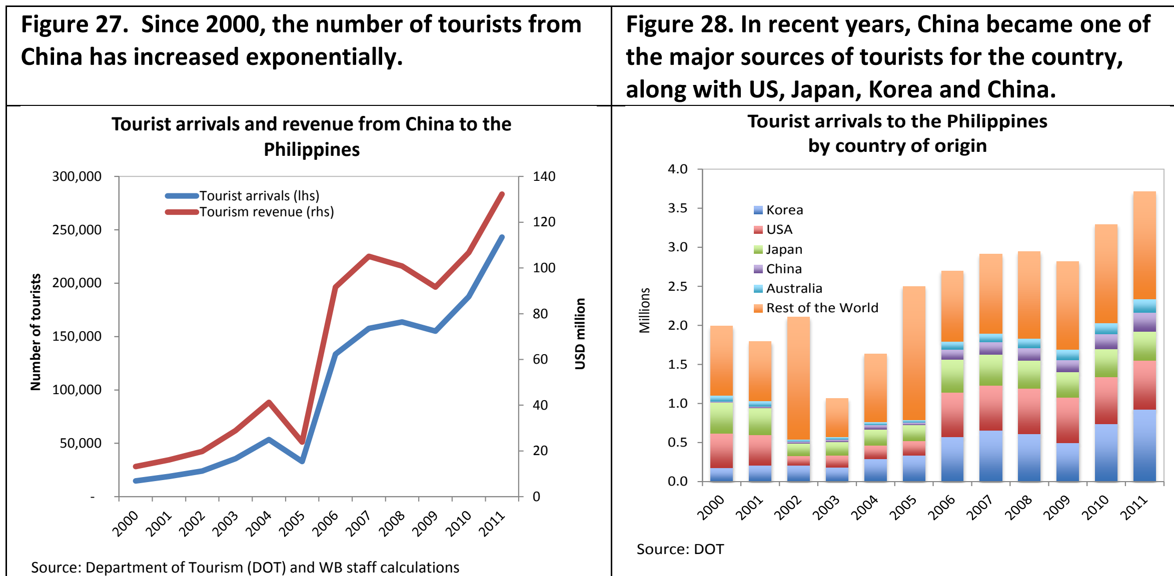



**Figure 27. Since 2000, the number of tourists from China has increased exponentially.**

**Figure 28. In recent years, China became one of the major sources of tourists for the country, along with US, Japan, Korea and China.**

**11. Given that China's economic linkages with the Philippines have grown significantly in recent years, concerns about the impact of a Chinese slowdown have naturally emerged.** The main economic linkages between China and the Philippines are trade and tourism. Philippine exports to China are likely to decline with a deceleration in Chinese growth. However, since external demand contributes little to Philippine economic growth, a sharp slowdown in the Chinese economy is unlikely to have a drastic effect on growth. However, higher growth in high-income countries could pull up Philippine electronic exports to China given that China serves as the assembly hub for electronics. Moreover, as China rebalances from investment to consumption, its demand for commodities may begin to decline, thereby reducing commodity prices for non-resource rich countries like the Philippines. This could contribute to lower import prices for the Philippines and help ease domestic inflation. In terms of tourism receipts, a Chinese slowdown could reduce the number of Chinese tourists visiting the Philippines. However, China's rising middle class suggests that the impact of such a slowdown would be limited. Finally, the low levels of FDI, FPI, and remittances suggest trivial impact on the domestic economy.

[41] In 2013, 17 cruise ships visited various destinations in the Philippines. According to the DOT, about 23 cruise lines are expected to make a port of call in the country this year, bringing in more than 23,000 tourists. See *http://www.sunstar.com.ph/cebu/business/2013/12/08/cruise-ships-bring-tourists-317820* for more details.

[42] The revenue estimates assume that the average Chinese tourist spends USD 64 per day and stays for an average of 8 nights in the Philippines. See *http://asia.nikkei.com/Politics-Economy/International-Relations/What-territorial-dispute-Chinese-tourists-enjoy-the-Philippines-anyway* for more details.

**Opportunities for the Philippines**

**12. However, China's slowdown also presents an opportunity for the Philippines.** With rising wages and production costs in China, territorial disputes, and the formation of the ASEAN Economic Community in 2015, investors will begin to seek new destinations for their labor-intensive, export-oriented businesses.[43] The Philippines stands to benefit and move up the global value chain, if it can provide relatively cheaper labor to produce goods and services of the same or better quality.

**13. As China rebalances towards consumption-led growth, the Philippines could expand its export portfolio to China from capital goods and parts to consumer goods**. China's rebalancing from an investment-led economy to one that is driven by consumption calls for its trade partners to diversify exports towards consumer goods. At present, Philippine exports to China are heavily concentrated on capital goods, and electronic parts and components. To take advantage of this opportunity, Philippine exports need to diversify into the production of final goods that will cater to China's rising consumption requirements.

**14. Likewise, in the medium term, China's aging population could provide opportunities for professional and skilled Filipino workers.** Both jobs in China and outsourced jobs in healthcare, education, information technology, and financial services, can be highly demanded.

**15. For the Philippines to take advantage of these opportunities, it needs to improve its competitiveness.** Aside from providing relatively cheap labor to foreign investors, the Philippines needs to lower the overall costs of doing business where it ranks in the lower 75th percentile. The high cost of power, logistics, and trade, including non-tariff barriers, needs to be addressed. Restrictions on foreign ownership, as well as lack of infrastructure, also need attention. Improving these is key to attracting more investments that can help create more and better jobs for many Filipinos.

[43] China's average annual wage in manufacturing increased by over six-fold from USD 1,057 in 2000 to USD 6,598 in 2012.

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# DATA APPENDIX

## Table A.1. Key economic indicators (2011 to 2016)

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| | | Actual | | | Projection | |
| **Growth and inflation** | (in percent of GDP, unless otherwise indicated) | | | | | |
| Gross domestic product (percent change) | 3.6 | 6.8 | 7.2 | 6.4 | 6.7 | 6.5 |
| Inflation (period average) | 4.8 | 3.2 | 3.0 | 5.0 | 4.5 | 4.0 |
| **Savings and investment** | | | | | | |
| Gross national savings | 23.1 | 22.3 | 23.2 | 22.9 | 24.7 | 26.4 |
| Gross domestic investment | 20.5 | 18.1 | 19.7 | 20.8 | 22.5 | 24.0 |
| **Public sector** | | | | | | |
| National government balance (GFS basis) [1/] | -2.1 | -2.4 | -1.5 | -2.1 | -2.1 | -2.1 |
| National government balance (Govt Definition) | -2.0 | -2.3 | -1.4 | -2.0 | -2.0 | -2.0 |
| Total revenue (Govt Definition) | 14.0 | 14.5 | 14.9 | 15.2 | 15.6 | 16.0 |
| Tax revenue | 12.3 | 12.9 | 13.3 | 13.6 | 14.0 | 14.3 |
| Total spending (Govt Definition) | 16.1 | 16.8 | 16.3 | 17.2 | 17.6 | 18.0 |
| National government debt | 51.0 | 51.5 | 49.2 | 48.3 | 47.0 | 45.6 |
| **Balance of payments** | | | | | | |
| Merchandise exports (percent change) | 4.1 | 21.2 | -3.6 | 8.9 | 10.0 | 10.4 |
| Merchandise imports (percent change) | 9.5 | 11.3 | -3.1 | 15.4 | 8.0 | 11.0 |
| Remittances (percent change of US$ remittance) | 7.2 | 6.3 | 7.4 | 6.1 | 5.6 | 5.1 |
| Current account balance | 2.5 | 2.8 | 3.5 | 2.0 | 2.2 | 2.4 |
| Foreign direct investment (billions of dollars) | 2.0 | 3.2 | 3.9 | 4.2 | 4.5 | 5.5 |
| Portfolio Investment (billions of dollars) | 3.1 | 4.2 | 0.4 | 2.0 | 2.0 | 3.0 |
| **International reserves** | | | | | | |
| Gross official reserves [2/] (billions of dollars) | 75.3 | 83.8 | 83.2 | 85.2 | 86.3 | 86.7 |
| Gross official reserves (months of imports) | 11.6 | 11.9 | 11.5 | 11.0 | 10.3 | 9.4 |
| **External debt** [3/] | 30.1 | 28.1 | 28.0 | 27.8 | 27.3 | 26.7 |

Source: Government of the Philippines for historical, World Bank for projections

1/ Excludes privatization receipts and includes CB-BOL restructuring revenues and expenditures (in accordance with GFSM);
2/ Includes gold;
3/ Worldbank definition. The difference with central bank data is that it includes the following: (i) Gross--Due to Head Office/ Branches Abroad of branches and offshore banking units of foreign banks operating in the Philippines, which are treated as quasi-equity in view of nil and/or token accounts of permanently assigned capital required of these banks; (ii) Long-term loans of non-banks obtained without BSP approval which cannot be serviced using the foreign exchange resources of the Philippine banking; and (iii) Long-term obligations under capital lease agreements.

## Table A.2. National Government cash accounts (GFS basis) (2010 to 2014)

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| | | | | | WB proj. |
| | (in percent of GDP, unless otherwise stated) | | | | |
| Revenue and grant | 13.4 | 14.0 | 14.5 | 14.9 | 15.2 |
| Tax revenue | 12.1 | 12.3 | 12.9 | 13.3 | 13.6 |
| Net income and profits | 5.4 | 5.9 | 6.1 | 6.2 | 6.2 |
| Excise tax | 0.7 | 0.7 | 0.7 | 1.0 | 1.0 |
| Sales taxes and licenses | 2.4 | 2.4 | 2.7 | 2.7 | 2.8 |
| Others | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 |
| Collection from Customs | 2.9 | 2.7 | 2.7 | 2.6 | 2.9 |
| Nontax revenue[1] | 1.3 | 1.6 | 1.6 | 1.6 | 1.6 |
| Grant | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| | | | | | |
| Total expenditure | 17.0 | 16.1 | 16.9 | 16.4 | 17.2 |
| Current expenditures | 13.8 | 13.3 | 13.6 | 13.3 | 12.9 |
| Personnel services | 5.2 | 5.1 | 5.1 | 5.0 | 5.2 |
| MOOE | 2.0 | 2.1 | 2.4 | 2.5 | 2.8 |
| Allotment to LGUs[2] | 2.4 | 2.4 | 1.9 | 2.1 | 2.0 |
| Subsidies | 0.2 | 0.5 | 0.5 | 0.6 | 0.1 |
| Tax expenditures | 0.5 | 0.3 | 0.5 | 0.2 | 0.2 |
| Interest payment | 3.4 | 3.0 | 3.1 | 2.9 | 2.6 |
| Capital outlays | 3.1 | 2.6 | 3.2 | 3.0 | 4.1 |
| Net lending | 0.1 | 0.2 | 0.3 | 0.1 | 0.2 |
| | | | | | |
| Balance (GFS definition) | -3.6 | -2.1 | -2.4 | -1.5 | -2.1 |
| Balance (GOP definition) | -3.5 | -2.0 | -2.3 | -1.4 | -2.0 |
| Primary Balance (GFS) | -0.2 | 0.8 | 0.7 | 1.4 | 0.6 |
| | | | | | |
| *Memorandum items* | | | | | |
| Privatization receipts (PHP billions) | 0.9 | 0.9 | 0.0 | 0.2 | 0.0 |
| CB-BOL interest payments (percent of GDP | 0.1 | 0.1 | 0.1 | 0.2 | 0.1 |
| Nominal GDP (PHP trillion) | 9.0 | 9.7 | 10.6 | 11.5 | 13.1 |

Source: Department of Finance, Bureau of Treasury, and Department of Budget and Management, WB staff calculations

1 Excludes privatization receipts (these are treated as financing items, in accordance with GFSM).

2 Allocation to Local Government Units (LGUs) excludes capital transfers which are included in capital outlays.